

**LEGAL ISSUES RELATING TO ALTERNATIVE INVESTMENTS
FOR PENSION FUNDS**

**KATHRYN M. BUSH
PARTNER
416.863.2633**

**JEREMY J. FORGIE
PARTNER
416.863.3888**

SEPTEMBER 30, 2010

The authors would like to acknowledge the substantial involvement of their partners Frank Guarascio and Jeffrey Trossman in the preparation of this paper

Blake, Cassels & Graydon LLP
Barristers, Solicitors
199 Bay Street
Suite 2800, Commerce Court West
Toronto, ON Canada
M5L 1A9

www.blakes.com

TABLE OF CONTENTS

	Page
I. INTRODUCTION.....	1
(a) General.....	1
II. ALTERNATIVE INVESTMENTS	2
(a) What are Alternative Investments?.....	2
(b) What is Infrastructure From a Pension Fund perspective?	3
(c) Why are Infrastructure Investments Attractive to Pension Funds?	4
(d) Impediments for Pension Funds in Making Infrastructure Investments.....	5
(i) Barriers to Entry.....	5
(ii) Scarcity Value.....	6
(iii) Lack of Transparency	6
(iv) Liquidity Risk	7
(v) Leverage Risk	7
(vi) Regulatory Risk	7
(vii) Reputational Risk.....	8
(viii) Contract Risk	8
(ix) Knowledge Risk.....	9
(x) Operational Risk	10
(xi) Other Risks.....	10
(e) Infrastructure – Direct and Indirect Investments	11
(f) Ownership and Control.....	11
(g) Basic Debt or Financing Considerations.....	12
(h) Investment Timeframe and Exit Strategies.....	12
III. LEGAL FRAMEWORK.....	13
(a) Overview.....	13
(b) Pension Benefits Act (Ontario).....	13
(i) General.....	13
(ii) Standard of Care	14
(c) Regulations Under the Pension Benefits Act (Ontario).....	16
(i) Statement of Investment Policies and Procedures	16
(ii) Permitted Investments – Quantitative Limits	17
1. The 10% Rule	17
2. Limits for Real Estate and Resource Properties	19
3. The 30% Rule	19
4. Non-Arm’s Length Transactions	21
(iii) Risk Based Monitoring	23
(d) Income Tax Act (Canada).....	23
(e) Foreign Investment Issues.....	25

TABLE OF CONTENTS

(continued)

	Page
(f) Common Law Fiduciary Duties.....	27
(g) Other Common Law Considerations	29
IV. PENSION REAL ESTATE CORPORATIONS	29
(a) Introduction.....	29
(b) Tax Rules	30
(i) Subparagraph 149(1)(o.2)(i) Corporations	30
(ii) Subparagraph 149(1)(o.2)(ii) Corporations	30
(c) Consequences of Non-Compliance.....	31
(d) Limitations on Activities.....	31
(e) Limitations on Investments.....	32
1. Activities versus Investments	32
2. Investments in Limited Partnerships.....	32
3. Which Pension Legislation Applies?	32
4. Quantitative Restrictions.....	33
V. PENSION INVESTMENT CORPORATIONS	34
(a) Introduction.....	34
(b) Tax Rules	34
(c) Pension Regulatory Rules.....	35
VI. LIMITED PARTNERSHIPS.....	37
(a) Using a Limited Partnership	37
(b) Limited Liability	38
(c) 30% Rule.....	39
(d) Governance Matters	40
1. Advisory Committee.....	40
2. Fund Investment Policies and Restrictions	41
3. Conflicts of Interest.....	41
(e) Standard of Care	43
(f) Key Person	44
(g) Subscription Financing Issues.....	45
(h) Side Letters	47
VII. CONCLUSION	48
SCHEDULE “A”.....	1
SCHEDULE “B”.....	1

Pension Fund Investment Issues

I. INTRODUCTION

(a) General

It is well established that pension funds are large investors and are increasing providers of long-term capital for infrastructure and other project investments. According to data collected by the Pension Investment Association of Canada (“PIAC”) there has been significant growth since 2000 in the asset classes (a) venture capital and private equity, (b) hedge fund investments and (c) infrastructure.¹

The manner in which registered pension plan assets are invested and the way in which that investment is regulated and supervised are crucial to the success of private pension plans in Canada. The regulation and supervision of pension assets has two main goals: first, to assure the safety and security of those assets and second, to create an environment in which asset management can obtain the best returns at an acceptable level of risk. At the same time, Canadian pension funds are Canada’s second largest source of capital after the chartered banks.²

This paper will address some of the pension regulatory, income tax and other legal issues that need to be addressed by pension funds when they make investments in various forms of alternative investments. The principal focus will be on infrastructure investments.

¹ Data published on the PIAC website (www.piacweb.org) indicates that pension fund investments in venture capital and private equity reported to PIAC grew by 579% to \$54.41 billion between 2000 and 2009. For hedge fund investments the growth in reported investments between 2004 (the earliest year for which numbers have been published on the PIAC website) and 2009 was 95% to total \$17.73 billion. In 2009, reported investments in infrastructure totalled \$34.96 billion, an increase of 67% since 2006. PIAC Composite Asset Mix Reports (1990 – 2009): Pension Investment Association of Canada, www.piacweb.org/publications

² It should be noted that some of the largest participants in alternative investments are public sector pension funds. Public sector pension funds may be structured as multi-employer pension plans or as jointly sponsored pension plans and some are structured as single employer plans. Most private sector pension plans are structured as single employer plans.

The discussion of pension legislation contained in this paper is limited³ to the *Pension Benefits Act* (Ontario)⁴ and the *Income Tax Act* (Canada).⁵ Foreign laws and domestic legislation specific to particular pension funds and the provisions of taxing statutes imposing such taxes as capital tax, land transfer or registration taxes and GST/HST are not dealt with in this paper.

II. ALTERNATIVE INVESTMENTS

(a) What are Alternative Investments?

As noted above, over the past two decades, pension plans have expanded their investment universe to include investments in alternative asset classes. These alternative investments include commodities, hedge funds, private equity, derivatives, commercial real estate and infrastructure investments. The most popular forms of alternative investments for pension funds are generally regarded to be real estate, private equity, infrastructure and hedge funds.

Pension fund sponsors and administrators should keep in mind that there are a number of risks that are particularly relevant to alternative investments, including liquidity risk, operational risk, counter-party risk, reputation risk and risks arising from outsourcing. Whether alternative investing is the right thing for any pension fund is a decision that must be made carefully. However, it is now generally accepted that sponsors and administrators of larger pension funds (i.e., \$1 billion or more) should be aware of the various types of alternative investment opportunities and understand what they are in terms of their return-risk characteristics and how they might fit into their portfolios. Although beyond the scope of this paper, it is important to note that there will continue to be other factors “pushing” the trend towards increasing investment by pension funds in alternative investments, particularly infrastructure. These factors include the desire among various levels of government (provincial and municipal) to encourage

³ It should be noted, however, that the principles discussed in this paper will apply to pension plans registered in other Canadian common-law jurisdictions. In this regard we note that in addition to Ontario, six (6) other common-law jurisdictions (i.e., Alberta, British Columbia, Manitoba, Newfoundland and Labrador, Nova Scotia, and Saskatchewan) have adopted the federal regulations governing permissible investments by pension funds, which set various parameters on the investments of registered pension plans, including limits on investments in individual companies. It should be noted, however, that the Federal investment regulations have not been adopted in New Brunswick and Québec.

⁴ R.S.O. 1990, c. P-8, as amended, hereinafter referred to as the “PBA”.

⁵ R.S.C. 1985, (5th Supp.), c.1, as amended, hereinafter referred to as the “ITA”.

private-public infrastructure partnerships where pension funds are logical investment partners. Indeed this is a reality well beyond Canada. For example, one of the key recommendations of the OECD Futures Project “Global Infrastructure Needs: Prospects and Implications for Public and Private Actors” is to “encourage the investment of pension funds and other large institutional investors in infrastructures.”⁶

(b) What is Infrastructure From a Pension Fund perspective?

In terms of investment opportunities, the precise definition of infrastructure is difficult to ascertain.⁷ Is infrastructure an asset class unto itself? Or is it a subset, or even an amalgam of other asset classes? Assuming infrastructure is a separate class, what delineation is there between different types of infrastructure? An in-depth analysis of what constitutes infrastructure, and what separates one category of “infrastructure” from another, is beyond the scope of this paper.⁸ For the purposes of this paper a standard definition of infrastructure such as the following will suffice: “the basic systems and services, such as transport and power supplies, that a country or organization uses in order to work effectively”⁹ Another useful definition refers to infrastructure as “the system of public works of a country, state, or region.”¹⁰

⁶ *Infrastructure to 2030: Main Findings and Policy Recommendations*, in “Infrastructure to 2030 (Volume 2): Mapping Policy for Electricity, Water and Transport”, OECD, Paris, 2007, at p. 27.

⁷ It is important to note that though the term infrastructure as used in this paper might be considered to mean a single, homogeneous asset class, it is by no means the case that infrastructure is necessarily homogeneous from an investment perspective, or even whether it is a separate asset class. Within infrastructure there may be many distinctions including economic vs. social infrastructure with the former denoting such things as toll-roads, bridges, airports, seaports, rail, and utilities, while the latter refers to schools, hospitals, prisons etc.. For a more comprehensive discussion of these distinctions see: Beeferman, L. “Pension Fund Investment in Infrastructure: A Resource Paper”, *Pensions and Capital Stewardship Project Labor and Worklife Program, Harvard Law School*, No. 3, December 2008 [Beeferman] and Inderst, G. (2009) “Pension Fund Investment in Infrastructure”, *OECD Working Papers on Insurance and Private Pensions*, No. 32, OECD Publishing, © OECD. [Inderst]

⁸ For a more expansive review of the categories and classification of infrastructure, the difference between them and the difficulty in discerning what constitutes infrastructure see Beeferman and Inderst, *Ibid*, as well as “Infrastructure to 2030 (Volume 1): Telecom, Land Transport, Water and Electricity”, OECD, Paris, 2006, and “Infrastructure to 2030 (Volume 2): Mapping Policy for Electricity, Water and Transport”, OECD, Paris, 2007.

⁹ Cambridge Advanced Learner’s Dictionary, retrieved from <http://dictionary.cambridge.org/dictionary/british/infrastructure> on September 3, 2010.

¹⁰ Merriam-Webster, retrieved from <http://www.merriam-webster.com/dictionary/infrastructure> on September 3, 2010.

Historically, public works have been built, constructed, and maintained through public finances. However, as governments move towards, or implement, systems of lower taxation and as citizens resist attempts to increase taxes (or alternatively cut other services) the ability of the public (i.e., governments at all levels – national, federal, state, provincial, municipal) to finance public works is limited. The OECD estimates that through to 2030, “annual investment requirements for electricity transmission and distribution, road and rail transport, telecommunication and water is likely to average 3.5% of world GDP, i.e., about US\$2 trillion per year.”¹¹ Absent sufficient government revenue, the investments required to build, expand, replace and sustain infrastructure must come from alternative sources. Governments, however, are constrained by the reality that outright privatization may not only not be necessary but that politically it is difficult to privatize many public works such as hospitals, schools, and roads. In lieu of privatization, governments have sought partnerships with the private sector where the private sector finances and builds infrastructure and the governments pay for and regulate its use. Pension funds, with their significant pools of capital, represent one source of such investment.¹²

(c) Why are Infrastructure Investments Attractive to Pension Funds?

Infrastructure investments are attractive to pension funds (particularly large defined benefit plans) for a number of reasons, including:

- stable and predictable cash flows
- long-term leases (e.g., 99 years) or concessions combined with the long life of infrastructure assets provides the ability to match long-term liabilities with returns;
- insensitivity of returns to interest rates, stock markets or business environment due to inelastic demand for services which leads to pricing power – there are high barriers to entry due to high initial costs; infrastructure may also be naturally monopolistic (e.g., utilities) or effectively monopolistic due to the high barriers to entry (e.g., airports, toll roads)

¹¹ Inderst, at p. 5.

¹² In the OECD area, total pension fund assets amounted to USD 17.9 trillion in 2005. “Infrastructure to 2030 (Volume 2): Mapping Policy for Electricity, Water and Transport”, OECD, Paris, 2007, at p. 37.

- inflation protection through a combination of the inelastic demand for the infrastructure and inflation indexing of the prices charged for the use of the infrastructure;
- portfolio diversification – since infrastructure is viewed as being weakly correlated with more traditional investments, it can allow for greater diversification of large investment portfolios
- socially responsible investing¹³

As one leading infrastructure investor stated “[t]he most significant benefit of infrastructure investments is that they generate stable, long-term cash flows. As I mentioned earlier, many assets, such as electrical and gas utilities, are government regulated. Others, such as toll roads, are closely watched by governments concerned about public safety and rates. The combination of regulatory regimes and strong, inelastic demand result in predictable long-term cash flows which result in return volatilities that are much lower than many other asset classes and, perhaps more importantly, can help pension funds match their long-term liabilities with similar long-term cash flows offering higher rates of return than fixed income products.”¹⁴

(d) Impediments for Pension Funds in Making Infrastructure Investments

Despite the attraction of infrastructure investments there are a number of significant issues and risks that pension funds must be aware of when making such investments.

(i) Barriers to Entry

One of the primary attractions for infrastructure is that there are significant barriers to entry – either high initial costs, or regulatory restrictions on entry. This benefit, however, is also an impediment as it has historically limited the ability of smaller pension funds to enter the

¹³ By assisting in the provision of public goods that are necessary for the operation of society, pension funds may be seen to be “giving back” and supporting the communities in which their members work and live.

¹⁴ Beeferman, at p. 57. Quote is from a speech by Michael Nobrega, CEO of OMERS, given at the U.S. Pensions and Investment Summit – “Infrastructure Investments for Increased Diversification: The Borealis Infrastructure (OMERS) Case Study.” September 1, 2006.

<http://www.borealisinfrastructure.com/news/newsreleases.aspx#sep12006>

infrastructure arena. Where large pension funds such as the Ontario Municipal Employees Retirement System (“**OMERS**”), the Canada Pension Plan Investment Board (“**CPPIB**”), the Ontario Teachers Pension Plan (“**OTPP**”) or the Alberta Investment Management Corporation (“**AIMco**”), among others, possess the financial capacity to make such investments directly or independently, many smaller pension funds do not, and must either avoid infrastructure investments, or invest through alternative means, such as through infrastructure funds or co-investment.¹⁵

(ii) **Scarcity Value**

As more institutional investors set their sights on infrastructure there is a risk that the potential returns on investment become degraded by ever increasing entry costs due to the scarcity value of investments. Recently, some pension funds have begun to turn away from infrastructure investments, at least for the time being, on the basis that the costs are too high and the returns insufficient to justify the increased costs: “The time to be in infrastructure is not now,.....[i]t’s too expensive, everyone’s in it. Whenever everyone’s in it, you want to back off.”¹⁶

(iii) **Lack of Transparency**

Where investments are made in unlisted infrastructure (i.e., through infrastructure funds or in unlisted infrastructure companies) there may arise issues with respect to the extent to which information is shared with the pension fund investors. In contrast to the requirements for listed companies to make information public, infrastructure funds and unlisted companies often face no such regulatory requirements. Additionally, in the absence of such information there is a

¹⁵ It is interesting to note in the case of OMERS and OTPP, for example, the recent amendments to their governing legislation which permits these large pension funds, through authorized subsidiaries and special purpose investment vehicles, to provide investment structures for third party pension funds which could potentially include infrastructure investment opportunities.

¹⁶ *Infrastructure king in no rush to invest again*. The Globe and Mail, retrieved from <http://www.theglobeandmail.com/globe-investor/infrastructure-king-in-no-rush-to-invest-again/article1644498/> on September 3, 2010.

resultant lack of independent data from which to measure the performance, either relative or absolute, of the fund or company, making it potentially difficult to assess their performance and/or value.

(iv) **Liquidity Risk**

The long-term nature of infrastructure investments which makes them attractive for pension funds also presents a risk in terms of inability to sell the investments into an active market. Although liquidity concerns are often not an issue for pension funds – there is rarely a need for a pension fund to quickly liquidate assets to raise cash (although this is not always the case where, for example, a pension fund is partially or fully wound-up) – the lack of a robust secondary market for infrastructure investments limits the ability to make divestments quickly and may dissuade investment.

(v) **Leverage Risk**

As with any investment that requires a significant amount of debt financing, there are risks associated with the amount of leverage required to make infrastructure investments. Where the prices for infrastructure investments increase, the extent to which any investment must be leveraged increases. Simultaneously, leveraged investments entail interest rate risks. Although interest rate risk can be hedged to a certain extent, given the long time frame for infrastructure investments, it may not be possible to hedge all of the risk, or to hedge interest rates effectively. Failure to adequately hedge interest rates may result in a significant reduction in overall rates of return, or even losses on the investment.

(vi) **Regulatory Risk**

Investment in infrastructure involves investment in public works. These investments necessarily include a public element – whether it is a direct involvement through a public-private partnership, or a more indirect involvement through regulation of privatized infrastructure (e.g., utilities or telecommunications). The existence of this public element to infrastructure investments brings with it political considerations. Given the long life of infrastructure investments – for example decades long concessions for operating hospitals, schools and prisons, and 99 year leases for operating toll roads or intra-city transportation systems – there is a risk

that changes in political leadership or approaches may result in a changing acceptance of such investments. Short of the risk that future governments may not honour agreements, there is the risk of greater public scrutiny of proposed fee increases, license renewals and the like. For public sector pension funds in particular this increased public scrutiny leads to another risk: reputational risk.

(vii) Reputational Risk

There are several facets to reputational risk which pension funds should be aware of in the context of infrastructure investments. One that may often not receive much consideration is the potential for pension fund infrastructure investments to cause harm to their members, either directly or indirectly.¹⁷ For example, a concern could arise where a public sector pension fund makes an infrastructure investment that leads to job losses in the public sector that may directly harm its membership. Even where a pension fund invests in a foreign jurisdiction (or another province/state/region) a concern arises that any job losses or other deleterious effects may lead to pension funds of that other jurisdiction investing in the jurisdiction of the former pension fund causing the same effects. In addition to negative publicity where excess costs or job losses are incurred, further reputational risks could arise where any environmental, health and safety or other concerns come to light.

(viii) Contract Risk

As with regulatory risk and liquidity risk, contract risk arises, at least in part, due to the long-term nature of infrastructure investments. Where a contract is intended to apply for a 25-year (or greater) period, it may well be that the prices set out in the contract, the labour and environmental issues addressed and the allocation of risks in the contract – intended to ensure that risks are borne by the party with the greatest ability to bear them – prove inadequate for the circumstances prevailing at some future point.

¹⁷ For a more comprehensive overview of the impacts pension fund infrastructure investments may have on members see Beeferman.

(ix) **Knowledge Risk**

Infrastructure investments are complex, involving extended time frames, the participation of governments, and consideration of political and public interest concerns. Given this complexity and the relative infancy of infrastructure as an investment opportunity, a number of commentators have noted that there is a lack of knowledge and expertise within pension funds, and the broader investment community, including legal, financial, and other advisors, with respect to infrastructure investments.¹⁸ Although some of the larger, more sophisticated pension funds either have specialist teams dedicated to infrastructure and have the wherewithal to support such teams, or can afford to engage in substantial due diligence and structural analysis including, where required, external service providers, smaller pension funds may lack the same capacity.

The potential result is limiting the investment opportunities for all but the largest pension funds to indirect investments through infrastructure funds or co-investment in infrastructure. Although infrastructure funds and co-investment permit the making of smaller investments, thereby affording smaller pension funds the opportunity of making infrastructure investments, the result is a loss of control (at least partially) over assets in terms of their acquisition, operation/construction and ultimately, disposal, as well as the often substantial management fees in the case of fund investments. For example, in the case of infrastructure funds, there exists the potential for the interests of the fund managers to diverge from the interests of pension funds, particularly in respect of investment horizons. Where the fund managers may focus on the short or medium-term prospects for gains and thereby divest assets early in their projected life, the pension funds will likely focus on the long-term prospect of steady returns: the divestment defeats the primary purpose of the pension funds' investment.

Direct investment, on the other hand, provides for direct ownership of the assets and resultantly, control over their use, but, as mentioned, often requires a significant level of investment and expertise, which smaller funds often lack.

¹⁸ See, for example, Inderst at p. 21-22 and Beeferman at p. 13.

(x) **Operational Risk**

In addition to increasing costs of entry reducing potential returns, demographic changes, revenue deviations, and the emergence of new technologies or infrastructure all present potential risks to projected returns on infrastructure investments, particularly considering their long-lived nature. One caution with respect to infrastructure investments by pension plans, or other private entities, is that such investments are still in the early stages where many of the assets in which pension funds and others have invested are still early in their projected lives. In many cases, it is still uncertain how investments in infrastructure will play out over the full projected life of the infrastructure. Though early indications are promising, there is a relative lack of long-term empirical data respecting returns on infrastructure investment compared to other categories of investments.

(xi) **Other Risks**

In addition to the considerations outlined above, there are risks where infrastructure investments are made in foreign jurisdictions (exchange rate risk), risks in the construction of infrastructure (risk of cost overruns), risks that a natural disaster may damage and/or destroy the infrastructure, and as yet undefined risks due to infrastructure investments being a new form of investment.

Although there are of course risks that may come to bear in assessing infrastructure investments, the exact mix of risks (and their significance) that will need to be addressed will depend in large measure on what the investment is, whether it is an investment in new (yet to be constructed) or existing infrastructure, and where the investment is to occur (domestic or foreign, urban or rural etc.). An awareness of these risk factors is essential in order for a pension fund to properly assess any proposed infrastructure investment and to address these factors through appropriate due diligence and structuring, where this is practical.

(e) **Infrastructure – Direct and Indirect Investments**

Historically it was more common for pension funds to invest in infrastructure through equity investments in publicly listed infrastructure companies.

As noted above, there has been a trend on the part of the larger Canadian pension funds to direct investment in infrastructure. Interestingly, Canadian funds, along with large Australian and Dutch pension funds, have led other jurisdictions in direct infrastructure investments.¹⁹ Given the scale of many infrastructure projects, it is not surprising that pension funds are increasingly examining co-investment opportunities and there are a number of significant Canadian pension fund direct infrastructure investments.²⁰

(f) **Ownership and Control**

Subject to constraints imposed under pension legislation (discussed in Part III below), pension funds (particularly where they participate in direct investments) will need to consider target ownership levels, representation on investee company board of directors and the desire (if any) for involvement in the management of the investee companies or investee businesses.

Target ownership (in the authors' experience) varies among different pension funds. Although it is difficult to generalize, a large pension fund investor that makes direct infrastructure investments (even on a co-investment basis) will often want to ensure that there remains a strong outside management team within the investee company or investee business and

¹⁹ Inderst, at p. 1 and Beeferman at p. 15.

²⁰ Some examples of major infrastructure investments by Canadian public sector pension funds include investments in gas distribution networks (Scotia Gas Networks (U.K.) by OTPP and OMERS; Wales & West Utilities (U.K.) by CPPIB; ports and terminals (Associated British Ports (U.K.) by OMERS; Vanterm, (Can.) Deltaport, (Can.) New York Container (U.S.) and Global Terminal (U.S.) by OTPP; electricity generation (Bruce Power (Can.) by OMERS; InterGen N.V. (U.S.), Northern Star Generation (U.S.) and SAESA Group (Chile) by OTPP; Puget Energy (U.S.) by CPPIB, AIMCo, BCIMC; Transelec (Chile) by CPPIB; water systems (Thames Water (U.K.) by AIMCo and BCIMC; Sutton and East Surrey Water (U.K.) by AIMCo; ESSBIO, Aguas Nuevo Sur Maule, S.A., and Esva S.A (Chile) by OTPP; AWG PLC (U.K.) by CPPIB. http://www.cppib.ca/files/PDF/PPIB_Infrastructure_Backgrounder_August_2010.pdf; <http://www.borealisinfrastructure.com> (OMERS); http://www.otpp.com/wps/wcm/connect/otpp_en/Home/Investments/Inflation+Sensitive/Infrastructure/; <http://www.aimco.alberta.ca/Pages/Investments/Infrastructure.aspx>; <http://www.bcimc.com/publications/pdf/Inventory/Inventory20090331.pdf>

will seek, where appropriate, board representation or governance participation (for example through shareholder agreements), particularly where a large investment has been made.

(g) Basic Debt or Financing Considerations

Although a discussion of debt or financing considerations is beyond the scope of this paper, it is important to note that direct infrastructure project investment may require significant amounts of project financing. Pension funds as investors in such projects will need to consider the prudent or appropriate level of debt financing and the best structure for borrowing including, for example, potential income tax advantages in holding debt at an operating company or holding vehicle level.

As discussed in Part III, pension funds are subject to restrictions under the ITA in their ability to borrow money; however, pension funds will sometimes be able to provide various forms of guarantees in connection with borrowing by other vehicles.

(h) Investment Timeframe and Exit Strategies

While pension funds may be “patient” long term investors and therefore a 15 to 20 year horizon (or even longer), may be desired and appropriate, a pension fund should still carefully consider exit strategies both with respect to its own investment as well as the investment made by the manager or promoter of the particular infrastructure investment.

For example, the pension fund investor should have a clear understanding of the investment fund manager’s exit strategy (where applicable) and may want earlier exit opportunities for itself in some cases (e.g. an initial public offering of a key investee company or where asset valuations rise substantially).

III. LEGAL FRAMEWORK

(a) Overview

An investment by an Ontario registered pension plan is subject to the PBA, the technical restrictions applicable to the investment of a pension fund set out in the investment regulations under the *Pension Benefits Standards Act, 1985* (Canada)²¹ (“**PBSA**”), the ITA, common law fiduciary duties and the plan documents themselves including, in particular, the plan’s written statement of investment policies and procedures (“**SIP&P**”). This section briefly discusses each of these areas and the legal principles applicable therein.

(b) *Pension Benefits Act (Ontario)*

(i) General

A primary concern of pension benefits legislation is the sufficient funding of pension plans so as to ensure that obligations are met both on an ongoing basis and in the event of plan termination. Investment choices made in respect of a pension plan can have a significant impact on the sufficiency of its funding. Accordingly, it is not surprising that investments by pension funds are regulated by pension benefits legislation.

Except as specified by regulations,²² section 62 of the PBA requires every person engaged in selecting a pension fund investment to ensure that the investment falls within the criteria set out in the PBA and prescribed by the PBA Regulations.²³ This includes compliance with standards of care, disclosure requirements, conflict of interest prohibitions, quantitative and qualitative limitations, and diversification requirements. The PBA generally imposes primary legal responsibility for the administration and operation of employer-sponsored pension plans and their related pension funds (including investment decisions) on the employer that maintains

²¹ R.S.C. c. 32 (2nd Supp.), as amended.

²² *Pension Benefits Act Regulations*, R.R.O. 1990, Reg. 909 (hereinafter referred to as the “**PBA Regulations**”) PBA Regulations, Section 47.1 exempts the Ontario Teachers’ Pension Plan from compliance with section 62 of the PBA for the period prior to 1992 and section 47.2 of the Regulations exempts the Ontario Public Service Pension Plan from the requirements of section 62.

²³ Subsection 115(1)(1) of the PBA provides the Government with the authority to pass regulations relating to the investment of pension funds.

the plan.²⁴ In the case of a corporate employer, this will generally mean that ultimate legal responsibility for the administration of such a plan rests with the board of directors of the employer.

(ii) **Standard of Care**

Section 22 of the PBA codifies many of the main elements of the common-law applicable to fiduciary conduct, including, the use of special knowledge and skill, avoidance of conflicts and responsibility for the selection, and ongoing supervision, of agents.

The basic standard of conduct is set out in subsection 22(1). The standard of care is essentially a “prudent person” standard which requires the administrator of a pension fund (*i.e.*, the principal employer under the plan in most single-employer pension plans) to exercise “the care, diligence and skill that a person of ordinary prudence would exercise in dealing with the property of another person.”²⁵

Under the “prudent person” approach, the selection of investments must be made with consideration given to the overall context of the investment portfolio. Each investment does not need to meet the test of prudence independently of the fund’s other investments. Rather, the particular investment will be judged in the context of the entire portfolio. An investment which

²⁴ While the corporation is typically the “legal” administrator of a single-employer registered pension plan, a board of trustees (in the case of a multi-employer pension plan) or a pension committee (particularly in Québec) can also be the “legal” administrator. Certain public sector pension plans are administered by special purpose corporations established by statute. The “legal” administrator should be distinguished from those individuals or companies providing administrative services to the plan (*e.g.*, the plan custodian or record keeper). While those individuals may often be generically referred to as “administrators” they are not the “legal” administrators of the plan. In this paper, all references to “administrator” will be to the “legal” administrator of the pension plan.

²⁵ This concept of the standard of care was originally articulated under the common law in cases such as *Whiteley v. Learoyd*, (1887), 12 App. Cas. 727 (H.L.). It is notable that the PBA expresses the standard of care expected of a pension fund administrator in the context of dealing with another person’s property. In *Fales v. Canada Permanent Trust Company*, [1977] 2 S.C.R. 302, the Supreme Court of Canada expressed the standard of care that was required of a trustee to be the degree of care that would be exercised by someone of ordinary prudence in managing his or her own affairs. There is a question of whether the standard of care is different in dealing with one’s own property as opposed to the property of another. The popular view is that a person would take more care with the property of another person than with his or her own property. Perhaps the appropriate standard in the context of administering a pension fund is the standard of a prudent investor (regardless of the ownership of the property). This seems to be the rationale underlying the addition of section 8(4.1) of the PBSA, for example, in addition to introducing the “prudent portfolio” approach.

might be considered too risky on its own might be prudent if balanced against a particularly conservative investment held in the portfolio.

The PBA also requires that, in the course of administering a pension plan and investing the plan assets, the administrator use “all relevant knowledge and skills that the administrator possesses or, by reason of the administrator’s profession, business or calling ought to possess.”²⁶ This may impose a higher duty on more sophisticated entities who have or, by reason of their profession, business or calling, ought to have, certain knowledge and skills that are pertinent to the administration of a pension plan and/or the investment of a pension fund.

The Pension Commission of Ontario²⁷ (the “PCO”) commented in an article entitled “Investment Responsibility: Prudence in Action” in the May, 1990 issue of the *PCO Bulletin*²⁸ that the predecessor to the present subsection 22(2)²⁹ made it incumbent on administrators and their agents, especially investment managers, to keep abreast of developments in investment theory, practices and tools, and to make a conscious study of whether their use is applicable to the achievement of the investment policies that ought to be adopted by a pension fund given the nature of the plan and its liabilities.³⁰

²⁶ See subsection 22(2) of the PBA. It is important that the members of every board or management committee established by the administrator to consider pension investments be given the opportunity to acquire the knowledge and skills required to make informed decisions or at least to identify the issues and determine where retention of external resources and delegation are appropriate. In general terms, committee members would have the ability to determine appropriate investments and classes of investments for the pension fund, the ability to determine the assets to be managed by internal and/or external investment managers, the ability to select, monitor and evaluate investment managers and the ability to ensure compliance with all legal and other requirements applicable to the pension fund.

²⁷ The PCO is the predecessor to the current Ontario pension regulator, the Financial Services Commission of Ontario.

²⁸ Vol. 1, Issue 2, pp. 11-13.

²⁹ i.e., subsection 23(2) of the *Pension Benefits Act*, 1987, S.O. 1987, c. 35 (the “1987 PBA”).

³⁰ For example, the failure to consider the use of hedging strategies (including, for example, derivatives) in appropriate circumstances (e.g., risk management) may result in a breach of the standard of care imposed by subsection 22(2) of the PBA. In an article entitled “The Use of Derivatives: Significant Issues for Pension Funds” in the Summer 1994 issue of the *PCO Bulletin* (Vol. 5, Issue 2, pp. 49-52 (the “1994 PCO Bulletin”)), the PCO remarked that subsection 22(2) of the PBA made it clear that it was no longer acceptable for plan administrators and investment managers to refrain from pursuing certain investment practices or strategies for lack of knowledge. The 1994 PCO Bulletin interpreted subsection 22(2) as imposing a duty on plan administrators and investment managers to acquire the necessary knowledge to arrive at a conscious and reasoned decision with respect to all available investments.

Prudence will ultimately be measured by the decision-making process involved in selecting the particular investment strategy.³¹ As such, prudence is a test of conduct, not performance. In this context, investment products, techniques and structures can be viewed as essentially neutral. It is the way in which they are used and how decisions as to their use are made that will be examined by a court or regulator to determine whether the prudence standard has been met.

(c) **Regulations Under the *Pension Benefits Act* (Ontario)**

The PBA has adopted the PBSA investment regulations (collectively, the “**Federal Investment Regulations**”), as they read on December 31, 1999. The Federal Investment Regulations consist of sections 6, 7, 7.1 and 7.2 of the Regulations under the PBSA (the “**PBSA Regulations**”) and Schedule III of the PBSA Regulations (“**Schedule III**”). The Federal Investment Regulations can be divided into two broad categories; namely: (i) the requirements relating to a SIP&P, and (ii) the regulations relating to permitted investments. The assets of every pension plan registered in Ontario must be invested in accordance with the Federal Investment Regulations “despite the provisions of the plan or an instrument governing the plan.”³² Sections 6, 7, 7.1 and 7.2 of the PBSA Regulations are reproduced at Schedule “A” to this paper. Schedule III is reproduced at Schedule “B” to this paper.

(i) **Statement of Investment Policies and Procedures**

The prudent person approach codified in section 22 of the PBA is supplemented with a requirement in subsection 78(1) of the PBA Regulations that the administrator of a pension plan establish a written SIP&P for the plan that meets the requirements of the Federal Investment Regulations.³³

³¹ Prudence in the investment of pension assets requires the administrator of the plan to have “regard to all factors that may affect the funding and solvency of the plan and the ability of the plan to meet its financial obligations” when drafting the statement of investment policies and procedures which will guide and govern the investment of the plan’s assets (see PBSA Regulations, s. 7.1(1)).

³² PBA Regulations, s. 79.

³³ For a discussion of the legal and regulatory requirements relating to the preparation of a SIP&P, please see: F. Guarascio, J. Trossman, and J. Forgie, Pension Fund Investment Issues, 2010 CBA/IPEBLA Pension and Benefit Law Conference, May 21, 2010.

(ii) **Permitted Investments – Quantitative Limits**

Schedule III sets out certain specific investment restrictions for pension plan funds. An overview of a number of those restrictions follows:

1. The 10% Rule

The Federal Investment Regulations prohibit more than 10 per cent of the total book value³⁴ of the plan's assets to be invested, directly or indirectly,³⁵ in any one person³⁶ or any two or more associated persons or affiliated corporations.³⁷ Any amount that is loaned to any such person or corporation must be included in this calculation.³⁸ This is known as the “**10% Rule**”.

³⁴ “Book value” is not defined in the “federal investment regulations” that were incorporated into the PBA. It is generally accepted, however, that the “book value” of an asset is the original cost of the asset at the time that it was acquired (including all direct costs associated with the acquisition), as opposed to the current market value of the asset.

³⁵ Schedule III, s. 2. Certain provisions of the Federal Investment Rules apply to investments held both “directly” and “indirectly” by the pension fund. Under such provisions within the Federal Investment Rules in order to assess indirect ownership, one must “look through” to the investments held by the entity in which the moneys of the pension fund have been invested. These holdings must be added to the direct holdings of the pension fund to determine if there is compliance with the 10% rule. More specifically, the Federal Investment Rules provide that the concept of “indirect investment” includes the holding, making, acquiring or lending of an investment, a property or money, as the case may be, by; (i) a real estate corporation, resource corporation or investment corporation in which the moneys of the plan have been invested in accordance with section 12, 13 or 14 of Schedule III; (ii) a real estate corporation, resource corporation or investment corporation of which a corporation referred to in paragraph (i) holds securities to which are attached more than 30% of the votes that may be cast to elect the directors of the real estate corporation, resource corporation or investment corporation; or (iii) a mutual or pooled fund or trust fund, in which the moneys of the pension fund have been invested.

³⁶ It should be noted that “person” is defined in section 1 of Schedule III to include an “entity”. An “entity”, in turn, is defined in section 1 of Schedule III to mean “(a) a corporation, trust, partnership or fund or an unincorporated association or organization, or (b) Her Majesty in right of Canada or of a province or the government of a foreign country or of a political subdivision of a foreign country, or an agency thereof.”

³⁷ Schedule III, s. 9(1). It should also be noted that the 10% Rule uses the term “invest” and not the term “transaction”. If the particular transaction is not an investment or loan, then it would not be covered by this statutory restriction.

³⁸ Schedule III, s. 9(1).

The 10% Rule does not apply in respect of moneys of a plan held by a bank, trust company or other financial institution to the extent that the moneys are fully insured as prescribed in the Federal Investment Rules.³⁹ The 10% Rule also does not apply in respect of investments in:⁴⁰

- a segregated fund or mutual or pooled fund that itself complies with the Federal Investment Regulations;
- an unallocated general fund of a person authorized to carry on a life insurance business in Canada;
- an investment corporation, real estate corporation or resource corporation;
- securities issued or fully guaranteed by the federal or provincial governments of Canada or an agency thereof;
- a fund composed of mortgage-backed securities that are fully guaranteed by the federal or provincial governments of Canada or an agency thereof; and
- a fund that replicates the composition of a widely recognized index of a broad class of securities traded at a public exchange.

On May 3, 2010, the Federal Government confirmed its intention to make modifications to the 10% Rule. It is possible that the 10% Rule will be changed to a market value or modified market value test. Draft legislation has not yet been released. Technically, changes to the federal investment rules made after December 31, 1999 do not automatically apply to pension plans governed by the PBA. It will be up to the Ontario Government to determine when and how (if at all), it wishes to incorporate into the PBA these changes to be made to the Federal Investment Regulations.

³⁹ Schedule III, s. 9(2).

⁴⁰ Schedule III, s. 9(3).

2. Limits for Real Estate and Resource Properties

Prior to recent amendments to Schedule III, Schedule III has imposed restrictions on real estate or Canadian resource properties investments by a pension fund.

On June 17, 2010, the Federal Government amended Schedule III in order to repeal the limits for real estate and resource properties. The elimination of the real estate and resource properties limits from the Federal Investment Rules will not automatically apply in Ontario. The Government of Ontario will need to make the corresponding changes to the Regulations under the PBA.

3. The 30% Rule

The Federal Investment Regulations provide that the administrator of a plan shall not, directly or indirectly, invest the moneys of the plan in the securities of a corporation to which are attached more than 30 per cent of the votes that may be cast to elect the directors of the corporation (the “**30% Rule**”).⁴¹ It is important to note that the 30% Rule does not necessarily apply to “voting shares”. Rather, it focuses on the votes that may be cast to elect the directors of the corporation.⁴²

The 30% limitation in subsection 11(1) of Schedule III does not apply in respect of investments in a special purpose corporation. However, before such an investment is made, the administrator must first obtain and deposit with the Ontario Superintendent of Financial Institutions (the “**Superintendent**”)⁴³ an undertaking by the corporation that, while those

⁴¹ Schedule III, s. 11(1).

⁴² In essence, the 30% Rule is a limit on certain classes of voting shares (*i.e.*, those that allow votes to be cast to elect the directors of the corporation). The 30% Rule does not limit the total equity that a pension fund may hold in a corporation. Accordingly, there are ways in which the investments can be structured to respect the 30% Rule while enabling the pension fund to exercise a degree of factual control in order to protect the interests of the pension fund as an investor.

In recent years, a number of Canadian pension funds have developed sophisticated structures which comply with the 30% Rule at the corporate level but interpose various types of entities between the investment and the ultimate pension fund owner. A number of these structures have been examined and ultimately approved by the senior regulators including, for example, the approval by FSCO of an investment structure used by the Ontario Teachers’ Pension Plan in connection with the attempted BCE transaction.

⁴³ Pursuant to subsection 66(2) the PBA Regulations, the reference to the Superintendent in the PBSA Regulations means the Ontario Superintendent of Financial Institutions.

securities are held, the corporation will comply with certain requirements that are prescribed in Schedule III. These requirements relate to the filing of financial statements, the activities of the corporation and the investments of the corporation.⁴⁴ In particular, a special purpose corporation is restricted from investing, or holding an investment, in securities of any other special purpose corporation of the same type to which are attached more than 30 per cent of the votes that may be cast to elect the directors of such corporation, unless the corporation first obtains and deposits with the Superintendent an undertaking by such corporation not to invest, or hold an investment in securities of any other special purpose corporation of the same type.⁴⁵

In much of the pension industry there is an increasingly broad consensus that the 30% Rule is outdated and serves little (if any) practical purpose. The 30% Rule has been the subject of considerable commentary and criticism in recent submissions made to the Ontario Expert Commission on Pensions (“**OEC**”) and the Alberta/British Columbia Joint Expert Panel on Pensions (“**JEPP**”).⁴⁶ Both the OEC and JEPP report have recommended changes⁴⁷ to the 30% Rule and this is an issue that should be monitored. On May 3, 2010 the Federal Government announced that despite various submissions from pension plan sponsors and pension plan service providers, it had concluded that the 30% Rule remains appropriate for “prudential reasons”. The position stated by the Federal Government appears to be at odds with the conclusions of the OEC and the JEPP, both of which considered the appropriateness of an expanded prudence test for pension funds with the sophistication to engage in more active management of investee companies.

⁴⁴ The investment restrictions imposed on a special purpose corporation under Schedule III are very similar (although not identical) to those imposed on tax-exempt pension investment corporations under the ITA. Most special purpose corporations (particularly if they are resident in Canada for tax purposes) are structured for income tax purposes as tax-exempt pension investment corporations but this is not always the case.

⁴⁵ This effectively limits the number of tiers of real estate, resource and investment corporations in an investment structure to two.

⁴⁶ Alberta and British Columbia, Joint Expert Panel on Pensions Standards, *Getting Our Acts Together: Pension Reform in Alberta and British Columbia* (Alberta/British Columbia Pension Standards Review, 2008).

⁴⁷ The OEC Report, for example, recommends at Recommendation 8-8 that “any plan with some recognized form of joint governance and with the requisite capacity to make complex investment decisions (as defined by regulations) should be allowed to adopt a resolution claiming an exemption from the 30% investment rule. The resolution should be filed with the pension regulator and have effect upon filing, unless and until it is successfully challenged.” The JEPP Report arguably goes further, recommending at Recommendation 7.2-A that “Alberta and British Columbia investment standards should be ‘uncoupled’ from the federal Schedule III, to remove quantitative restrictions on investments and increase reliance on the prudent investor principle.”

4. Non-Arm's Length Transactions

The Federal Investment Regulations set out various restrictions on non-arm's length transactions.⁴⁸ Specifically, the Federal Investment Regulations prohibit a plan administrator from directly or indirectly lending to, investing in, or entering into a transaction on behalf of the plan with a "related party".⁴⁹ The non-arm's length prohibition extends through the first year after a person is no longer considered to be a "related party".⁵⁰

"Related party" is a defined term under Schedule III. In certain circumstances, it can be quite difficult to determine whether a person or entity is a related party in respect of the particular pension plan and the application of the related party rules under Schedule III should be reviewed carefully in an investment transaction. In general, a related party, in respect of plan, includes, *inter alia*, the following persons:⁵¹

- the plan administrator;
- officers, directors and employees of the plan administrator;
- persons responsible for holding or investing the pension fund and officers, directors and employees of such persons;
- an association or union representing members of the pension plan and officers and employees of such entities;
- an employer who participates in the plan, or an employee, officer or director thereof;
- a member of the plan;
- where the employer is a corporation, significant shareholders of the corporation;

⁴⁸ Section 22 of the PBA also prohibits certain conflicts of interest that may arise in connection with the administration and investment of a pension plan. For example, subsection 22(4) states that the administrator of a pension plan cannot "knowingly permit the administrator's interest to conflict with the administrator's duties and powers in respect of the pension fund". Also, subsection 22(9) of the PBA prohibits, subject to certain limited exceptions, a pension plan administrator from benefiting from the pension plan.

⁴⁹ Schedule III, s. 16(1).

⁵⁰ Schedule III, s. 16(2).

⁵¹ A "related party" also includes the spouse or child of any person who is a related party.

- corporations affiliated with the employer; and
- a corporation directly or indirectly controlled⁵² by a person prohibited above.

Excluded from the definition of related party is Her Majesty in right of Canada or of a province, or an agency⁵³ thereof, or a bank, trust company or other financial institution that holds the assets of the plan, where that person is not the administrator of the plan.

In addition, the following exceptions to the non-arm's length prohibition are also permitted:

- section 17 of Schedule III provides that the administrator of a plan may enter into a transaction with a related party on behalf of the plan if the transaction is required for the operation or administration of the plan and the terms and conditions of the transaction are not less favourable to the plan than market terms and conditions;⁵⁴
- the administrator of a plan may invest the moneys of the plan in the securities of a related party if those securities are acquired at a public exchange; and

⁵² Section 3 of Schedule III outlines situations where one person or entity will be considered to control another person or entity. Specifically, (a) a person or plan controls a corporation if securities of the corporation to which are attached more than 50 per cent of the votes that may be cast to elect the directors of the corporation are beneficially owned by the person or plan and the votes attached to those securities are sufficient, if exercised, to elect a majority of the directors of the corporation; (b) a person or plan controls an unincorporated entity, other than a limited partnership, if more than 50 per cent of the ownership interests into which the unincorporated entity is divided are beneficially owned by the person or plan and the person or plan is able to direct the business and affairs of the unincorporated entity; (c) the general partner of a limited partnership controls the limited partnership; and (d) a trustee of a trust controls the trust.

⁵³ Schedule III does not explain what types of entities will be considered to be "agencies" of Her Majesty. Accordingly, questions as to whether an otherwise related party will be excluded as being a Crown "agency" will need to be determined on a case by case basis after examining all of the facts.

⁵⁴ "Market terms and conditions" in respect of a transaction is defined in section 1 of Schedule III to mean "terms and conditions, including those relating to price, rent or interest rate, that would apply to a similar transaction in an open market under conditions requisite to a fair transaction between parties who are at arm's length and acting prudently, knowingly and willingly." A "transaction" is broadly defined and includes the making of an investment in securities.

- the administrator may enter into a transaction with a related party on behalf of the plan if the value of the transaction is nominal or the transaction is immaterial to the plan.⁵⁵

On May 3, 2010, the Federal Government confirmed its intention to make amendments to the Federal Investment Regulations in order to provide a general prohibition on pension fund investment in the shares of a sponsoring employer.

(iii) **Risk Based Monitoring**

FSCO implemented a risk-based approach for monitoring defined benefit pension plan investments as of January 1, 2006. FSCO has adopted this risk based monitoring system in order to identify such issues as significant breaches of investment regulations, unusual investment under-performance and serious asset-liability mismatch. FSCO now requires administrators of defined benefit pension plans to file an Investment Information Summary (“IIS”) concurrent with the annual filing of financial statements required under section 76 of the PBA Regulations. An automated assessment process is apparently intended to assist FSCO in flagging plans for detailed review. FSCO’s computer program analyses the data provided in the IIS as well as in the actuarial reports filed in respect of the pension plan. Plans flagged for review may be identified through a comparison of the plan’s investment performance to the average investment performance of defined benefit plans over the same period or as compared to market indices. The selection of a plan for detailed review does not constitute a judgment by FSCO as to how well the investments of the plan’s assets are being managed or whether they are being invested prudently. FSCO may or may not follow-up with the plan administrator as a result of the review.

(d) ***Income Tax Act (Canada)***

The ITA also contains provisions which are relevant to the investment of pension fund assets which are applicable to a pension plan registered under the ITA. In particular, the ITA contains certain prescribed conditions relating to investments which a pension plan (regardless of the legal structure of its pension fund) must comply with in order to retain its registered status.

⁵⁵ The criteria for determining whether a transaction is nominal or immaterial to the plan should be contained in the SIP&P. See, subsection 7.1(1)(h) of the PBSA Regulations.

Prescribed registration provisions under the ITA including regulation 8501(2)(a) of the *Income Tax Regulations*⁵⁶, (“**ITA Regulations**”) in conjunction with subsection 147.1(11)(c) of the ITA, provide that the registration of a pension plan under the ITA may be revoked at any time a pension plan fails to comply with the conditions set out in, *inter alia*, ITA Regulations 8502(h), 8502(i) and 8514.

ITA Regulations 8502(h) and 8514 specify the type or category of property that may be held in a pension fund. Prohibited investments include capital stock or debt of a corporation or partnership and their affiliates who participate in a pension plan, and investments prohibited under applicable federal or provisional pension benefits legislation. However, exceptions are available for, among other things, securities listed on a stock exchange, debt securities of certain government bodies and certain types of mortgages on real property in Canada.⁵⁷

ITA Regulation 8502(i) limits the ability of a pension trustee or any other person holding property in connection with a pension plan to borrow money for purpose of the pension plan. Restrictions imposed include:

- (i) the borrowing must not exceed a term of 90 days;
- (ii) the borrowing must not be part of a series of loans and repayments; and
- (iii) the property held in connection with the pension plan must not be used as security for borrowed money (except where the borrowing is necessary to meet pension benefit obligations without resorting to a distressed sale of pension fund assets).

In the case where the money is borrowed to acquire real property for the purpose of producing income from that real property, the total amount borrowed must not exceed the cost of the real property and the pension fund must not use other property of the fund as security for the loan.

⁵⁶ C.R.C., c.945, as amended, hereinafter referred to as the ITA Regulations.

⁵⁷ ITA Regulation 8514(2). See also the exception for certain multi-employer pension plans in ITA Regulation 8514(2.1).

As discussed more fully in Parts IV and V below, the ITA also provides for the establishment of tax-exempt pension plan investment corporations. These corporations are frequently used by registered pension plans as investment vehicles and, depending on the circumstances, may be used as a “blocker entity” in order to insulate a pension fund (i.e., its other assets) from various liabilities including foreign tax and tax reporting obligations.

(e) **Foreign Investment Issues**

Until a few years ago, Canadian pension funds were required to invest no more than 30 per cent of the book value of their investments in foreign property by virtue of the foreign property penalty tax under the ITA. Although structures were developed to effectively circumvent this restriction, it did limit the extent to which pension funds were able to invest outside Canada. With the repeal of the foreign property penalty tax in 2005, there is essentially now no restriction on pension funds’ ability to invest in the United States, Europe or elsewhere.

Needless to say, the mere fact that a pension fund is exempt from Canadian tax does not in any way eliminate a fund’s exposure to foreign taxes on foreign investments. Foreign investments must be carefully planned with the benefit of local tax advice to ensure all foreign tax leakages are taken into account in evaluating the investment.

Most developed countries’ tax systems do not tax foreign investors on capital gains realized on exit, unless the investment derives most of its value from real property. In the case of real property investments, there are sometimes opportunities to mitigate foreign capital gains taxes through the use of intermediate entities resident in favourable jurisdictions, depending on the circumstances. In any event, local reporting and withholding requirements arising in connection with an exit should be fully investigated up-front.

If the pension fund is to receive a stream of interest or dividends from the investment, care should be taken to ensure that the most favourable treaty rates are available. In the case of U.S. investments, tax exempt pension funds established in Canada may be able to avail themselves of the special 0% rate of withholding tax on dividends and interest derived from the

United States by a Canadian resident tax exempt pension fund.⁵⁸ This exemption does not, however, apply if the income is derived from a trade or business or from a “related person”. In any event, under the recently enacted protocol amending the Treaty, a pension fund will be eligible for treaty benefits only if most of the beneficiaries are residents of Canada and/or the United States.⁵⁹

In some cases, a Canadian pension fund investing in certain U.S. vehicles (for example, some private equity and infrastructure investment vehicles) may be concerned about possible attribution of “effectively connected income” (“**ECI**”). ECI can arise if, for example, a pension fund were to invest in a U.S. business that is organized as a fiscally transparent entity such as limited liability corporation (“**LLC**”). A Canadian pension fund investing in a U.S. vehicle which in turn invests in U.S. based infrastructure investments will need to consider whether there could be FIRPTA tax. The term FIRPTA refers to U.S. tax legislation that imposes taxes on non-U.S. persons that realize or are allocated gains from U.S. real property interests, including shares of U.S. real property holding companies. While not all U.S. infrastructure investments will necessarily be FIRPTA investments, it may well be the case that some infrastructure investments in the United States would be (or would include) FIRPTA investments. While a detailed discussion of these issues is beyond the scope of this paper, these issues can often be managed with an appropriate “blocker” entity to “quarantine” the U.S. tax exposure and/or U.S. tax reporting obligations. Care must be taken to select a blocker that does not result in the loss of otherwise available treaty benefits. For example, if the Canadian pension fund invests in a vehicle such as a corporation that is resident in a third country (i.e., outside the United States), it may not be possible to claim the Treaty exemption on U.S. source income received by that corporation.

If a pension fund invests in a foreign based trust, it is also necessary to consider the proposed “non-resident trust” (“**NRT**”) rules under the ITA.

⁵⁸ Article XXI of the Canada/United States Income Tax Convention (the “**Treaty**”).

⁵⁹ Article XXIX-A of the Treaty.

In part due to significant concerns expressed by the pension industry in connection with the previously proposed NRT rules, the Federal Department of Finance issued a number of comfort letters under which it committed to recommend changes to the NRT rules intended to exempt registered pension plans from the application of the NRT rules. The recent 2010 Federal Budget states that there will be a broad exception from the NRT rules for registered pension plan trusts, elected master trusts and other persons exempt from Part 1 tax under the ITA.

On August 27, 2010, the Department of Finance released draft legislation which includes a definition of an “exempt person” in section 94 of the ITA. It has been proposed that, for the purposes of the NRT rules, an “exempt person” includes a person exempt from tax under Part I of the ITA because of subsection 149(1), which includes, for example, a trust governed by a registered pension plan or an elected master trust. It has also been proposed that Canadian corporations “all of the shares, or rights to shares, of which are held at that time by exempt persons” or “without share capital all of the property of which is held at that time exclusively for the benefit of exempt persons”, as well as “a partnership all the members of which are at that time are exempt persons” will be exempt persons for the purposes of the NRT rules. These exemptions, if enacted would exempt pension plans, and various associated entities through which they make investments, from the application of the NRT rules.

(f) **Common Law Fiduciary Duties**

Over and above the statutory requirements referenced above, the administrator of a pension plan will also be subject to general fiduciary duties under the common law with respect to the administration of the plan and the investment of the pension fund (including developing and implementing an appropriate investment policy). The common law fiduciary duty in the pension context has been explained by Professor Gillese as follows:

The result of one person being held to be a fiduciary in respect of another is that the first person owes a duty of loyalty to the other. In the pension plan context, the duty of loyalty translates into an obligation on behalf of those administering the plan to act honestly, prudently, diligently, even-handedly, with strict candour and confidentiality and strictly in the best interests of the plan members. The duty of loyalty precludes those administering the

plan from making unauthorized profits, from delegating their responsibilities and from placing themselves in a position of conflict of interest.⁶⁰

The fiduciary duty, also described as one of “utmost good faith”, results in the actions of the fiduciary being “viewed with a strictness unknown to most other areas of law”.⁶¹ As such, “even where the fiduciary acts in good faith and in fact reaps a profit for the beneficiary, his actions will constitute a breach of fiduciary duty where he places his own interests ahead of, *or equal to*, the party to whom he owes the duty”.⁶² According to author Mark Vincent Ellis in his text *Fiduciary Duties in Canada*:

a central manifestation of the duty of utmost good faith is, in the modern context, the most poignant: the fiduciary is strictly prohibited from using his position to reap a personal gain. Any such use will result in the proceeds being held in trust for the benefit of the person to whom the duty was owed, independent of whether or not that person would or could have so profited... To benefit personally from an opportunity, the awareness of which arises from the fiduciary position, is inconsistent with the basic premise of fidelity in that it promotes the fiduciary’s disposition toward self interest.⁶³

The nature of these potential duties and the extent of the likely risk to the plan administrator with respect to any particular duty will differ depending on the plan type. In the case of a defined benefit pension plan, as members are generally not directly at risk as a result of the selection of investments, the plan sponsor/administrator is less likely to be subject to liability for breach of fiduciary duties relating to the plan investment provided those investments comply with applicable law and perform adequately having regard to the investment policy implemented by the sponsor/administrator and general market conditions.

⁶⁰ Eileen E. Gillese, “Fiduciary Responsibility – A Regulator’s Viewpoint” (1995) PCO Bulletin, Vol. 6, Issue 2.

⁶¹ *Regal Hastings Ltd. v. Gulliver*, [1942] 1 All E.R. 378 at 381.

⁶² Mark Vincent Ellis, *Fiduciary Duties in Canada*, looseleaf (Toronto: Thomson Carswell, 2006) at 1-2.1-4.1.

⁶³ Ellis, *Fiduciary Duties in Canada*. at 1-6.

(g) **Other Common Law Considerations**

Older trust and fiduciary considerations emphasized the importance of the preservation of capital and the avoidance of risk. The prudent portfolio approach dictated by statute largely supersedes this view, if it has not already been superseded by evolving case law. However, it will be necessary to review plan documentation, including plan texts and funding agreements to ensure, at the very least, that any contemplated investment strategies or borrowing arrangements (including any related guarantees) are not prohibited. Where they are prohibited, it will be necessary to determine whether the plan documentation can be validly amended to permit them. Where trust or other funding documentation is silent or ambiguous, it is recommended that for certainty it be amended, if possible, to expressly permit the investment and/or borrowing strategies to be employed.

IV. PENSION REAL ESTATE CORPORATIONS⁶⁴

(a) **Introduction**

The simplest form of investment in real estate by a pension fund is for the fund to acquire title directly, however, Canadian pension funds rarely make such investments.⁶⁵ Rather, pension funds in Canada more commonly invest in real estate through a subsidiary pension real estate corporation. In addition to the tax exempt status of pension real estate corporations under the ITA, there are several benefits to the use of corporations including, among others: limited liability⁶⁶; indefinite existence; and the ability to borrow.⁶⁷

⁶⁴ This information is based upon an article in a Blakes Bulletin on Real Estate Development *Issues Affecting Investments by Pension Funds in Development Projects*, published on October 1, 2006, and available at: http://blakes.com/english/legal_updates/real_estate/oct_2006/Real_Estate-October2006.pdf

⁶⁵ There are a number of issues that a pension fund should consider in making real estate investments, however, a detailed description of the various legal, tax and business issues that should be considered by a pension fund in connection with a real estate investment is beyond the scope of this paper.

⁶⁶ Limited liability is a significant consideration, specifically where the investment is being made in large scale or risky projects, such as office buildings and shopping centres. The nature of real estate assets typically introduces an inevitable element of risk to the investment. There may be concerns with environmental liability, in addition to the unavoidable exposure to potential liability arising from the simple operation and management of real property. Pension funds, which are typically seen by third parties as having 'deep pockets', are naturally reluctant to take on such potential liability.

(b) **Tax Rules**

There are two types of pension real estate corporations which are exempt from tax under Part I of the ITA and which may be used for real estate investments by pension funds: a subparagraph 149(1)(o.2)(i) corporation and a subparagraph 149(1)(o.2)(ii) corporation.

(i) **Subparagraph 149(1)(o.2)(i) Corporations**

A subparagraph 149(1)(o.2)(i) corporation must have been incorporated before November 17, 1978, solely in connection with, or for the administration of, a registered pension plan. A subparagraph 149(1)(o.2)(i) corporation, unlike a subparagraph 149(1)(o.2)(ii) corporation, does not face any limitations on the nature of the activities in which it may engage, or on the type of assets it may hold. This lack of restrictions makes a subparagraph 149(1)(o.2)(i) corporation more appealing, however, such corporations are relatively rare since the number of such corporations was obviously frozen in 1978.

The only limitation imposed upon a corporation incorporated pursuant to subparagraph 149(1)(o.2)(i) (i.e., in the case of a corporation with share capital), and which it shares with a subparagraph 149(1)(o.2)(ii) corporation (discussed below), is with respect to the ownership of its shares.

(ii) **Subparagraph 149(1)(o.2)(ii) Corporations**

Although subparagraph 149(1)(o.2)(i) corporations are more appealing as an investment vehicle, subparagraph 149(1)(o.2)(ii) corporations are, unsurprisingly, more prevalent. In addition to the share ownership restrictions referred to above, subparagraph 149(1)(o.2)(ii) limits the corporation's (i) activities, (ii) investments, and (iii) borrowing, as discussed below.

⁶⁷ See the discussion in Part III(d) above dealing with restrictions imposed under the ITA or borrowing of money by registered pension plans. Additionally, a corporation is a familiar vehicle for debt financing and allows for leverage, which has become extremely important as a means for improving returns that pension funds require from their real estate investments. Pension real estate corporations are able to borrow money and to grant security (essentially for the purpose of earning income for real property or an interest therein) whereas their parent pension funds are usually more restricted.

(c) Consequences of Non-Compliance

To maintain their tax-exempt status pension real estate corporations must operate within the limitations imposed under the ITA. The restrictions in paragraph 149(1)(o.2)(ii) are stated to apply “at all times” since the later of November 16, 1978, and the date of incorporation of the corporation. Thus, a single misstep over that period of time will render the corporation taxable under Part I of the ITA. In contrast, pension resource corporations established pursuant to subparagraph 149(1)(o.2)(ii.1), although subject to similar restrictions, are only required to meet such requirements throughout the periods during which they seek tax-exempt status.

(d) Limitations on Activities

Subparagraph 149(1)(o.2)(ii) imposes limitations on the activities of pension real estate corporations. In particular, under clause 149(1)(o.2)(ii)(A), they must limit their “activities” to:

- (i) acquiring, holding, maintaining, improving, leasing or managing capital property that is real property or an interest in real property owned by the corporation, another corporation described in subparagraphs 149(1)(o.2)(ii) and (iv) or a registered pension plan; and
- (ii) investing its funds in a partnership that limits its activities to acquiring, holding, maintaining, improving, leasing or managing capital property that is real property or an interest in real property owned by the partnership.

Subclause 149(1)(o.2)(ii)(A) raises several interpretation issues including: the distinction between the activities and investments of the real estate corporation; the requirement to hold “capital property”; what constitutes “improving” real property; permissible business activities; co-ownership with other pension corporations; use of nominees or bare trustees; and investments in partnerships. A discussion of all of these issues is beyond the scope of this paper.⁶⁸

⁶⁸ For a more comprehensive discussion of these issues see: F. Guarascio, J. Trossman, and J. Forgie, *Pension Fund Investment Issues*, 2010 CBA/IPEBLA Pension and Benefit Law Conference, May 21, 2010.

(e) **Limitations on Investments**

An additional limitation imposed on subparagraph 149(1)(o.2)(ii) corporations is in respect of the investments that they may undertake. Clause 149(1)(o.2)(ii)(B), provides that such corporations must not make investments other than in real property or an interest therein or investments that a pension plan is permitted to make under the PBSA or a similar law of a province. The reference to “investments that a pension plan is permitted to make” brings into consideration the various regulatory requirements and restrictions examined above (i.e., the various qualitative and quantitative limitations). Several issues arise, however, with respect to the interpretation of the investment limitations in clause 149(1)(o.2)(ii)(B):

1. Activities versus Investments

Subparagraph 149(1)(o.2)(ii) seemingly implies that there is a distinction between activities and investments. Certain investments may be permitted even though the activities of the entity in which the investment is made would not qualify under the activity tests set out in clause 149(1)(o.2)(ii)(A).

2. Investments in Limited Partnerships

The investment by a pension real estate corporation in units of a partnership is a permitted activity under subclause 149(1)(o.2)(ii)(A)(II) provided the partnership limits its activities as specified therein.⁶⁹

3. Which Pension Legislation Applies?

Clause 149(1)(o.2)(ii)(B) clearly specifies that a pension real estate corporation is limited to making investments that a pension plan is permitted to make under the PBSA or a similar law of a province. Obviously one interpretation would be to look to the pension legislation applicable to the pension fund or funds that own the shares of the pension real estate corporation.

⁶⁹ At common law, even though a limited partner cannot (under limited partnership law) take an active part in the management of the business, they would nevertheless be considered to be carrying on the business of the partnership. In 2001 the ITA was amended to add section 253.1 which provides that, for the purposes of (among other provisions) paragraph 149(1)(o.2), where a pension real estate corporation is a limited partner of a limited partnership (whose liability is limited under applicable law), the corporation is not, solely because of the acquisition and holding of limited partnership units, considered to be carrying on any activities of the limited partnership.

However, given that clause 149(1)(o.2)(ii)(B) refers to “a pension plan” rather than “the pension plan,” an argument may be made that a proper interpretation of the provision is that the applicable legislation is that of any of the jurisdictions that will accommodate the investment the pension real estate corporation wishes to make.⁷⁰

While this issue may be seen as moot given that most jurisdictions, including Ontario, require compliance with the PBSA investment regulations, it may gain significance should any province(s) amend their pension investment regulations to deviate from the federal regulations.

4. Quantitative Restrictions

It is clear that the various qualitative restrictions (as discussed above) apply to the investments of a pension realty corporation. What is arguably less clear is whether the quantitative restrictions (i.e., percentage thresholds) also apply and, if so, whether they do so at the level of the pension realty corporation or at the level of the shareholder pension fund.

The wording of clause 149(1)(o.2)(ii)(B) is imprecise in its reference to “a pension plan” rather than to “the pension plan.” Furthermore, applying the quantitative restrictions to the pension realty corporation leads to incongruous and awkward results. This suggests that only the qualitative restrictions, and not the quantitative restrictions, were intended to apply to investments by a pension realty corporation. CRA has indicated that the quantitative test under clause 149(1)(o.2)(ii)(B) applies per corporation and not at the pension fund level, however, CRA also indicated that they were discussing with the Department of Finance (Canada) whether this rule should be relaxed.⁷¹ It is the authors’ understanding that this matter is still under review by the Department of Finance.

⁷⁰ It is worth noting that (i) the shares of the pension real estate corporation could be owned by several pension funds which might be subject to the pension legislation of different jurisdictions, and (ii) the shares of the pension real estate corporation do not necessarily need to be owned by any pension funds (i.e., the shareholders could be other entities listed in subparagraph 149(1)(o.2)(iv)). If the shares can be held by entities other than pension plans it raises the possibility that the provision may be interpreted in this way.

⁷¹ Canadian Tax Foundation Annual Conference, November 27, 2007. See also, David M. Sherman, ed., *The Practitioner’s Income Tax Act*, 34th ed. (Toronto: Thomson Carswell, 2008), 1130.

Care must be taken by pension fund administrators if the pension realty corporation is a limited purpose vehicle (as it often is) since, being precluded from taking into account the broader spectrum of investments held by the shareholder pension fund, they may quickly find themselves in breach of the quantitative limits.

V. PENSION INVESTMENT CORPORATIONS

(a) Introduction

In addition to pension real estate corporations (discussed in Part IV above) and special purpose corporations aimed specifically at Canadian resource property investments, pension and tax rules permit a pension plan to create a special purpose limited liability investment corporation that is exempt from income tax under the ITA. This provides limited liability protection by insulating a pension fund and its assets from liabilities that may arise in respect of certain investments and is sometimes used as a vehicle for holding private equity, infrastructure and other types of investments where there are potential liability, foreign tax or foreign tax reporting concerns.

(b) Tax Rules

To qualify as tax exempt under subparagraph 149(1)(o.2)(iii) of the ITA, a pension investment corporation must meet the following requirements:

1. at least 98% of the corporation's assets must be cash and investments;
2. the corporation must not issue debt obligations;
3. at least 98% of the corporation's income for tax purposes must be derived from (or from dispositions of) investments;
4. all shares (and rights to acquire shares) of the corporation must be owned by one or more registered pension plans or certain other specific entities specified in the regulations; and

5. all investments of the corporation must be investments that a pension fund is permitted to make under the PBSA or a similar law of a province. (See the discussion under “Pension Real Estate Corporations – Quantitative Restrictions”.)

Many investment funds which invest in private equity and sometimes also in infrastructure projects are structured as limited partnerships (both under Canadian provincial laws or under the laws of a foreign jurisdiction). Consequently, the pension investment corporation would invest as a limited partner in the limited partnership and the portfolio which comprises the private equity or infrastructure assets are held in, or beneath, the limited partnership.

Some of the issues that have arisen in interpreting these tax rules include the following:

- (a) the meaning of an “investment” – in addition to shares and debt, an investment would generally include limited partnership interests provided the holder of the interest actually has limited liability;
- (b) what constitutes an “issuance” of debt – in the context of a limited partnership, provisions relating to cash calls must be structured carefully to avoid a debt issuance by the limited partner, and it must be made clear that partnership level debt is not debt of the limited partner for this purpose. This is discussed in more detail in Part IV(c) below.
- (c) **Pension Regulatory Rules**

As noted in Part III above, the provisions of the PBA relating to investment corporations (found in Schedule III) are structured as exceptions to the 10% Rule and the 30% Rule meaning that a pension fund can hold all of the voting shares of the investment corporation and more than 10% of its assets can be invested in that corporation.

An investment corporation is defined under Schedule III.⁷² The way in which the definition is worded is important in understanding what restrictions apply to an investment corporation and how the quantitative limits under the Schedule III are to be applied. There are five parts to the definition:

1. the investments in the investment corporation are limited to those that can be made by the pension plan that invests in the pension corporation - this is important to note because it means, for example, that the 10% rule can be tested at the level of the pension fund and therefore an investment corporation can under the pension legislation limit its investments to an investment in one entity;
2. the corporation must hold at least 98% of its assets in cash, investments and loans;
3. the corporation must not issue debt obligations;
4. the corporation must obtain at least 98% of its income from investments and loans; and
5. the corporation must not lend any of its assets to, or invest in, a related party of the pension plan.

In addition to meeting these requirements to be an investment corporation, the administrator of the pension plan must file an undertaking with the Superintendent on behalf of the investment corporation in which the investment corporation provides its undertaking to comply with the investment limits mentioned previously and to provide access to information such as the corporation's annual financial statements, audited financial statements (if any) and a listing of the corporation's assets including their market value.⁷³

⁷² Schedule III, s. 1, "investment corporation".

⁷³ Schedule III, s. 14.

There are some additional restrictions that need to be addressed through undertakings where the investment corporation holds shares in another investment corporation (stacking).⁷⁴

Schedule III does not specify where (*i.e.*, in which jurisdiction) the corporation must be incorporated and does not require the corporation to be resident in Canada for tax or general corporate law purposes.

As previously discussed, one of the areas to watch out for is the prohibition against issuing debt obligations. While there may be arguments to be made about what “issue” means in this context, plan administrators need to be cautious in circumstances where, for example, the investment corporation is assuming outstanding obligations from another investor or, where there has been a default, and an amount is owed by the investor to the underlying investment vehicle (*e.g.*, a limited partnership).

VI. LIMITED PARTNERSHIPS

(a) Using a Limited Partnership

As mentioned earlier, many investment funds are structured as limited partnerships. A limited partnership offers “fiscal transparency” since its income is allocated to and taxed in partners’ hands and is also recognized as a permissible investment structure under applicable pension fund legislation.

A limited partnership is a partnership governed by statute (for example, the *Limited Partnership Act* (Ontario))⁷⁵ and a limited partnership agreement among its partners. It is a special type of partnership that consists of at least one general partner and one or more limited partners. It is typical for a pension fund investor to make its investment by acquiring limited

⁷⁴ Schedule III, s. 14(g). As noted in Part III(c) above, included in the undertaking by investment corporation is a commitment not to invest in over 30% of the shares to which are attached votes to elect directors of another investment corporation unless that corporation undertakes not to invest in another investment corporation. This effectively limits the number of tiers of investment corporation to two.

⁷⁵ R.S.O. 1990, c. L-16.

partnership units or interests in a limited partnership vehicle. In this section we will discuss some of the issues relating to investment funds that are structured as limited partnerships with third party general partners and managers.

(b) **Limited Liability**

Limited liability is a cornerstone of any pension plan investment. A basic principle of a limited partnership is that a limited partner is not liable for the debts of the partnership beyond the amount it has contributed or agreed to contribute to the partnership. Limited liability may be lost, however, if the limited partner takes part in the control or management of the business of the partnership. Generally speaking, a limited partner that remains a truly passive investor with no management responsibilities, no directors or officers of the limited partner, and which does not take an active part in the business or take part in the control or management of the business should not lose its limited liability and become liable as a general partner.

Each province and territory in Canada has its own legislative provisions dealing specifically with limited partnerships and addressing the issues of limited liability of limited partners and the circumstances for potential loss of limited liability. The legislation dealing with limited partnerships in all but four provinces and territories provides that a limited partner becomes liable as a general partner when the limited partner takes part in the “control of the business”.⁷⁶ The legislation in British Columbia and the Yukon provides that a limited partner becomes liable as a general partner when the limited partner takes part in the “management of the business”.⁷⁷ The legislation in Manitoba provides that a limited partner becomes liable as a general partner when it “takes an active part in the business”⁷⁸ of the partnership. In Quebec, the

⁷⁶ *Limited Partnerships Act*, R.S.O. 1990, c. L.16, s. 13; *Partnership Act*, R.S.A. 2000, c. P-3, s. 64, *Partnership Act*, R.S.S. 1978, c. P-3, s. 64; *Partnership Act*, R.S.N.W.T. 1988, c. P-1, s.70; *Partnership Act*, R.S.N.W.T. (Nu.) 1988, c. P-1, s. 70; *Limited Partnership Act*, R.S.N.L. 1990, c. L-17, s. 16; *Limited Partnerships Act*, R.S.N.S. 1989, c. 259, s. 17; *Limited Partnership Act*, S.N.B. 1984, c. L-9.1, s. 17; *Limited Partnerships Act*, R.S.P.E.I. 1988, c. L-13, s. 12.

⁷⁷ *Partnership Act*, R.S.B.C. 1996, c. 348, s. 64; *Partnership and Business Names Act*, R.S.Y. 2002, c.166, s.63.

⁷⁸ *The Partnership Act*, C.C.S.M. c. P30, s. 63.

legislation prohibits the limited partner from giving anything more than an advisory opinion with regard to the management of the partnership.⁷⁹

The Manitoba standard of taking an “active part in the business” suggests a threshold that is lower than the Ontario (and other provinces) threshold of taking part in the “control of the business”. At the same time, the Manitoba legislation offers greater protection to the limited partner because it restricts the extension of general liability to “active” limited partners to only two situations: (i) liability extends only to those persons with whom the partner deals on behalf of the partnership; and (ii) liability arises when the third party first dealt with the limited partner but ceases when the third party became aware that it was dealing with a limited partner. Therefore, in Manitoba, simply telling people with whom the partnership is dealing that the pension fund is a limited partner preserves the pension fund’s limited liability opposite those persons, even if the pension fund then proceeded to take an active part in the business of the partnership. (One downside, however, to forming a Manitoba limited partnership is that a list of partners, together with their contributions, must be filed with the relevant governmental authority.)

As a result, it is somewhat less likely that a limited partner of a Manitoba limited partnership will lose its limited liability than a limited partner of an Ontario limited partnership (leaving aside complicated interprovincial jurisdiction issues, as it is not clear in every province that a limited partner resident in that province, when dealing with other residents of that province, in respect of its participation in a Manitoba limited partnership, would have its limited liability rights interpreted based on the provisions of Manitoba partnership legislation rather than the legislation of his province of residence).

(c) **30% Rule**

As discussed above, where a pension fund (or an investment corporation) invests in a limited partnership there is a question as to whether the plan administrator is required to look through the limited partnership and determine whether the partnership portfolio complies with the 30% Rule or the related-party restrictions. For this reason, we see a number of plan

⁷⁹ Art. 2244 C.C.Q.

administrators who will take steps (for example, through the use of side letters with the general partner or manager) to ensure that the partnership (taking into account the pension fund's proportionate investment in the partnership) does not cause the pension fund to go "off side" on the 30% Rule or to violate the related-party restrictions.

(d) **Governance Matters**

In a limited partnership fund structure, there is often an interplay between pension fund investors who will often want at least some oversight over the general partner's activities, and the general partner who wants, to the extent possible, full discretion over its activities.

1. Advisory Committee

It is extremely common for a fund structured as a limited partnership to have an Advisory Committee made up of representatives of the limited partners and the general partner (usually as a non-voting member). The primary purpose of the Advisory Committee is to allow representatives of investors with a minimum level of capital commitment to have some oversight over the general partner's activities. It also allows both the general partner and the limited partners a forum to discuss fund matters. In some cases, the Advisory Committee will include investment experts who are not representatives of limited partners to provide guidance to the general partner.

The roles and responsibilities of the Advisory Committee will vary and can range from a purely advisory role to a decision-making role in some limited circumstances. Advisory Committees are, for example, sometimes vested with the responsibility to approve exceptions to investment restrictions, approve replacements of key personnel, valuations and to consult with the general partner on conflicts of interest. In some cases (although this is not typical), the Advisory Committee may have responsibility to approve investments.

This range of responsibility necessarily gives rise to the concern that limited partners risk losing their limited liability status by virtue of having a representative on a fund's Advisory Committee. In most jurisdictions, there is a relative degree of comfort in the industry that the customary activities of an Advisory Committee should not pose any issue. To the extent that the Advisory Committee's role extends beyond this customary role, there is more of a concern. If the

Advisory Committee has an expanded role, a Manitoba limited partnership is a structure option. In any event, the Advisory Committee's responsibilities should be carefully considered by any pension fund investor whose representative will be participating in the Advisory Committee.

Many pension plans historically were not permitted to indemnify or insure their employees if they took an Advisory Committee membership and in some cases pension fund investors may decide that even if they are entitled to representation on the Advisory Committee, it just does not make sense for liability concerns or otherwise to take advantage of it. One alternative to resolve this dilemma is to negotiate with the general partner a right for the investor to send non-voting observers to Advisory Committee meetings.

2. Fund Investment Policies and Restrictions

The general partner directly, or through a related manager or investment advisor, will usually be responsible for investments by the limited partnership. Most limited partnership agreements will contain some description of the investment policies or mandate of the limited partnership. These are generally, and in some cases unfortunately, worded very loosely and as a result, it is even more important to consider the inclusion of specific investment restrictions in the limited partnership agreement. Investment restrictions can include restrictions on investing in certain industries (tobacco, arms and other potentially undesirable industries), concentration limits (for example, the partnership cannot invest more than 20% of its commitments in a portfolio company), limits on borrowing and portfolio company guarantees, geographical restrictions, prohibitions and investments in pooled funds and the like. Often these are driven by risk management concerns, but a pension plan's own policies, restrictions and social responsibilities may also play a role.

3. Conflicts of Interest

As discussed above, conflicts are a very important consideration for pension fund investors. The general partner of a fund structured as a limited partnership is often subject to a variety of conflicts of interest — between itself and its staff and operations, between itself and limited partners and between itself and the investors in other funds managed by the general partner. Common conflicts of interest situations include, for example, if:

- the general partner employs a related company to provide services to the partnership or the partnership's investee companies;
- the general partner or related parties invest in the partnership's investee companies;
- the partnership invests in a company in which a prior fund managed by the general partner (or one of its affiliates) has an interest; and
- the general partner invests directly or on behalf of other funds managed by it in portfolio companies within the fund's investment mandate.

Limited partnership agreements should have protocols to deal with conflict of interest situations. In many cases, these protocols will include an approval by the Advisory Committee if a conflict exists. Limited partnership agreements often deal specifically with the common conflict of interest situations mentioned above. For example, limited partners may require that if the general partner uses the services of a related company, these services should be provided on arm's length terms or market terms. Any delegation by the general partner should expressly not relieve the general partner of its obligations under the limited partnership agreement. In addition, to the extent that the general partner delegates responsibilities that are traditionally undertaken by the general partner, it should be made clear that no additional remuneration will be payable to such service provider. For example, if the general partner is paid a management fee under the limited partnership agreement, it should be not be entitled to hire a portfolio investment advisor as the general partner is already being paid for those services. Limited partnership agreements should also cover the extent to which the partnership is permitted to invest in companies in which the general partner or any of its related parties has an interest and investments by the general partner directly or on behalf of other funds in investee companies within the Partnership's investment mandate.

Generally, a key premise of any conflicts protocol is the premise that general partners should be restricted in any activities which may misalign the general partner's interest with that of the limited partners of the partnership.

(e) **Standard of Care**

The general partner of any limited partnership should comply with a standard of care in connection with the management and conduct of the partnership's business and should be required to act honestly, in good faith and in the best interests of the partnership.

Some pension fund investors require that the general partner and its manager also comply with the standard of care imposed under section 22 of the PBA.⁸⁰ As noted in Part III above, this provision provides that, the plan administrator is subject to a codified standard of care in connection with the investment of the pension fund. The standard of care is essentially a prudent person standard which requires the plan administrator to "exercise the care, diligence and skill in ... the investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person". The PBA also provides that the administrator must use "all relevant knowledge and skill that the administrator possesses or, by reason of the administrator's profession, business or calling ought to possess". Importantly, the PBA expressly provides for the administrator to engage "agents" in order to "carry out any act required to be done in the ... administration and investment of the pension fund". The PBA goes on to provide that the "agent" appointed by the plan administrator to carry out investment activities on behalf of the pension fund is subject to the same standard of care as the administrator.

The statutory framework under the PBA raises a number of issues that need to be considered from both the administrator perspective and from the perspective of an investment manager or advisor. For example, the plan administrator may request that the standard of care provided under the PBA be imposed on the investment advisor or investment manager and included in a subscription agreement or in another written agreement.

⁸⁰ PBA, s. 22.

The plan administrator may also take the position that the investment manager or investment advisor is an “agent” of the plan administrator and therefore subject to the statutory standard of care imposed under the PBA.⁸¹ This is something that many investment managers attempt to resist.

The PBA section 22 standard of care can be addressed directly in the partnership agreement or elaborated in a management agreement or side letter with a positive obligation to the effect that the general partner and any manager agree and acknowledge that their duties and obligations include the standard of care imposed on an administrator of a pension plan provided in section 22 of the PBA or any successor legislation.

(f) **Key Person**

Two important factors in a pension fund’s decision to invest are the experience and the track record of a fund’s principals. There will be certain principals who will be critical to the success of the fund. In order to ensure that these principals remain dedicated to the continued success of the fund, there may be trigger events which allow for the removal of the general partner and manager in the event certain principals are not associated with the management of the fund.

These key person trigger events can include objective and subjective triggers. Examples of objective triggers include death, disability, bankruptcy, termination of employment, default, continued ownership of the general partner, certain individuals ceasing to be managers. Subjective triggers include “ceasing to be actively involved” or “ceasing to devote necessary/substantially all business time and attention” or “ceasing to devote a majority of professional time”.

⁸¹ It should be noted that in at least one court decision (R. v. Norton [2006] O.J. No. 2031)), the court adopted an expansive view of what constitutes an “agent” for the purposes of the PBA suggesting that it could be any service provider that is engaged by the plan administrator to assist in the administration of the plan, rather than a narrower common law test as to what constitutes an “agent”.

The main objective of key person provisions is to clearly set out the expectations of investors regarding the time that principals must commit to the fund.

The consequences or remedies of a key person event will depend on all the circumstances. Dissolution of the partnership should be avoided from an investor pension fund's perspective as it will more likely lead to an unworkable outcome. A remedy which is more investor friendly and makes more sense is the suspension or termination of the commitment period with some options or alternatives to deal with the replacement of the general partner and manager.

(g) Subscription Financing Issues

Increasingly, investment funds (for example, some private equity funds) which are structured as limited partnerships are borrowing on the security of limited partner subscriptions. This raises the question as to whether the borrowing creates a problem for a pension plan investor under the ITA or applicable pension benefits legislation, both of which restrict borrowing by a pension fund or its investment corporation.

Before discussing the topic of borrowing by a limited partnership, it is important to remember, as discussed above, that there are restrictions imposed on the borrowing of money by a registered pension plan.

Where a pension plan or a pension investment corporation invests in a limited partnership and under the terms of the limited partnership agreement the partnership can borrow, and in some cases allow a third party lender to enforce the terms of the limited partnership agreement where there is a default under the loan, the question becomes at what point could the borrowing activities of the limited partnership and the consequential debt owed to a third party lender be construed as a debt obligation or borrowing on the part of the limited partners including, in our case, a pension plan investor or its investment corporation.

Fortunately, CRA has provided some fairly helpful guidance on this topic and their position has generally been that the mere fact that a limited partnership can borrow and that a third party lender can require the general partner to enforce the terms of the limited partnership agreement including provisions relating to defaulting partners is not the same thing as a debt obligation on the part of the limited partners. For example, CRA has issued advanced tax rulings under which it was clear that limited partnership interests were held directly by a registered pension plan trust and where borrowing occurred at the level of the limited partnership.⁸² In effect, the critical point seems to be that the lender does not have direct recourse to the limited partners and must instead enforce its rights against the limited partnership with the result that the limited partners continue to have the same obligations to which they were always subject under the limited partnership agreement.

Nevertheless, pension fund investors should carefully consider whether the description of the borrowing in the limited partnership agreement and any acknowledgement by limited partners of the assignment by the partnership of the limited partners' subscription agreements constitutes borrowing by the pension fund or its investment corporation, if applicable. In addition to the threshold issue, often the limited partnership agreement will contain very broadly described obligations on the part of limited partners in connection the limited partnership's credit facility to the limited partnership to provide documents and information to the lender. These obligations often include obligations to provide financial statements and legal opinions and a general obligation to provide all information as the lender may "reasonably require". Pension fund investors should carefully evaluate these provisions to determine whether or not they are in a position to provide this information. Often, general partners will be willing to limit the scope of these requirements either in the limited partnership agreement or in a side letter. The topic of side letters is discussed below.

⁸² CRA Views, Ruling 2000-0055463 (2001).

(h) **Side Letters**

It is common practice for pension plan investors (including where the investor is an investment corporation) to enter into a side letter with the investment fund including, for example, a side letter between the investment corporation and the manager or general partner of a limited partnership which holds the portfolio investments. In negotiating a side letter, the goal is, to the extent possible, to make the side letter more of a formal agreement, as opposed to a comfort letter. However, to the extent that a request is absolutely critical, and of benefit to all investors, the preference would be to include the provision in the limited partnership agreement in the case of a limited partnership.

A few examples of side letter covenants that a pension fund or a pension investment corporation may want to consider are:

- “Most Favoured Nation” clause providing an obligation to disclose all other side letters or special arrangements with other investors (i.e., investors with the same or a lesser total capital commitment) and requirement to offer any such special arrangements to the pension fund or investment corporation;
- tax accommodations (for example, U.S. ECI and FIRPTA issues) including in the case of a limited partnership, for example, consultation by the general partner with the limited partner on withholding taxes that are questionable;
- investment exclusion privileges which allows the pension investor to opt-out of a capital call in the event that the investment being by the fund would result in a violation of law or regulation (*e.g.*, the 30% Rule) applicable to the pension fund investor;⁸³

⁸³ Where a pension fund (or an investment corporation) invests in a limited partnership there is a question as to whether the plan administrator is required to look through the limited partnership and determine whether the partnership portfolio complies with the 30% Rule or the related party restrictions. For this reason, we see a number of plan administrators who will take steps (for example through the use of side letters with the general partner or manager) to ensure that the partnership (taking into account the pension fund’s proportionate investment in the partnership) does not cause the pension fund to go “off side” on the 30% Rule or to violate the related party restrictions.

- to provide tax, financial information, or other additional reporting required by the pension fund or the pension corporation (as an investor);
- prohibition against investment in related parties to the pension plan;
- (in the case of an investment fund that is structured as a limited partnership) provision for the appointment of an advisory committee member nominated by the pension fund or pension investment corporation (in its capacity as a limited partner);
- certain restrictions on borrowings by the partnership (where the investment fund is structured as a limited partnership) and to ensure that there can be no recourse to the pension fund or pension corporation;
- to reduce management fees payable by a large investor;
- reimbursement of legal fees; and
- special call request notice accompanied by specific or prescribed information.

VII. CONCLUSION

The investments of pension funds and their related entities in Canada are governed by the ITA, federal and provincial pension benefits statutes, common law considerations and the plan documents themselves (including, in particular, the SIP&P). It is important for plan administrators, lawyers, investment managers and other advisors of the pension fund to be familiar with the manner in which each of these regulates the investments of pension funds and determines the structure of appropriate pension fund investment vehicles. This is particularly important in the case of alternative investments which may also require careful consideration of structuring and foreign tax issues.

SCHEDULE "A"

SECTIONS 6, 7, 7.1 and 7.2 OF THE PBSA REGULATIONS

Pension Benefits Standards Regulations, 1985

INVESTMENTS

6. (1) Every plan shall provide that the moneys of the pension fund are to be
- (a) invested in accordance with Schedule III; and
 - (b) invested
 - (i) in a name that clearly indicates that the investment is held in trust for the plan and, where the investment is capable of being registered, registered in that name,
 - (ii) in the name of a financial institution, or a nominee thereof, in accordance with a custodial agreement or trust agreement, entered into on behalf of the plan with the financial institution, that clearly indicates that the investment is held for the plan, or
 - (iii) in the name of The Canadian Depository for Securities Limited, or a nominee thereof, in accordance with a custodial agreement or trust agreement, entered into on behalf of the plan with a financial institution, that clearly indicates that the investment is held for the plan.
- (2) For the purposes of subsection (1), "custodial agreement" means an agreement providing that
- (a) an investment made or held on behalf of a plan pursuant to the agreement
 - (i) constitutes part of the plan's pension fund, and
 - (ii) shall not at any time constitute an asset of the custodian or nominee; and
 - (b) records shall be maintained by the custodian that are sufficient to allow the ownership of any investment to be traced to the plan at any time.

SOR/91-709, s. 1; SOR/95-86, s. 2.

7. The administrator of a plan shall maintain a current record that clearly identifies every investment held on behalf of the plan, the name in which the investment is made and, where appropriate, the name in which the investment is registered.

7.1 (1) The administrator of a plan shall, before the later of July 1, 1994 and the day on which the plan is registered, establish, on behalf of the plan, a written statement of investment policies and procedures in respect of the plan's portfolio of investments and loans, including

- (a) categories of investments and loans, including derivatives, options and futures,
- (b) diversification of the investment portfolio,
- (c) asset mix and rate of return expectations,
- (d) liquidity of investments,
- (e) the lending of cash or securities,
- (f) the retention or delegation of voting rights acquired through plan investments,
- (g) the method of, and basis for, the valuation of investments that are not regularly traded at a public exchange, and
- (h) related party transactions permitted under section 17 of Schedule III and the criteria to be used to establish whether a transaction is nominal or immaterial to the plan, having regard to all factors that may affect the funding and solvency of the plan and the ability of the plan to meet its financial obligations.

(2) The statement of investment policies and procedures referred to in subsection (1) shall include a description of the factors referred to in that subsection and the relationship of those factors to those policies and procedures.

(3) The administrator of a plan shall submit the statement of investment policies and procedures referred to in subsection (1)

(a) to any pension council that has been established, within 60 days after the later of

(i) the day on which the statement is established, and

(ii) the day on which the pension council is established; and

(b) where a plan is a defined benefit plan, to the actuary to the plan on or before the day that is the later of

(i) 60 days after the day on which the statement is established, and

(ii) the day on which the actuary is appointed.

SOR/93-299, s. 2; SOR/2002-78, s. 5.

7.2 (1) The administrator of a plan shall review and confirm or amend the statement of investment policies and procedures referred to in subsection 7.1(1) at least once each plan year.

(2) A copy of all amendments to the statement of investment policies and procedures shall be submitted, within 60 days after the statement is amended,

(a) to any pension council that has been established; and

(b) where the plan is a defined benefit plan, to the actuary to the plan.

SOR/93-299, s. 2; SOR/2002-78, s. 6.

SCHEDULE “B”

PERMITTED INVESTMENTS

INTERPRETATION

1. In this Schedule,

“child”, in respect of a person, means

- (a) the child of the person,
- (b) the child of the person’s spouse or common-law partner, or
- (c) the spouse or common-law partner of a child of the person; (*enfant*)

“debt obligation” means a bond, debenture, note or other evidence of indebtedness of an entity; (*titre de créance*)

“entity” means

- (a) a corporation, trust, partnership or fund or an unincorporated association or organization, or
- (b) Her Majesty in right of Canada or of a province or the government of a foreign country or of a political subdivision of a foreign country, or an agency thereof; (*entité*)

“investment corporation”, in respect of a plan, means a corporation that

- (a) is limited in its investments to those that are authorized for the plan under this Schedule,
- (b) holds at least 98 per cent of its assets in cash, investments and loans,
- (c) does not issue debt obligations,
- (d) obtains at least 98 per cent of its income from investments and loans, and
- (e) does not lend any of its assets to, or invest any of its moneys in, a related party of the plan; (*société de placement*)

“loan” includes a deposit, financial lease, conditional sales contract, repurchase agreement and any other similar arrangement for obtaining money or credit, but does not include investments in securities or the making of an acceptance, endorsement or other guarantee; (*prêt*)

“market terms and conditions”, in respect of a transaction, means terms and conditions, including those relating to price, rent or interest rate, that would apply to a similar transaction in an open market under conditions requisite to a fair transaction between parties who are at arm’s length and acting prudently, knowledgeably and willingly; (*conditions du marché*)

“person” includes an entity; (*personne*)

“public exchange” means

- (a) the Alberta Stock Exchange,
- (b) the Montreal Stock Exchange,
- (c) the Toronto Stock Exchange,
- (d) the Vancouver Stock Exchange,
- (e) the Winnipeg Stock Exchange,
- (f) in France, the Stock Exchange (Paris),
- (g) in the United Kingdom, The Stock Exchange (London), and
- (h) in the United States,

- (i) the American Stock Exchange,
- (ii) the Boston Stock Exchange,
- (iii) the Chicago Board of Trade,
- (iv) the Cincinnati Stock Exchange,
- (v) the Detroit Stock Exchange,
- (vi) the Midwest Stock Exchange,
- (vii) the National Association of Securities Dealers Automated Quotation System,
- (viii) the National Stock Exchange,
- (ix) the New York Stock Exchange,
- (x) the Pacific Coast Stock Exchange,
- (xi) the Philadelphia-Baltimore-Washington Stock Exchange,
- (xii) the Pittsburgh Stock Exchange,
- (xiii) the Salt Lake Stock Exchange, or
- (xiv) the Spokane Stock Exchange; (*bourse*)

“real estate corporation” means a corporation incorporated to acquire, hold, maintain, improve, lease or manage real property other than real property that yields petroleum or natural gas; (*société immobilière*)

“real property” includes a leasehold interest in real property; (*biens immeubles*)

“related party”, in respect of a plan, means a person who is

- (a) the administrator of the plan or who is a member of a pension committee, board of trustees or other body that is the administrator of the plan,
- (b) an officer, director or employee of the administrator of the plan,
- (c) a person responsible for holding or investing the assets of the plan, or any officer, director or employee thereof,
- (d) an association or union representing employees of the employer, or an officer or employee thereof,
- (e) an employer who participates in the plan, or an employee, officer or director thereof,
- (f) a member of the plan,
- (g) where the employer is a corporation, a person who directly or indirectly holds, or together with the spouse or common-law partner or a child of the person holds, more than 10 per cent of the voting shares carrying more than 10 per cent of the voting rights attached to all voting securities of the corporation,
- (h) the spouse or common-law partner or a child of any person referred to in any of paragraphs (a) to (g),
- (i) where the employer is a corporation, an affiliate of the employer,
- (j) a corporation that is directly or indirectly controlled by a person referred to in any of paragraphs (a) to (h),
- (k) an entity in which a person referred to in paragraph (a), (b), (e) or (g), or the spouse or common-law partner or a child of such a person, has a substantial investment, or
- (l) an entity that holds a substantial investment in the employer,

but does not include Her Majesty in right of Canada or of a province, or an agency thereof, or a bank, trust company or other financial institution that holds the assets of the plan, where that person is not the administrator of the plan; (*apparenté*)

“resource corporation” means a corporation that has, at all times since the date on which it was incorporated,

- (a) limited its activities to acquiring, holding, exploring, developing, maintaining, improving, managing, operating or disposing of Canadian resource properties,
- (b) restricted its investments and loans, other than investments in Canadian resource properties or property to be used in connection with Canadian resource properties owned by it and loans secured by Canadian resource properties to persons resident in Canada for the exploration or development of such properties, to investments and loans authorized for a plan under this Schedule, and
- (c) not borrowed money other than for the purpose of earning income from Canadian resource properties; (*société minière*)

“security” means

- (a) in respect of a corporation, a share of any class of shares of the corporation or a debt obligation of the corporation, and includes a warrant of the corporation, but does not include a deposit with a financial institution or an instrument evidencing such a deposit, and
- (b) in respect of any other entity, any ownership interest in or debt obligation of the entity; (*titre ou valeur mobilière*)

“transaction” includes

- (a) the making of an investment in securities,
- (b) the taking of an assignment of, or otherwise acquiring, a loan made by a third party,
- (c) the taking of a security interest in securities, and
- (d) any modification, renewal or extension of a prior transaction,

but does not include a payment of pension benefits or other benefits, a transfer of pension benefit credits or a withdrawal of contributions from a plan; (*opération*)

“voting share” means a share of any class of shares of a corporation that carries voting rights under all circumstances, by reason of an event that has occurred and is continuing or by reason of a condition that has been fulfilled. (*action avec droit de vote*)

2. For the purposes of this Schedule, the making, holding or acquiring of an investment indirectly by an administrator on behalf of a plan, the holding, acquiring or owning of property indirectly by an administrator on behalf of a plan or the lending of money indirectly by an administrator on behalf of a plan includes the holding, making, acquiring, owning or lending of an investment, a property or money, as the case may be, by

- (a) a real estate corporation, resource corporation or investment corporation in which the moneys of the plan have been invested in accordance with section 12, 13 or 14;
- (b) a real estate corporation, resource corporation or investment corporation of which a corporation referred to in paragraph (a) holds securities to which are attached more than 30 per cent of the votes that may be cast to elect the directors of the real estate corporation, resource corporation or investment corporation; or
- (c) a mutual or pooled fund or trust fund in which the moneys of the plan have been invested.

3. (1) For the purposes of this Schedule,

- (a) a person or plan controls a corporation if securities of the corporation to which are attached more than 50 per cent of the votes that may be cast to elect the directors of the corporation are beneficially owned by the person or plan and the votes attached to those securities are sufficient, if exercised, to elect a majority of the directors of the corporation;
- (b) a person or plan controls an unincorporated entity, other than a limited partnership, if more than 50 per cent of the ownership interests into which the unincorporated entity is divided are beneficially owned by the person or plan and the person or plan is able to direct the business and affairs of the unincorporated entity;

(c) the general partner of a limited partnership controls the limited partnership; and

(d) a trustee of a trust controls the trust.

(2) For the purposes of this Schedule, a person or plan who controls an entity controls any other entity that is controlled by the entity.

4. For the purposes of this Schedule, a corporation is a subsidiary of another corporation if it is controlled by the other corporation.

5. For the purposes of this Schedule, one entity is affiliated with another entity if the entity is controlled by the other entity or if both entities are controlled by the same person.

6. For the purposes of this Schedule, a person or plan has a substantial investment in

(a) an unincorporated entity if the person, the plan or an entity controlled by the person or plan beneficially owns more than 25 per cent of the ownership interests in the unincorporated entity; and

(b) a corporation if

(i) the voting rights attached to voting shares of the corporation that are beneficially owned by the person or plan, or by an entity controlled by the person or plan, exceed 10 per cent of the voting rights attached to all of the outstanding voting shares of the corporation, or

(ii) shares of the corporation that are beneficially owned by the person or plan, or by an entity controlled by the person or plan, represent ownership of more than 25 per cent of the shareholders' equity of the corporation.

7. For the purposes of this Schedule, a person or plan is associated with

(a) a corporation that the person or plan controls and every affiliate of every such corporation;

(b) a person who controls the person or plan;

(c) a partner who has a substantial investment in a partnership in which the person or plan has a substantial investment;

(d) a trust or estate in which the person or plan has a substantial investment or for which the person or plan serves as trustee or in a similar capacity to a trustee;

(e) the spouse or common-law partner of the person; and

(f) a brother, sister or child or other descendant of the person, or the spouse or common-law partner thereof.

APPLICATION

8. This Schedule does not apply in respect of

(a) an insured plan or a plan in respect of which all benefits are provided through an annuity contract issued by the Government of Canada; or

(b) investments held in an unallocated general fund of a person authorized to carry on a life insurance business in Canada.

QUANTITATIVE LIMITS

9. (1) The administrator of a plan shall not directly or indirectly lend moneys of the plan equal to more than 10 per cent of the total book value of the plan's assets to, or invest moneys equal to more than 10 per cent of the total book value of the plan's assets in,

(a) any one person;

(b) two or more associated persons; or

(c) two or more affiliated corporations.

(2) Subsection (1) does not apply in respect of moneys of a plan held by a bank, trust company or other financial institution to the extent that the moneys are fully insured by the Canada Deposit Insurance Corporation, by the Canadian Life and Health Insurance Compensation Corporation or by any similar provincial body established for the purpose of providing insurance against loss of deposits with trust companies or other financial institutions.

(3) Subsection (1) does not apply in respect of investments in

(a) a segregated fund or mutual or pooled fund that complies with the requirements applicable to a plan that are set out in this Schedule;

(b) an unallocated general fund of a person authorized to carry on a life insurance business in Canada;

(c) an investment corporation, real estate corporation or resource corporation;

(d) securities issued or fully guaranteed by the Government of Canada, the government of a province, or an agency thereof;

(e) a fund composed of mortgage-backed securities that are fully guaranteed by the Government of Canada, the government of a province, or an agency thereof; or

(f) a fund that replicates the composition of a widely recognized index of a broad class of securities traded at a public exchange.

10. (1) The administrator of a plan shall not, directly or indirectly, invest moneys of the plan in real property or Canadian resource properties if, at the time the investment is made,

(a) the book value of the investment in any one parcel of real property or Canadian resource property exceeds 5 per cent of the book value of the plan's assets;

(b) the aggregate book value of all investments in Canadian resource properties exceeds 15 per cent of the book value of the plan's assets; or

(c) the aggregate book value of all investments in real property and Canadian resource properties exceeds 25 per cent of the book value of the plan's assets.

[Note that pursuant to SOR/2010-149, the Canadian resource and real estate quantitative limits have been repealed.]

(2) Where real property is subdivided into two or more parcels and the beneficial ownership of the real property remains the same, or where a person directly or indirectly acquires two or more parcels for consolidation, the real property shall be treated as one parcel for the purposes of the investment limits set out in this section.

11. (1) Subject to subsection (2), the administrator of a plan shall not, directly or indirectly, invest the moneys of the plan in the securities of a corporation to which are attached more than 30 per cent of the votes that may be cast to elect the directors of the corporation.

(2) Subsection (1) does not apply in respect of investments in securities of

(a) a real estate corporation;

(b) a resource corporation; or

(c) an investment corporation.

12. (1) The administrator of a plan shall not, directly or indirectly, invest the moneys of the plan in the securities of a real estate corporation to which are attached more than 30 per cent of the votes that may be cast to elect the directors of the corporation, unless the administrator first obtains and deposits with the Superintendent an undertaking by the corporation that, while those securities are held, the corporation will

(a) file with the Superintendent, at such intervals or times as the Superintendent directs,

- (i) copies of its annual financial statements,
 - (ii) copies of its audited financial statements in respect of fiscal years ending after December 31, 1994,
 - (iii) a list clearly identifying the assets of the corporation and the market value of each asset,
 - (iv) a list of the names of its officers, directors and shareholders, and
 - (v) a certificate stating that the corporation is complying with its undertaking;
- (b) permit the Superintendent or an authorized member of the Superintendent's staff to visit its head office and to examine its books and records;
- (c) limit its activities to acquiring, holding, maintaining, improving, leasing or managing real property other than real property that yields petroleum or natural gas;
- (d) not carry on the activities referred to in paragraph (c) in respect of any real property that is not owned by, or on behalf of, or mortgaged to,
- (i) the plan,
 - (ii) the corporation,
 - (iii) any other real estate corporation in which securities to which are attached more than 30 per cent of the votes that may be cast to elect the directors of that corporation have been invested in by, or on behalf of, the plan pursuant to this subsection, or
 - (iv) any other real estate corporation in which securities to which are attached more than 30 per cent of the votes that may be cast to elect the directors of that corporation are owned by the corporation or by a real estate corporation referred to in subparagraph (iii);
- (e) procure, at the request of the Superintendent and at its own expense, an appraisal by one or more accredited appraisers of any parcel of real property owned by it or on its behalf;
- (f) not lend any of its assets to, or invest any of its moneys in, a related party of the plan;
- (g) restrict its investments and loans, other than investments in real property or in the securities of other real estate corporations, to those authorized for the plan under this Schedule; and
- (h) not invest, or hold an investment, in securities of any other real estate corporation to which are attached more than 30 per cent of the votes that may be cast to elect the directors of that corporation, unless the corporation first obtains and deposits with the Superintendent an undertaking by the other real estate corporation not to invest, or hold an investment, in the securities of any other real estate corporation.
- (2) A list of assets referred to in subparagraph (1)(a)(iii)
- (a) shall not include any asset, other than an asset referred to in paragraph (1)(g), that is not authorized under this Schedule; and
 - (b) shall value any securities that are included in the assets of the corporation at a value not exceeding the market value thereof.
- (3) Any financial statement of a plan filed pursuant to subsection 12(3) of the Act shall value the common shares of the real estate corporation held by, or on behalf of, the plan at a value not greater than the amount obtained by multiplying
- (a) an amount equal to the total assets of the corporation less the sum of its total liabilities and its preferred capital stock
- by
- (b) the number of common shares of the corporation held by, or on behalf of, the plan divided by the total number of the issued and outstanding common shares of the corporation.

13. (1) The administrator of a plan shall not, directly or indirectly, invest the moneys of the plan in the securities of a resource corporation to which are attached more than 30 per cent of the votes that may be cast to elect the directors of the corporation, unless the administrator first obtains and deposits with the Superintendent an undertaking by the corporation that, while those securities are held, the corporation will

(a) file with the Superintendent, at such intervals or times as the Superintendent directs,

(i) copies of its annual financial statements,

(ii) copies of its audited financial statements in respect of fiscal years ending after December 31, 1994,

(iii) a list clearly identifying the assets of the corporation and the market value of each asset,

(iv) a list of the names of its officers, directors and shareholders, and

(v) a certificate stating that the corporation is complying with its undertaking;

(b) permit the Superintendent or an authorized member of the Superintendent's staff to visit its head office and to examine its books and records;

(c) limit its activities to acquiring, holding, exploring, developing, maintaining, improving, managing, operating or disposing of Canadian resource properties;

(d) not carry on the activities referred to in paragraph (c) in respect of any Canadian resource property that is not owned by, or on behalf of,

(i) the plan,

(ii) the corporation,

(iii) any other resource corporation in which securities to which are attached more than 30 per cent of the votes that may be cast to elect the directors of that corporation have been invested in by, or on behalf of, the plan pursuant to this subsection, or

(iv) any other resource corporation in which securities to which are attached more than 30 per cent of the votes that may be cast to elect the directors of that corporation are owned by the corporation or by a resource corporation referred to in subparagraph (iii);

(e) procure, at the request of the Superintendent and at its own expense, an appraisal by one or more accredited appraisers of any Canadian resource property owned by it;

(f) not lend any of its assets to, or invest any of its moneys in, a related party of the plan;

(g) restrict its investments and loans, other than investments in Canadian resource property or properties to be used in connection with Canadian resource properties owned by it, loans secured by Canadian resource properties to persons resident in Canada for the exploration or development of such properties and investments in the securities of other resource corporations, to investments and loans authorized for the plan under this Schedule;

(h) not borrow money other than for the purpose of earning income from Canadian resource properties; and

(i) not invest, or hold an investment, in securities of any other resource corporation to which are attached more than 30 per cent of the votes that may be cast to elect the directors of that corporation, unless the corporation first obtains and deposits with the Superintendent an undertaking by the other resource corporation not to invest, or hold an investment, in the securities of any other resource corporation.

(2) A list of assets referred to in subparagraph (1)(a)(iii)

(a) shall not include any asset, other than an asset referred to in paragraph (1)(g), that is not authorized under this Schedule; and

(b) shall value any securities that are included in the assets of the corporation at a value not exceeding the market value.

(3) Any financial statement of the plan filed pursuant to subsection 12(3) of the Act shall value the common shares of the resource corporation held by, or on behalf of, the plan at a value not greater than the amount obtained by multiplying

(a) an amount equal to the total assets of the corporation set out in the balance sheet less the sum of its liabilities and its preferred capital stock

by

(b) the number of common shares of the corporation held by, or on behalf of, the plan divided by the total number of the issued and outstanding common shares of the corporation.

14. The administrator of a plan shall not, directly or indirectly, invest the moneys of the plan in the securities of an investment corporation to which are attached more than 30 per cent of the votes that may be cast to elect the directors of the corporation, unless the administrator first obtains and deposits with the Superintendent an undertaking by the corporation that, while those securities are held, the corporation will

(a) file with the Superintendent, at such intervals or times as the Superintendent directs,

(i) copies of its annual financial statements,

(ii) copies of its audited financial statements in respect of fiscal years ending after December 31, 1994,

(iii) a list clearly identifying the assets of the corporation and the market value of each asset,

(iv) a list of the names of its officers, directors and shareholders, and

(v) a certificate stating that the corporation is complying with its undertaking;

(b) permit the Superintendent or an authorized member of the Superintendent's staff to visit its head office and to examine its books and records;

(c) hold at least 98 per cent of its assets in cash, investments and loans;

(d) not issue debt obligations;

(e) obtain at least 98 per cent of its income from investments and loans;

(f) not lend any of its assets to, or invest any of its moneys in, a related party of the plan; and

(g) not invest, or hold an investment, in securities of any other investment corporation if there are attached to those securities more than 30 per cent of the votes that may be cast to elect the directors of that corporation, unless the corporation first obtains and deposits with the Superintendent an undertaking by the other investment corporation not to invest, or hold an investment, in the securities of any other investment corporation.

15. For the purposes of sections 16 and 17,

(a) where a transaction is entered into by, or on behalf of, a plan with a person who the administrator of the plan, or any person acting on the administrator's behalf, knows will become a related party to the plan, the person shall be considered to be a related party of the plan in respect of the transaction; and

(b) the fulfilment of an obligation under the terms of any transaction, including the payment of interest on a loan or deposit, is part of the transaction and not a separate transaction.

16. (1) Subject to sections 17 and 18, the administrator of a plan shall not, directly or indirectly,

(a) lend the moneys of the plan to a related party or invest those moneys in the securities of a related party; or

(b) enter into a transaction with a related party on behalf of the plan.

(2) Subject to sections 17 and 18, during the period of twelve months after the day on which a person ceases to be a related party of a plan, the administrator of the plan shall not, directly or indirectly,

(a) lend the moneys of the plan to that person or invest those moneys in the securities of that person; or

(b) enter into a transaction with that person on behalf of the plan.

17. (1) The administrator of a plan may enter into a transaction with a related party on behalf of the plan if

(a) the transaction is required for the operation or administration of the plan; and

(b) the terms and conditions of the transaction are not less favourable to the plan than market terms and conditions.

(2) The administrator of a plan may invest the moneys of the plan in the securities of a related party if those securities are acquired at a public exchange.

(3) The administrator of a plan may enter into a transaction with a related party on behalf of the plan if the value of the transaction is nominal or the transaction is immaterial to the plan.

(4) For the purposes of subsection (3), in assessing whether the value of a transaction is nominal or whether a transaction is immaterial, two or more transactions with the same related party shall be considered as a single transaction.

GENERAL

18. Sections 9 to 16 do not apply in respect of

(a) investments in a corporation that are held by, or on behalf of, a plan as a result of an arrangement, within the meaning of subsection 192(1) of the *Canada Business Corporations Act*, for the reorganization or liquidation of the corporation or for the amalgamation of the corporation with another corporation, if the investments are to be exchanged for shares or debt obligations;

(b) assets that are acquired by, or on behalf of, a plan through the realization of a security interest held by, or on behalf of, the plan and that are held for a period not exceeding two years from the day on which the assets were acquired.