

20 Questions Directors Should Ask about **Pension Governance**

Scott Sweatman, LLB



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Preface

CPA Canada has developed this *20 Questions* publication as part of its commitment to improving corporate governance. Our objective is to help company directors better understand the legal responsibilities and other aspects regarding the governance of pension and group benefit plans in Canada. This guidance is primarily directed at pension plan governance issues; however much of the commentary applies equally to group benefit plans.

While we direct our discussion to company directors, who are ultimately responsible for the oversight of pension and benefit plans, this guidance applies equally to pension committees, boards of trustees or others responsible for directing the administration of pension plans, whether public or private. This *20 Questions* publication may also help management understand the board's and their own role in the plan's governance and administration.

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Introduction

Pension plans play an important role in Canadian organizations. They help companies attract and retain workers, help employees plan and build funds for their retirement, and help smooth the transition from employment to retirement for employee and employer alike. But the importance of pension funds extends much further—influencing the capital markets in which they invest and contributing to the health of the Canadian economy overall.

Given these broad impacts, pension governance is a key consideration for boards of directors, who bear ultimate responsibility for all aspects of their companies' pension commitments. This *20 Questions* publication aims to help directors discharge their governance responsibilities in ways that optimize benefits to pension plan stakeholders while minimizing the financial risks and reputational consequences inherent to plan governance, for both directors and their corporations.

Good pension plan governance sets a process for making well-informed decisions that meet the prudence standard required by law. Good governance focuses on decisions, not results, and it can serve as an important defence against claims for breach of trust.

Of course, plan governance is not one-size-fits-all. The circumstances of a plan's sponsor, administrator and beneficiaries, and other plan-specific factors will shape what is appropriate and feasible. This publication doesn't set out answers or specific governance protocols. Rather, it provides questions and context to help directors build a framework for creating and maintaining well-defined governance practices and for delegating and overseeing governance functions in ways that comply with the board's legal responsibilities and suit the needs of the company they govern, its business and their plan.

This *20 Questions* publication aims to help directors understand:

- the significance of the pension promise for employees, sponsoring organizations and capital markets
- their roles and legal responsibilities for pension plan oversight
- aspects of good pension plan design, including the review and amendment of plans in place
- policies for funding the plan and reporting financial results to stakeholders
- policies and procedures governing how and where the plan's fund are invested
- the risks of operating pension plans, and some strategies for managing and mitigating those risks
- special pension plan governance issues, including delegation of plan administration to third parties, oversight of Supplemental Employee Retirement Plans, and legacy pension plan issues arising on the purchase or sale of a business

Although this publication focuses on the governance of pension plans sponsored by a single employer or a related group of employers, it also highlights some questions that directors should ask themselves about their role in overseeing any retirement savings or benefit plan.

The Pension Promise

In recent years, awareness has risen about the importance of retirement savings and the financial health of the plans in which they participate. All pension plans are based on a promise: a commitment by an employer to its workers that they will have a crucial source of funds available to them and their dependents in their retiring years. From plan beneficiaries through sponsors and administrators to capital markets, this promise touches a range of stakeholders in different and significant ways.

Significance for Plan Beneficiaries

As of 2013, 6,185,000 employees were members of Canada's registered pension plans, with just over half of them working in the public sector. About 38 per cent of all Canadian employees are covered by a registered pension plan, including 18 per cent of Canadian private sector employees.¹

A breakdown in the governance of a pension plan and a loss of security of pension assets could profoundly affect the quality of life of beneficiaries in their retiring years. For private sector employees who are fortunate enough to have a pension plan, their pension assets at retirement can be one of the most significant components of their personal assets.

¹ Statistics Canada, "Pension plans in Canada, as of January 1, 2014" (July 22, 2015) online: www.statcan.gc.ca/daily-quotidien/150722/dq150722b-eng.htm, accessed Nov. 8, 2015 [StatsCan].

Significance for Plan Sponsors and Administrators

For plan sponsors and administrators, pension funds can add significant shareholder value and strengthen their ability to attract and retain employees. However, pension plan obligations and their fund assets also carry material financial risks and reputational consequences to the plan sponsor's ongoing viability.

Risks related to pension funding changes with financial market cycles must be managed carefully:

- **In times of deficit:** Plan sponsors risk unfunded or underfunded defined benefit liabilities, as the sponsor must inject cash into the pension fund to meet minimum legislative funding standards.
- **In times of surplus:** The risk to plan sponsors is trapped capital. The provisions of the plan related to the allocation of surplus or actuarial excess in the plan are an important consideration for plan governance.

A recent study found that the median funded status of Canadian defined benefit plans is 89 per cent, down 1.6 per cent from the end of 2014.* The study also found that only 18 per cent of pension plans are more than fully funded from year to year.

*Rick Baert, "Aon Hewitt: Canadian Pension plans to continue to see funding declines", *Pensions & Investments* (31 March 2015), online: www.pionline.com/article/20150331/ONLINE/150339965/aon-hewitt-canadian-pension-plans-continue-to-see-funding-declines.

Significance for General Economy

Pension funds invest large amounts of funds in capital markets, real estate and infrastructure. In 2013, the total market value of assets in registered pension plans in Canada was \$1.5 trillion.² Collectively, the top ten public pension funds in Canada managed \$714 billion in assets in 2011. These assets represent some 35 per cent of all Canadian retirement assets and 80 per cent of public pension plan assets.³ Canada's top ten defined benefit pension funds have invested a total of about \$400 billion in Canadian assets.⁴

These statistics underscore the importance of good pension plan governance, not only to protect and build the assets of the plan but also to guard the personal liability and reputations of the directors responsible for overseeing the plan. If mishandled, pension and benefit plan risks can lead to costly litigation and the negative public exposure of a class action suit. In the next section, we explore the roles and responsibilities of directors in ensuring good pension plan governance.

² Statscan, *ibid*.

³ The Top 10, Canada's Top Ten Pension Funds: Helping Drive National Prosperity [Top 10].

⁴ *Ibid*.

Directors' Roles and Responsibilities

1. What Are the Key Aspects of Good Pension Plan Governance?

Directors are responsible for making sure processes and structures are in place that oversee, manage and administer the pension plan and the related pension fund.⁵ This includes allocating responsibilities and setting up mechanisms to provide accountability to plan members and the plan sponsor. Good governance requires clear accountability for decisions made about the plan, the implementation of control mechanisms to encourage good decision-making, and the regular review and reassessment of the plan's design.

From a legal perspective, pension governance aims to provide checks and balances for compliance with legal obligations related to the plan's administration and investment of plan assets. These legal obligations are imposed by statutes such as the pension benefits standards legislation and the *Income Tax Act*, as well as the common law, which gives rise to fiduciary duties, negligence accountabilities and contractual obligations.

Good governance requires comprehensive and critical review of plan documents and administrative policies and practices *before* problems arise. By asking questions, seeking information from management and third-party service providers and providing seasoned input, directors can help protect the plan administrator and other parties involved in the running of the plan (including themselves) from legal liability related to administration of the plan and the pension fund and potentially

5 These processes and structures apply equally to SERPs and non-registered capital accumulation plans.

improving plan administration and fund performance. Good pension plan governance also fosters timely, cost-effective delivery of benefits to plan members.

2. Does the Board Understand the Extent of the Organization’s Responsibilities as Plan Sponsor and Administrator?

A corporation is usually both the sponsor and the administrator of its pension plans and related pension funds. Directors should be aware of this dual role, as different legal obligations apply to the corporation depending on whether it is acting as plan sponsor or plan administrator in performing particular duties in respect of the plan.

Most significantly, the corporation owes fiduciary duties to plan beneficiaries when acting in its capacity as plan administrator, so it must put the beneficiaries’ interests before its own. When acting as plan sponsor, however, a corporation is not a fiduciary to plan beneficiaries in the strict sense and may act in its own best interest.

In light of these different, and potentially conflicting, legal obligations for board and committee members overseeing a pension plan, it is important to identify and understand which duties the sponsoring corporation and the board perform in their capacity as plan sponsor versus plan administrator.

Plan Sponsor Responsibilities	Plan Administrator Responsibilities
<ul style="list-style-type: none"> • establishing, amending and terminating the plan • determining funding and governance policies for the plan • setting accounting and actuarial assumptions and policies for the plan • approving the audit and actuarial valuation of the plan 	<ul style="list-style-type: none"> • interpreting the plan’s terms and related documents • administering the plan in accordance with its terms and applicable laws • investing plan assets and developing a statement of investment policies and procedures • overseeing and delegating responsibility for the plan’s day-to-day administration • implementing an appropriate pension plan governance structure

This dual role and the conflicts of interest that can arise are discussed in more detail below.

Statutory Requirements—Pension Legislation

As noted, registered pension plans are subject to pension benefits standards legislation. For example, the *Pension Benefits Standards Act* (1985) (“federal PBSA”) is the minimum standards pension legislation governing federally regulated entities. The *Pension Benefits Act* (Ontario) (“Ontario PBA”) governs pension plans with a plurality of membership in Ontario. Each province has its own pension legislation, except Prince Edward Island, which has not yet proclaimed its legislation in force. To qualify for and maintain registration under pension legislation, the pension plan must satisfy all of the legislation’s requirements.

Directors should also be aware of the statutory penalties that federal and provincial pension legislation can impose on the directors, officers or agents of a corporate administrator for contravening the legislation or an order made by a superintendent of pensions. Penalties range from \$100,000 for a first conviction to \$200,000 for subsequent convictions, and they apply to directors who may have caused, authorized or acquiesced in the commission of an offence under the legislation.⁶

Statutory Requirements: *Income Tax Act*

Registered Pension Plans

Registered pension plans must be registered under the *Income Tax Act*. To qualify for registration and obtain the favourable tax treatment, a pension plan must satisfy certain requirements, such as:

- limits on the amount of benefits that can be provided under a defined benefit pension plan and the amount that can be contributed to a defined contribution arrangement
- reporting obligations imposed on the administrator and funding agent
- restrictions on the investments that pension funds can make

⁶ Other than smaller fines imposed by regulators under prior pension legislation, the writer is not aware of any instances where directors or officers have been convicted under recently expanded offence and penalty provisions for non-compliance under which officers and directors can be held personally responsible. That said, directors should be aware of these provisions and that pension plan administrators have been subject to court action. See, for example, *Corewall Inc. v. Ontario (Superintendent of Pensions)* (1995), 12 CCPB 103 and the judgment of Ontario Court of Justice in the Canadian Commercial Workers Industry Plan (CCWIPP) trustee prosecution where Justice Beverly Brown imposed fines of \$18,000 on each of the nine trustees of the multi-employer pension plan along with surcharges of \$4,500 each for breaching the Ontario *Pension Benefits Act*.

Supplemental Employee Retirement Plans

Unlike defined benefit and defined contribution pension plans, supplemental employee retirement plans (SERP) are not tax-sheltered vehicles, so the *Income Tax Act* imposes no limits on benefits provided or contributions made under a SERP, other than the administrative test whether such contributions are “reasonable.” Similarly, tax law does not restrict the manner in which the assets of a SERP may be invested, if a decision is made to fund part or all of the SERP liabilities. If a decision is made to fund a SERP, it is normally done by establishing a retirement compensation arrangement via a custodial trust agreement.⁷ (SERPs are discussed in question 19.)

The Board’s Ultimate Responsibilities

Under federal and provincial pension legislation, primary legal responsibility for administering a pension plan and its related pension funds lies with the plan’s “administrator,” which usually is the corporation. Because most corporations are governed by a board of directors, ultimate legal responsibility under the pension legislation rests solely with the board. Although functions may be delegated (as discussed below), ultimate responsibility cannot.

Standard of Care

Pension legislation establishes varying standards of prudence expected of pension plan administrators when it comes to administering a registered pension plan and related fund. For example, under the *Ontario Pension Benefits Act (PBA)*, an administrator must use “all relevant knowledge and skill that [it] possesses or, by reason of [its] profession, business or calling, ought to possess”.⁸ The knowledge and skill that the administrator “ought to possess” is significant. By contrast, the federal *Pension Benefits Standards Act (PBSA)* requires an administrator to exercise “a degree of care that a person of ordinary prudence would exercise in dealing with the property of another person.”⁹ Other jurisdictions prescribe similar standards of care. These statutory obligations are enforceable by the applicable superintendent of pensions, and they are largely independent of the causes of action available in tort, fiduciary or trust law.

7 “A retirement compensation arrangement (RCA) is a plan or arrangement between an employer and an employee under which: the employer or employee makes contributions to a custodian of the RCA trust; and the custodian may be required to make distributions to the employee or another person on, after, or in contemplation of the employee’s retirement, the loss of an office or employment, or any substantial change in the services the employee provides”. Canada Revenue Agency, “Retirement Compensation Arrangements” (28 January 2015), online: www.cra-arc.gc.ca/tx/bsnss/tpcs/pyrll/clcltng/spcl/rrngmnt-eng.html.

8 *Pension Benefits Act*, RSO 1990, c. P 8, s. 22(1) [PBA].

9 *Pension Benefits Standards Act*, RSC 1985, c. 32 (2nd Supp), s. 8(4) [PBSA].

The distinction between an administrator's statutory versus fiduciary duties is important, particularly given the different forms and remedies that a person alleging a breach may seek, which range from statutory penalties to uncapped common law damages.

Conflicts of Interest

Pension legislation prohibits certain conflicts of interest that may arise in connection with a pension plan's administration.¹⁰ For example, a plan administrator (which includes the board) cannot knowingly permit its own interest to conflict with its duties and powers as administrator of the pension fund.

Pension legislation as well as the courts in Canada recognize that an employer-administrator does not violate conflict of interest prohibitions simply because it is both the employer and the administrator. For example, in the oft-cited case of *Imperial Oil Ltd. v. Ontario (Superintendent of Pensions)*¹¹ a group of employees objected to their employer's pension plan amendment which made eligibility for early retirement benefits more restrictive. Their argument was that the amendment was void on the basis that the employer was in a conflict of interest by ultimately reducing pension plan liabilities as a result of the more onerous early retirement eligibility and thereby increasing pension surplus available in the plan for the employer to use to reduce its service costs. The Pension Commission of Ontario rejected the employees' argument and thus affirmed what has since been coined the "two-hats" principle of employer-administration:

The Act recognizes that an employer may wear "two hats" in respect of pension plans. Indeed, section 8 specifically states that an employer may be an administrator. In that way, it acknowledges that an employer may play two roles and it is self-evident that the two roles may come into conflict from time to time.

This leads to the conclusion that, at least in the first instance, when the word "administrator" is used in section 22, it is used to mean the person or body administering the fund and who stands in a special fiduciary relationship with the plan members courtesy of the fiduciary standard of care set out in subsection 22(1) ...

¹⁰ See for example federal PBSA ss. 8(6)-(11) and Ontario PBA ss. 22(4).

¹¹ *Imperial Oil Ltd. v. Ontario (Superintendent of Pensions)* 1995, 18 CCPB 198.

We are of the view that an employer plays a role in respect of the pension plan that is distinct from its role as administrator. Its role as employer permits it to make the decision to create a pension plan, to amend it and to wind it up. Once the plan and fund are in place, it becomes an administrator for the purposes of management of the fund and administration of the plan. If we were to hold that an employer was an administrator for all purposes once a plan was established, of what use would a power of amendment be? An employer could never use the power to amend the plan in a way that was to its benefit, as opposed to the benefit of the employees.¹²

Board members should carefully review the terms of reference (or by-laws) for the pension committee or pension investment committee to determine the extent to which conflicts of interest may arise and how they would be addressed.

Importantly, directors should bear in mind that conflicts of interest arise in respect of *decisions*, not *roles*. For example, a conflict of interest does not arise simply because a trustee is also an officer of the company or a member of a union's executive. While conflicts should be examined and managed case-by-case, applying conflict of interest protocols on an ad hoc basis is rife with liability. It is better governance to follow a procedure designed and established before the conflict arises.

Investment Restrictions

Federal and provincial pension legislation in Canada restrict how registered pension plan assets can be invested. For example:

- no more than 10 per cent of the value of a plan's assets may be invested in or loaned to any one entity (subject to exceptions)¹³
- a pension fund may not own more than 30 per cent of the voting securities of any one corporation (subject to exceptions)¹⁴
- limits apply to investments in real estate and resource property
- investments in and loans to related parties are subject to restrictions¹⁵

12 *Ibid.* at paras. 30-33. See also Ari Kaplan and Mitch Frazer—*Pension Law*, 2d ed, (Toronto: Irwin Law Inc., 2013) at pp. 326-327.

13 Currently, value is assessed by using the *book* value of the assets, however, as of July 1, 2016, the threshold will be established using the *market* value of a plan's assets, in accordance with recent amendments to the Permitted Investments rules found in Schedule III of the Federal PBSA.

14 Ontario recently announced that it intends to eliminate this restriction. The Department of Finance, Canada, also released a consultation paper in June, 2016 seeking stakeholder input on the usefulness of the 30 per cent rule. Whether the "30 per cent rule" will be eliminated for all plans or only sufficiently large plans remains to be seen.

15 *Pension Benefits Standards Regulation*, CRC, s. 12(f) (1985).

The plan administrator is responsible for ensuring that plan assets are invested in accordance with these restrictions.

Fiduciary Duties

In addition to the requirements of pension legislation and the *Income Tax Act*, plan administrators are subject to common-law fiduciary duties with respect to the plan and its funds' investment. While management is responsible for the day-to-day aspects of these functions, the board is responsible for overseeing that they are properly carried out.

Basic Fiduciary Duties	Typical Fiduciary Roles of Plan Administrators
<ul style="list-style-type: none"> • duty to act reasonably and prudently • duty of loyalty to those persons whose interest the fiduciary is protecting (i.e., plan beneficiaries) • duty to avoid conflicts of interest • duty not to profit from the fiduciary's position and to account for any undisclosed profit • duty to hold an "even hand" between competing interests of those on whose behalf the fiduciary is acting 	<ul style="list-style-type: none"> • investing plan assets (including developing and implementing a statement of investment policies and procedures) • calculating and paying benefits • properly remitting contributions in the correct amounts and within the time required • communicating with plan members • administering the plan in compliance with its terms and applicable law

Regulatory Guidelines

Canada's various pension regulators have issued a multitude of regulatory guidelines. Board members should be familiar with the following guidelines and resources in particular to ensure management and the board, as plan administrator, adhere to these minimum best practice standards.

- *Office of the Superintendent of Financial Institutions (OSFI) and provincial regulators*—If a plan is federally regulated, the administrator's board members should follow the OSFI's best practices guidelines for plan governance. The guidelines are not law but whether they have been followed can influence a court in determining whether a course of conduct meets the industry standard of care and the administrator has met its statutory or common-law obligations. Provincial regulators also release policy statements and interpretive guidelines.
- *Canadian Association of Pension Supervisory Authorities (CAPSA)*—CAPSA, which counts OSFI and the provincial regulators among its members, has also issued best practices guidelines for pension plan administrators. CAPSA Guideline No. 4—"Pension Plan Governance Guidelines" recommends a broad, flexible outline of pension plan governance practices, and its frequently asked questions

documents offer related guidance, clarification and examples. CAPSA's "Self-Assessment Questionnaire" can help plan administrators evaluate how successfully their plan follows effective governance principles.

Delegation

Pension legislation permits a pension plan administrator to delegate its duties to agents, including employees or board members of the administrator (including pension committees — see question 3) and service providers, where it is reasonable and prudent to do so. Delegating at least some responsibilities to agents, employees and service providers is often prudent. For example, a plan administrator typically does not have the expertise required to determine an appropriate investment portfolio for the plan. However, delegation does not relieve the administrator of its ultimate responsibility for the pension plan and related pension fund. Board functions and tasks may be delegated, but overall fiduciary responsibility and supervision may not.

Courts have held boards of directors responsible for failure to properly supervise the individuals responsible for investments.¹⁶ As a result, delegated roles and reporting relationships should be clearly identified, risk management frameworks and controls should be implemented, and oversight mechanisms should be established and documented to ensure compliance with legal duties. Some of the key principles of delegation are identified by OSFI and CAPSA in their commentary and guidance for plan administrators.¹⁷

Pension Reform

Pension reform is a topic of an ongoing debate and study among policy makers.¹⁸ The driving question is: What can be done to help Canadians save more for their retirement? These studies have prompted numerous

16 *R v Cristophe et al*, 2009 ONCJ 586, 2009 CarswellOnt 7683, for example. The pension plan at issue was a multi-employer defined benefit pension plan. The Financial Services Commission of Ontario determined that pension investments for several years were not in compliance with the Ontario PBA. Each member of the investment committee was found guilty of failing to follow PBA investment limits. The investment committee's defence of due diligence was rejected. The board of trustees was found guilty for breach of supervisory duties. The court noted that fiduciaries must retain expert advisors if they do not have the requisite knowledge to fulfill their role. The court also stated that the law requires prudent and reasonable supervision of individuals. The board of trustees and the investment committee were criticized for the lack of detail in their meeting minutes and for not providing a reason for investment decisions.

17 See OSFI's "Guideline for Governance of Federally Regulated Pension Plans" and CAPSA's "Pension Plan Governance Guidelines", excerpts of which are included in the appendix to this paper.

18 See, for example, Canada, Expert Commission on Pensions, *A Fine Balance* (Ottawa: Ontario Expert Commission on Pensions 2008) and Alberta and British Columbia, Report of the Joint Expert Panel on Pension Standards, *Getting Our Acts Together—Pension Reform in Alberta and British Columbia*, (2008). Reforms in Quebec and New Brunswick were effected in 2008 and 2013, respectively.

reforms to pension legislation in several provinces and at the federal level, with a significant emphasis on new pension plan designs, such as target benefit plans, hybrid defined benefit and defined contribution plans.

Another result of these reforms is the rise of jointly sponsored or jointly governed pension plans in the public sector, with union and management joint trusteeship, and in the private sector, where employers are seeking ways to shift investment risk to employees. These kinds of plans may necessitate a reconsideration of pension governance. Shared risk requires shared governance between employers and employees, and not every employer in Canada is willing or able to give employees a governance role.

There is also a growing emphasis among some regulatory authorities in Canada on written governance and funding policies. Directors should be aware of these policies in order to avoid the liability and the unforeseen financial impact of failing to adhere to these funding and governance policy requirements.¹⁹

3. Is There a Written Policy or Terms of Reference for the Governing Pension Committee?

Boards may discharge their oversight duties and responsibilities by creating a mandate for a variety of board committees, such as:

- a committee responsible for pension investment only
- a committee with both investment and plan administration responsibilities
- an audit committee
- a human resources/compensation committee

Often no single committee has exclusive oversight responsibility for the pension plan and fund and comprehensive reporting to the entire board. The terms of reference of the board and any related management or audit committee should clearly set out the responsibilities that have been delegated to the various committees. Directors should review these terms of reference periodically, and also satisfy themselves that all responsibilities have been in fact delegated.

¹⁹ *Pension Benefits Standards Act* (British Columbia), SBC 2012, c 30, ss 44 & 42; *Employment Pension Plans Act* (Alberta), SA 2012, c E-8.1, ss 43 & 47.

Members' expectation that the benefit promise will be kept and remain competitive in the marketplace can lead to a conflict of interest for directors, given their dual role as fiduciaries to plan members and as directors responsible for the company's financial well-being. The board's responsibility should be clearly defined in a mission statement contained within a written governance document (i.e., terms of reference) and made in coordination with management. This will enable the board to engage in its oversight duties without interfering with the responsibilities of internal management and staff or external service providers on a day-to-day basis. This is no easy task, and its difficulty will vary with the organization's size and the sophistication of its internal resources.

The written governance policy should describe a process that permits the board to identify the key participants in the governance structure and how these participants relate to one another in terms of responsibility, accountability and authority in a way that properly aligns all areas of the fund's governance structure.

The makeup of the board should also be carefully considered, both to avoid undue conflicts of interest and to make sure that the plan administrator meets its legal standard of care. Pension legislation in certain jurisdictions requires the plan administrator to create governance documents that establish a process to identify directors' roles, responsibilities and educational and skill requirements for executing the administrator's duties in relation to the plan.²⁰ This is good governance practice, regardless of whether the laws of the plan administrator's jurisdiction require it.

In general, there are empirical links between weak governance, lack of due diligence in board member selection and failure to perform ongoing board self-evaluation. Specific problems include:

- lack of delegation
- lack of clarity between board and management responsibilities
- micro management of delegated bodies by the board
- lack of clarity in the board's mission
- failure to identify key risk management gaps and performance monitoring indicators²¹

20 *Pension Benefits Standards Regulation* (British Columbia), BC Reg 71/2015, s 50; *Employment Pension Plans Regulation* (Alberta), Alta Reg 154/2014, s 53.

21 These factors are identified in Keith Ambatscheer, Ronald Capelle & Hubert Lum, "The Pension Governance Deficit: Still With Us" (2008) 1:1, *Rotman International Journal of Pension Management* at p. 14.

Directors must exercise caution in their involvement in the plan's daily administration. Day-to-day decisions are best left to operational personnel, be they internal or external experts. However, at a minimum, board members responsible for the oversight of pension governance should be primarily responsible for three key areas:

- investment management
- pension benefit administration
- pension plan and fund administration

These responsibilities should be clearly articulated to address some fundamental objectives:

- pension benefits under the plan's terms are properly calculated and paid
- the standard of care set out under the plan's terms is met by confirming the fund is invested and managed prudently so there are sufficient assets to meet the plan's obligations to members
- compliance with all laws and regulations applicable to the calculation and payment of benefits while overseeing compliance with the plan's terms governing the investment and management of the fund assets

4. What Evaluation Processes Are in Place to Adhere to the Governance Structure and Written Policy?

Written policies can be a blessing or a curse. While they increase transparency and clarity of purpose, they can also increase legal risk, as failure to live up to a definitive procedure may create liability for directors. Written policies should be realistic (rather than aspirational), fit with the organization's goals and practices, and be reviewed periodically to check for proper implementation.

An Organization for Economic Cooperation and Development (OECD) study concluded that some serious cases of governance failure could have been avoided through more balanced representation of stakeholder groups on the governing body, better training of key stakeholders, and codes of conduct to address conflicts of interest.²² To overcome governance shortfalls, the OECD suggests:

²² Fiona Stewart and Juan Yermo, "Pension Fund Governance: Challenges and Potential Solutions" (2008), OECD, Working Papers on Insurance and Private Pensions, No. 18 at p. 7.

- ensuring that a governance document clearly defines the main duties of pension fund boards, focusing on key strategic decisions and functions, such as the choice of investment policy, selection and monitoring of the fund's key executive staff and external service providers, and monitoring of the fund's performance
- requiring that the documents governing the pension plan and/or the administrator clearly define the role and responsibility of the governing board, calling on the pension fund board to set out clear, measureable objectives
- encouraging members of the governing board to restate annually that they are aware of their governance obligations and other key documents relating to the fund
- considering the appointment of a top executive responsible for investment management (e.g., chief investment officer) and use of subcommittees (e.g., investment committee) to ensure that key topics receive sufficient consideration (subject to the fund's governance resources).²³

As part of the formal evaluation process for the plan's governance structure and delegation model, management and external advisors should report to the board at least annually on their compliance with their delegated mandates. In turn, the board should provide feedback and direction to management as required. Embedding this two-way reporting in the governance structure helps ensure that the roles and responsibilities of all parties are manageable and properly delegated. While smaller pension plans may need to rely more on external advisors than their larger counterparts, the board cannot turn a blind eye to its oversight responsibilities.

²³ OECD, *supra* note 15 at p. 14.

U.K. Stewardship Code—7 principles of good governance

Directors of companies with large pension fund investments outside of Canada should be aware of the U.K. Stewardship Code, which aims to promote better quality of monitoring and engagement between investee companies and institutional (pension fund) investors. The code asserts the board's role in "establishing the culture, values and ethics of the company" and in setting the "tone from the top".²⁴ While only U.K. investors are required to comply with the code, directors of large Canadian pension funds may wish to incorporate the code's seven principles into their governance practices.

The code commits institutional investors to:

1. publicly disclose their policy on how they will discharge their stewardship responsibilities
2. have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed
3. monitor the companies they invest in
4. establish clear guidelines on when and how they will escalate their stewardship activities
5. be willing to act collectively with other investors where appropriate
6. have a clear policy on voting and disclosing voting activity
7. report periodically on their stewardship and voting activities²⁵

24 Financial Reporting Council, 2015 *Annual Report*, "Developments in Corporate Governance and Stewardship" at p. 3.

25 Financial Reporting Council, September 2012, *The UK Stewardship Code*, at p. 5.

Pension Plan Design

Employers in Canada have no legal or statutory duty to provide pension or benefit plans to their employees unless there is an existing collective agreement or the organization has acquired a corporation with pension and benefit plans and is required to continue providing those benefits.

In reality, pension and benefits are an important component of competitive employee remuneration in most sectors of the Canadian economy. Employers may also be bound by unconditional pension and benefit promises they have made in the past.

5. What Is the History of the Pension and Benefit Plans? When Were They Last Reviewed from a Cost-Benefit Perspective?

Directors should articulate the purpose and objectives of existing pension and benefit plans and evaluate whether they are being met. Just because a pension or benefit plan is already in place does not mean its current form cannot change, especially if other forms of compensation would better align with the employer's business goals and objectives while still attracting and retaining employees.

Mature organizations may sponsor several pension plans, requiring directors to oversee a mix of defined contribution plans, legacy defined benefit provisions, and plans that have converted from defined benefit to defined contribution. A pension fund's assets may be disproportionately large relative to the organization's operating assets, requiring the chief financial officer and audit committee to consider how to deal with the assets and corresponding liability.

In low discount rate environments, the assets and liabilities of defined benefit plans are often mismatched. Directors should consider the corporation's philosophy toward funding defined benefit plans. For example, does the organization aim to provide only the minimum funding to defined benefit plans needed for the plan to survive and avoid potential litigation by disgruntled employees and their unions? Or does the organization seek to fully and conservatively fund its pension promises? Is there fear of trapping capital inside the defined benefit trust fund if a market opportunity to eliminate funding deficits arises? Directors should review the plan's structure and text to ensure they reflect the organization's approach to such problems.

6. What Steps Are Taken to Make Sure Employees Understand the Plan and Their Responsibilities to Optimize Their Benefits?

One common flaw in plan delivery is that plan sponsors fail to clearly explain to their employees the purpose, objectives and rules of the plan and employees' responsibility to optimize their benefits. Setting up a plan and delegating its administration to a service provider or consultant is not enough. The plan sponsor should make sure employees know about the tools available to help them plan their finances and meet their retirement goals. Canadian courts have not been kind to employers who have neglected to adequately advise employees of the nuances of their plans and their benefits and risks.²⁶

By contrast, gaining an understanding of how employees perceive the value proposition of pension and benefit plans can give directors invaluable information for use when creating or changing the structure

26 *Deraps v Labourer's Pension Fund of Central and Eastern Canada*, 1999 OJ 3281 (Ontario Court of Appeal). The spouse of a union member signed a waiver waiving all rights to her spousal pension benefits on her husband's death. The wife sued claiming that no one had explained the waiver to her. The court found that the plan advisor owed a duty of care to provide her with "complete and clear information."

Spinks v R, [1996] FCJ No 352 (Federal Court of Appeal). The employer described the main features of the pension plan at a standard benefits information session given to an immigrant employee when he was hired, but did not point out a foreign service buy-back feature of the plan (in the meeting or booklets), which the employee would have been interested in had he known about it. The court held that an employer has a "duty of reasonable disclosure" when an employee has a unique need for specialized information. The employee reasonably relied on booklets and administrative process to inform him about his pension rights. Also, the employee cannot be expected to ask specialized questions; it's up to the employer to point out aspects of the benefit plan that may be of interest to the employee.

Allison v Noranda, 2001 NBCA 67 (New Brunswick Court of Appeal). The employer's severance package gave a terminated employee the option of a lump sum or salary continuance. The offer letter did not spell out the difference in the pension benefit under the two options. The letter did advise the individual to obtain independent legal advice in considering the offer. The terminated employee picked one option, but later claimed that he would not have done so if he had been aware of the impact on his pension entitlement. The court held that the employer was liable for failing to disclose the difference. The court said, "a caution to seek independent advice cannot override an obligation to make full disclosure."

of employee compensation, and of pensions and benefits in particular. Seeking input from employees, internally or from the market, can help the organization win buy-in for changes and identify potential implementation hurdles.

7. Are the Employee Communications That Explain the Pension and Benefit Plans Up-to-Date and Free of Legal Liability?

When a board approves material changes to an existing pension or benefit arrangement, employees may argue their compensation has changed to such a degree that they have been constructively dismissed, particularly where pension or benefit promises are part of their employment agreements. Changes are easier to make where the pension and benefit plans contain sufficient reservation of rights to amend (or terminate) existing plan provisions. To mitigate such claims, employers should give notice and/or pay consideration to offset any adverse financial impact of the change. Boards should also seek advice on their legal obligations to their employees regarding unilateral changes to pension and benefit entitlements.

8. Are There Potential Organized Labour Considerations and Demands Associated with the Plan?

Boards that are considering changes to existing plans should consider how unions might respond and, to the extent possible, work with unions and employees to implement any changes. Pension and benefit entitlements may be enshrined in collective agreements. These would need to be amended to accommodate any changes, even if the union is on board. Depending on the relationship between the union and management, engaging with unions early in the change management process is important for gaining their input and identifying issues that could stall the process.

Funding and Financial Reporting Policies

9. Is a Written Funding Policy in Place and, If So, What Is Its Scope?

An effective governance model for pension plans starts with the pension promise, regardless of whether the commitment was pledged to employees or negotiated with the union. Once the promise is clearly identified and understood, a funding policy should be developed that includes provisions on management supervision.

A funding policy is fundamental to the plan's governance framework. The policy assists the fiduciaries responsible for plan oversight to better understand and follow clearly articulated strategies aligned with the plan's objectives in order to reduce the risks and costs of delivering on the pension promise.

Before Alberta and British Columbia introduced new pension legislation in 2014 and 2015, respectively, there was no legislative requirement in Canada to adopt a funding policy for a defined benefit plan. Nevertheless, most defined benefit plans of any significant size have adopted some form of written funding policy.

Developing a funding policy requires discipline and expertise on the part of the plan sponsor and the board. As with all governance, the funding policy should evolve with changing capital markets, demographics and investment opportunities that arise. The funding policy should also align with the organization's governance capabilities and other governance policies.

In particular, a funding policy should address:²⁷

- the funding objectives for the plan regarding benefit security, benefit levels, stability and affordability of employer and employee contributions and the extent to which contribution levels can be adjusted
- the demographic characteristics of the plan's beneficiaries
- the financial position of the pension plan
- the financial position of the sponsor and the competing organizational demands for cash
- the terms of the plan documents and related agreements, such as a collective bargaining agreement between the plan's sponsor and the beneficiaries (see question 10)
- material risks that may affect the plan's going concern funding requirements, tolerances for those risks and internal controls for managing them (see question 11)
- the parameters of acceptable risk for the going concern and solvency funding ratios of the plan and expectations for the amortization of unfunded liabilities and solvency deficiencies
- an assessment of whether the policy puts the plan sponsor at any risk of a cash call beyond the ability of the corporation to fund or leverage existing credit covenants with their bank by way of letters of credit to secure the solvency deficiency
- minimum funding requirements under applicable pension legislation and how the plan will deal with unexpected funding deficiencies
- situations where accelerated funding of the deficiency beyond minimum statutory requirements is permissible or required
- maximum limits applicable to the pension plans under the *Income Tax Act*
- the use of surplus or actuarial excess determined by the actuary, including legislative and plan provisions on the use of excess funding
- the accounting and financial reporting implications of the pension plan

The development of a well-documented funding policy requires coordination with the plan's actuary. Frequent actuarial valuation reports and a robust discussion with the actuaries about their suggested actuarial methods and assumptions should be integral to the funding policy and aligned with the plan's own risk tolerance limits.

27 See CAPSA Guideline No. 7—"Pension Plan Funding Policy Guideline" issued in November 2011.

Keep in mind that the plan beneficiaries are entitled to see a copy of the funding policy. In theory, disclosure of the policy should improve the transparency of the sponsor's funding decisions and increase beneficiaries' understanding of pension funding issues. The board should be prepared to defend and adapt the funding policy if challenged.

10. Are the Fund and Agreed Contributions from Employer and Employees Enough to Meet Any Benefit Obligations Negotiated Under a Collective Bargaining Agreement?

Because of the long-term nature of pension and non-pension post-retirement benefits (discussed in more detail below), plan sponsors should take a long-term view of the sufficiency of current contribution requirements to provide promised benefits. Members are living longer, generational demographics are shifting, and medical costs are increasing. Today's contribution levels may not be enough to fund tomorrow's entitlements. Contribution rates or a decision to pre-fund benefits will be a significant bargaining issue with unions, and their position should be considered in discussions about the sufficiency of contributions or changes to coverage.

11. What Risk-Testing Has Been Conducted to Provide That Pension Funding and Related Financial Reporting Would Match Expected Returns?

While each plan's risk profile and tolerance are unique, all funding policies for defined benefit plans should address the following inherent risks:

- **Going concern assumption risk** —*The risk that the events set out in the going concern actuarial assumptions turn out to be far worse than originally anticipated, resulting in an asset-liability mismatch.*

Since all actuarial assumptions bear a level of risk, a clear understanding of those risks within the assumptions the actuary has proposed is fundamental. The biggest drivers of liabilities, and thus uncertainty, are usually the fund's rate of return and the mortality rate of the plan's members. Directors should consider the short- and long-term rate of

return assumptions of the various asset class investments within the plan and keep up with changing actuarial standards, such as updated mortality tables.

- **Mismatch of cash flow risk** —*The risk that certain investments may have to be liquidated when their values have been depressed by poor and unexpected market conditions.*

Directors should consider whether the plan has investments with a high degree of volatility that could affect the plan's ability to pay benefits should the value of those investments decline dramatically.

- **Solvency risk** —*The risk that the plan's liabilities on the windup of the plan will exceed the assets available to settle them.*

In response to extended periods of low long-term bond and interest rates in Canada, many plans have developed liability-driven investment (LDI) strategies to avoid the volatility associated with more traditional equity investments. LDI strategies are far more developed than they were several years ago, which should bring comfort to directors responsible for defined benefit plan oversight.

- **Inflation risk** —*The risk that members' pension benefits will not keep up with inflation.*

Whether a plan provides *ad hoc* indexing or some form of guaranteed indexing, inflation risk must be taken into account within the funding policy to address situations where members' pension benefits are not keeping up with the rate of inflation, ultimately eroding the value of the pension promise.

Risk management and mitigation related to pension plan operations and investments are discussed at question 17.

12. How Are Results Reported to Investors?

Provincial and federal pension legislation require pension plan administrators to file financial statements for the pension fund. Audited financial statements are required for plans with defined benefit formulas and assets valued at over \$10 million as at the plan's fiscal year end. Audited financial statements must be prepared in accordance with the accounting standards contained in the *CPA Canada Handbook - Accounting* and

CPA Canada Handbook-Assurance. Pension regulators hold that the new accounting standards for pension plans should apply to both the pension plans and the pension funds.

Pension plan financial statements are coming under increasing scrutiny. Pension regulators are requesting increased disclosure in financial statements to enable them to assess plan administrators' objectives, policies and processes for managing capital. Credit rating agencies and institutional investors are reviewing them to assess the health of a pension plan and whether its liabilities could adversely affect the sponsor organization. From a governance perspective, directors should ensure that the auditors preparing the pension plan's financial statements are truly independent and have the required expertise.

Investment Policies and Procedures

13. Does the Statement of Investment Policies and Procedures (SIP&P) Clearly Set Out the Investment Performance Objectives and Other Criteria for the Pension Committee’s Review?

Good governance focuses on prudent, well-documented decision-making, and not on investment results based on factors that are often outside of the board’s control. For each pension plan, a SIP&P should be in place setting out terms governing investment policies and procedures for the plan’s portfolio of investments and loans. According to the Financial Services Commission of Ontario, the SIP&P should address:

- the types of investments and loans used by the fund
- diversification of holdings
- asset mix and expected rates of return
- liquidity of investments²⁸

The SIP&P should also set out the sponsor’s policy toward pension plan investments, changes in response to market conditions, compliance with relevant legislation and regulatory guidance, conflicts of interest and expectations regarding codes of conduct, discussed below. As discussed later in this section, the SIP&P should also clearly state the board’s investment philosophy, strategy and risk profile in line with the company’s funding policy.

²⁸ Financial Services Commission of Ontario, “FAQs—Statement of Investment Policies and Procedures,” at www.fsco.gov.on.ca/en/pensions/legislative/Pages/sipp.aspx

Meeting the “Prudent Person” Standard

Pension legislation requires a “prudent person portfolio approach” to managing pension plan investments. By following this approach, the board should meet its fiduciary obligations for the plan’s funding as obligations come due. Putting the prudent person standard into practice can be challenging, given the limited time and expertise available to most board members. Delegating authority to make investment decisions to management is therefore crucial. If management lacks the requisite investment expertise, they should retain it at a reasonable price.

Responding to Market Changes

A common challenge facing board members responsible for pension plan investment oversight is the extent to which a fund’s investment policy should be amended in response to changes in the investment landscape and emerging opportunities. Keeping up with what other pension plans are doing and what other investment opportunities may exist is important, but board members and management should be wary of following the pack.

Investment policies are not one-size-fits-all; they must suit the unique circumstances of a given plan and sponsor. Frequent investment policy changes defeat the purpose of a well-designed investment policy based on sound principles and objectives and developed based on the experience and expertise of current and former directors and management. Frequent changes can also be counterproductive and form the basis of allegations of active management of the pension fund by board members who may not have the requisite expertise.

Compliance with Legislation and Regulatory Guidelines

Directors should consider whether the SIP&P clearly states that it complies with applicable pension and tax laws and regulatory guidelines. With the exception of Ontario registered plans, SIP&Ps are not required to be filed with the pension regulators.²⁹ Some jurisdictions require a statement filed with the annual information return indicating that the SIP&P has been established and that the plan complies with the policy. For example, the Ontario PBA requires an investment information summary to be filed for all defined benefit plans within six months of the plan’s fiscal year-end. Regulators may ask to view SIP&Ps, and pension legislation generally gives plan members the same right of access.

²⁹ Effective January 1, 2016, administrators of Ontario-registered pension plans must file the pension plan’s SIP&P with the Financial Services Commission of Ontario (FSCO). Before this change, plans registered in Ontario were required to have an SIP&P but did not have to file it with the regulator.

14. Are Management and External Investment Managers Required to Verify Compliance with the SIP&P Annually?

Larger pension funds in Canada make a practice of reviewing their SIP&P quarterly and conducting a more robust review annually to ensure that external managers are able to certify compliance with the quantitative and qualitative parameters of the SIP&P. This is not always simple, given the many parties that may be involved in executing the fund's goals and objectives and the challenges inherent in monitoring decisions delegated to management and third-party investment managers.

Conflicts of Interest and Codes of Conduct

SIP&Ps often lack a sufficiently robust approach to conflicts of interest. Directors should review the SIP&P to ensure its conflict of interest guidelines apply to all board members, the pension and/or investment committee, management and the plan administrator. While definitions of "conflict of interest" vary from plan to plan, a fundamental component is that no one involved in the investment process may exercise their powers in respect of the plan in their own interest or in the interest of related third person, or act on behalf of the plan in any situation of actual, potential or perceived conflict between their personal interests or their corporate interests and their duties with respect to the investment of the pension fund.

Disclosure is an integral part of an SIP&P's conflict of interest provisions. Individuals should disclose the nature and extent of any actual, potential or perceived conflict of interest to the CEO or CFO and the chair of the investment committee (if any) as soon as the individual is aware of the conflict. Disclosure should be made whether the conflict arises before or after the transaction giving rise to the conflict is completed. For purposes of transparency and subsequent disclosure, the disclosure should be made in writing to the committee chair so that the chair can in turn advise the other committee members of the potential conflict. Abstention from all discussions and decisions made regarding the matter giving rise to the conflict should be the minimum default response.

Because ultimate responsibility rests with the plan administrator, the board should ensure that its delegates and third-party service providers meet the same conflict of interest and conduct expectations. While these expectations often reflect legal obligations, the nature of the plan sponsor itself may require additional considerations.

15. Does the SIP&P Clearly State That the Board's Investment Philosophy, Strategy and Risk Profile Is in Line with the Company's Funding Policy, and Does It Include Policies for Permitted Investments and Investment Guidelines?

The overarching goal of a SIP&P is to make sure that the pension plan assets are invested prudently. The principles of responsibility, accountability, delegation and supervision apply equally to investment policies as they do to governance generally, so the SIP&P and governance policy should align with one another.

As with governance, there is no one-size-fits-all asset mix. When setting investment limits and guidelines, the board should consider the plan's characteristics, such as the demographics of the plan's membership.

Assets may include a mix of:

- short-term instruments
- fixed-income instruments
- public and private equities
- real property
- derivatives
- infrastructure

Environmental, Social and Governance Factors

Increasingly, larger pension funds in Canada and globally are taking into account environmental, social and governance (ESG) factors and other non-balance sheet sustainability factors in their investment philosophies. Canada's large public sector pension funds, including CPP, Ontario Teachers', Healthcare of Ontario Pension Plan, Ontario Municipal Employees Retirement System, British Columbia Investment Management Corporation and others, have incorporated ESG factors into their investment policies. CPP Investment Board has stated:

We believe that organizations that manage Environmental, Social and Governance (ESG) factors effectively are more likely to create sustainable value over the long-term than those that do not. As we work to fulfill our mandate, we consider and integrate ESG risks and opportunities into our investment decisions.

In Ontario, all SIP&Ps must now include information about whether the SIP&P incorporates ESG considerations and, if so, the plan's investment strategy for addressing them.

To date, Financial Services Commission of Ontario (FSCO) has not legislatively defined what it considers ESG factors to be. Recent guidance from FSCO describes ESG factors in high-level terms as follows:

- **Environmental**—the way a company or industry interacts with the physical environment
- **Social**—the impact of a company or industry on a community or society
- **Governance**—how a company or industry and the countries in which it operates are governed

Ontario's current regulations do not explicitly require plan administrators to include ESG factors in their investment decision-making process, only that administrators disclose whether those factors are considered when making investment decisions. This will present challenges not only for many Ontario-registered pension plans but also for pension plans in other Canadian jurisdictions that are considering the extent to which they should incorporate ESG factors in their investment strategies and disclose ESG-based investment decisions to plan members.

16. For Defined Contribution Plans, How Does the Company Monitor Performance of Member-Directed Investments?

Some directors mistakenly believe that defined contribution plans need less governance and oversight than defined benefit plans, in part because defined contribution arrangements transfer investment risk from the employer to the employees.

While this is true to some extent, directors are not free from responsibility for defined contribution investment oversight. Pension, securities and insurance legislation impose considerable liability for directors if management and the board do not regularly review the selection and oversight of investment options available to plan members in order to ensure the options are sufficiently diversified and competitively priced.³⁰

³⁰ There is an increasing focus on the disclosure of management fees. See for instance, the U.S. Department of Labor 401(k) regulations, which require plan providers to give more details about what employers pay for retirement plan administration and other services. In Canada, National Instrument 31-103, adopted by Canadian Securities Regulators, includes fee disclosure requirements effective July 15, 2016.

Risk Assessment and Management Controls

17. How Are the Risks of Operating the Plan or Legacy Plans Evaluated?

Pension fund investors and pension committees tend to focus on the annual returns on investments when evaluating the performance of the fund and the experts they hire to advise on the fund's investment. This is not surprising. Investment returns are tangible and are relatively easy to communicate accurately in reports to stakeholders.

However, the inherent risks of investments are often not understood or properly evaluated, and the long-term risks to sponsoring organizations are often overlooked. With plan members living longer and long-term interest rates remaining low, the liabilities associated with defined benefit and benefit plans are increasing.

Attention to the risks present in any investment environment is key to sustainable asset management.

(I)n fulfilling your duties as a trustee, risk plays a much more important role than do returns. Returns are the past; risk is the future. The investment committee can attempt to influence the direction of the Fund only in the future, not in the past. Benjamin Graham, the father of security analysis, once said, "the essence of investment management entails the management of risk, not the management of returns."³¹

31 Jeffrey V. Bailey, CFA, Jesse L. Phillips, CFA and Thomas M. Richards, CFA, *A Primer for Investment Trustees* © 2011 The Research Foundation of CFA Institute ISBN 978-1-934667-33-0 at p. 47.

Investment risk generally arises in three areas:

- capital market risk
- active management risk
- liquidity risk

For pension fund investments, additional risks include the solvency funding risk of defined benefit plans and the liabilities that the rising cost of health care benefits bring. Combined, these risks pose a potentially greater risk to the survival of the plan sponsor as a going concern if those costs escalate beyond the employer's ability to pay for them.

In fact, solvency liability funding requirements of defined benefit plans could pose the biggest challenge to pension plan governance and the highest reputational risk for the directors responsible for their oversight.

At a minimum, directors should verify that management conducts a periodic asset-liability study to help identify and manage the risk factors facing the plan and its sponsor. Asset-liability studies project assets and liabilities into the future under diverse economic and market scenarios. Actuaries can evaluate a variety of asset mixes and investment strategies to help determine which strategies are best suited to the plan's objectives and the company's ability to withstand the impact of market volatility on plan liabilities. An asset-liability study should aim to:

- re-evaluate liability benchmarks to ensure that the key financial objectives are still achievable
- evaluate how alternative investment options might reduce the overall funding volatility on assets versus liabilities
- evaluate investment strategies undertaken and their impact on the plan's objectives
- test the plan's sensitivity to a variety of risks in order to develop a realistic risk strategy and funding policy
- evaluate and explore risk transfer options to manage changing longevity risks

The board should also examine any legacy risks arising from promises made by former board members and management, including the extent to which promises to former employees (e.g., through collective bargaining) can be amended to mitigate those liabilities. If not, directors should determine what steps can be taken to settle some legacy liabilities and remove them from the balance sheet over a reasonable time period.

One little understood liability facing large Canadian corporations arises from promises made in the past to provide post-retirement non-pension benefits, also known as other post-employment benefits (OPEB). Most OPEB liabilities relate to promises made by previous employers to provide health, dental and life insurance benefits to retirees and their dependants for their lifetime. These liabilities are often poorly documented, unfunded and, in most cases, uninsured.

As part of directors' ongoing risk assessment and management, the board should require an annual report from management on pension administration and compliance that covers:

- membership statistics, particularly any movement from one year to the next that would affect ongoing funding costs, liabilities and asset matching requirements such as the number of retirements, departures and new member entrants
- liabilities, on both going concern and solvency bases, with emphasis on trends
- whether the investment managers are complying with the SIP&P
- whether transactions and investment holdings meet the terms of investment management agreements
- whether the investment managers have had any significant changes to their management structure
- asset and liability mix policy
- compliance with the pension funding guidelines
- currency guidelines, if any, to ensure that the fund is effectively managing its foreign currency risk exposure
- voting rights associated with equity investments and whether management has acted to ensure investment managers have voted proxies as instructed;
- compliance with restrictions on related-party transactions
- investment assets and liabilities, on an ongoing basis
- conflict of interest reporting
- fraud prevention and detection compliance
- any other compliance with ongoing management initiatives that the board has required management to report on and comply

Board members should also explore with management and their advisors the various de-risking strategies that are available for their defined benefit pension plan. De-risking strategies can vary from full or partial conversion of defined benefit to defined contribution design,

amendments to reduce or remove indexation, the introduction of lower benefit accrual formulas, and a variety of liability-driven investment (LDI) strategies.

In Canada, there is a trend for defined benefit plans to de-risk financial obligations to retirees through the purchase of buy-in (and buy-out) annuities. A buy-in annuity enables the plan administrator to purchase an annuity contract from an insurance company. In exchange, the insurer pays periodic payments to the plan that mirror the projected benefit payments. While a buy-in annuity does not relieve the plan sponsor from ultimate responsibility to pay the promised benefits, the insurer assumes the longevity risk inherent in a defined benefit plan as well as the associated investment risk.

By contrast with a buy-in annuity, where the assets and liabilities remain on the plan sponsor's balance sheet, the more traditional buy-out annuity transfers the liabilities to the insurer such that the insurer and not the sponsor, makes pension payments directly to retirees and assumes all investment and longevity risk, thereby removing the pension liabilities from the balance sheet. Buy-outs are most common on a plan termination and wind-up.

Special Issues and Situations

18. What Is the Board's Role When Pension Plan Administration Is Delegated to Third-Party Advisors?

A board should not be directly involved in the hiring and supervising of third-party advisors to the administrator of a pension or benefit plan. Directors should focus primarily on policy setting, strategy, risk assessment and monitoring of the performance of the various governing fiduciaries.

The board should periodically review management's processes to satisfy itself that:

- management has the requisite knowledge and skills to perform its delegated function and carry out its own internal due diligence processes and oversight
- service providers are selected in a competitive environment while avoiding conflicts of interest in other aspects of the sponsor or administrator's business
- appropriate reporting mechanisms are in place to facilitate proper management and third-party oversight

If management has established a sufficiently solid network of internal and external consultants to help hire, supervise and oversee external advisors, the board should not be involved unless absolutely necessary. That being said, management should be encouraged to seek board input whenever there are changes in the strategic direction of the plan investments or unanticipated changes in the plan's risk profile.

Management should also work closely with their actuarial consulting and investment management firms to negotiate lower fees whenever possible, particularly as the pension fund's size and buying power increase. In theory, lower investment management and related administrative fees should help lead to higher investment returns for plan members.

19. If Provided, Are Supplemental Employee Retirement Plans (SERP) Benefits Subject to Appropriate Board Oversight?

SERPs are often established to supplement pension accruals and make whole employees whose earnings are affected by the maximum pension accrual rules under the *Income Tax Act* and regulations. In the past, companies provided SERPs only to their senior executives, but recent survey data shows that half of Canadian SERPs now cover a far broader range of employees.³²

Most SERPs mirror the provisions of the base registered pension plan offered to the employees. SERPs may be funded by prefunding, letter of credit or partial funding to a retirement compensation agreement (RCA), similar to a registered pension plan, or they may be unfunded, where benefits are paid out of general revenues on a pay-as-you-go basis. The proportion of funded to unfunded SERPs remains low.

In most cases, pension standards legislation does not apply to a SERP's accrued benefits or contributions. However, some jurisdictions in Canada may apply certain aspects of their legislation, or argue that the legislation should apply, to secure the SERP promise.

SERPs often comprise part of the total compensation referenced within the employees' employment contracts. These terms are often overlooked or have not been updated in years, which may prompt challenges by the employees upon a reorganization or change of control of the corporation. Given the significant liabilities that accrue for longer-service employees, directors should ensure SERPs are subject to appropriate oversight.

³² Mercer, *Supplemental Executive Retirement Plans in Canada* (April 2015) [unpublished, archived at www.mercer.ca/content/dam/mercer/attachments/north-america/canada/serp-database-report-canada-eng-april-2015-mercer.pdf].

For example, the board should be alert to any triggering events related to SERPs set out in employment agreements. Such events may include:

- a change of control of the corporation that triggers the SERP's immediate funding
- non-solicitation and non-competition provisions that affect the SERP entitlement
- a formula within the SERP that requires a certain number of years of service before all or a portion of the SERP is payable

In addition, directors should monitor the coordination of the SERP liability on the corporation's balance sheet and the potential integration of the SERP with registered pension plan benefits. For example, if the registered pension plan is amended, consider the impact on SERP liabilities and how changes to the registered pension plan should be communicated to the SERP member, who may expect their SERP benefits to continue to mirror the registered pension plan's former terms. In such cases, the SERP member might argue that the reduced or adjusted accrual of the registered pension plan without notice is a form of constructive dismissal.

20. On the Purchase or Sale of a Business, Are the Target's Current and Legacy Pension Liabilities Understood Well Enough to Determine Representations and Warranties?

In business transactions, representations and warranties from both vendor and purchaser, whether in an asset or share transaction, can be extensive and require careful due diligence by parties on both sides well before the deal is completed.

Due diligence issues related to pension plans vary depending on whether the transaction is a share or an asset deal:

- In a share transaction, the buyer assumes all of the seller's pension and benefit plan assets and liabilities, as well as any obligations negotiated through collective agreements.
- In an asset deal, the buyer does not necessarily assume pension assets and liabilities, unless the buyer is deemed as a successor employer to a collective agreement or agrees to provide a similar level of benefits as part of the bargain.

Problems often arise after the transaction closes, particularly where the acquired company has provided a multitude of pension and benefit promises to legacy employee groups under previous corporate structures. Documentation of legacy plans is often poorly organized or poorly understood, which makes the scope of risk difficult to determine.

Whether the organization is the buyer or seller, directors should ensure the following due diligence steps are taken:

- Establish whether the pension and benefit documents are up to date and in the data room.
- Identify key human resource personnel to involve in the transaction to ensure that the historical documents and promises that were made to key executives and employee groups are well understood and adequately documented. If there are gaps in the historical documentation, consider what steps should be taken to verify key provisions and ensure the benefits can be accurately costed, documented and absorbed post-closing.
- Ensure long-standing legacy plan regulatory filings, such as asset transfer agreements, plan merger approvals and surplus sharing arrangements, comply with legislative and regulatory requirements.
- Review what may appear to be innocuous documentation, including old employee booklets and internal corporate memoranda. Such employee communications may constitute promises or representations made by prior employer-owners and provide significant benefit entitlements (e.g., OPEBs) for the retired employee's lifetime. These promises are often understated in the organization's balance sheet, and changing such benefits for retirees is likely contractually impossible.³³
- Determining whether a change of control would trigger the funding of SERP benefits or other deferred compensation such as deferred stock unit plans.

³³ See *Lacey v Weyerhaeuser Company Limited*, 2013 BCCA 252 [Lacey] and *Dayco (Canada) Ltd v CAW-Canada*, 1993 SCR 230. The courts have determined that such promises crystallized or vested at retirement and cannot be terminated without proper consideration being paid to the retiree group. In *Lacey*, the trial court found that although the retiree benefits were voluntary, they become enforceable by way of a unilateral contract. The court considered the employee's continued work as acceptance of the contract. The B.C. Court of Appeal agreed with the trial court, and stated that once the employee retired, "the retired employee no longer had the option to seek more attractive employment within the salaried market," so discontinuing benefits would be a breach of contract.

Based on this review, steps can be taken to ensure appropriate warranties and indemnifications are included in the purchase-and-sale agreement and help the buyer avoid surprises and unexpected costs arising from legacy plans in the future.

Summary

Given the significance of pension plans to employees, sponsoring organizations and capital markets, pension governance calls for diligent oversight on the part of directors. Boards need to be knowledgeable about the issues and developments involved in pension governance and ensure a framework is in place to ensure the organization's pension promises have been and will continue to be met. In discharging this obligation, directors' key responsibilities involve:

- reviewing and, when needed, amending the plan to ensure it continues to meet its objectives in line with the sponsor's broader goals
- clarifying roles and responsibilities of committees and delegates involved in plan administration and making sure delegated activities are performed
- establishing mechanisms to oversee compliance with the legislative requirements and the pension plan documents and administrative policies
- verifying that beneficiaries understand the plan and any responsibilities they may have to optimize their benefits
- confirming that policies are in place and followed for funding the plan and communicating its performance to stakeholders
- verifying that policies are in place and followed for investment of pension funds and performance objectives
- identifying, managing and mitigating risks associated with the plan and fund investments and establishing an appropriate internal control framework

Where plan sponsors establish and continually promote a robust corporate governance culture, strong and effective pension fund governance generally follows.

Appendix

Delegation

OSFI discusses delegation in its “Guideline for Governance of Federally Regulated Pension Plans:”

While the administrator may delegate management functions, accountability for direction setting and supervision cannot be delegated. To the greatest extent possible the supervision function should be independent of the management functions. The chain of delegation should be documented and performance objectives and reporting relationships established between the two roles.

CAPSA’s “Pension Plan Governance Guidelines” set out a number of principles, three of which are relevant to delegation:

Principle 3: Roles and Responsibilities

The plan administrator should clearly describe and document the roles, responsibilities, and accountability of all participants in the pension plan governance process. The plan administrator is expected to oversee and assume responsibility for the pension plan but is not expected to manage the plan on a day-to-day basis; may delegate operational management tasks, but is ultimately responsible and accountable for managing the plan and for selecting and monitoring the actions of delegates and committees; should ensure that the pension governance structure, roles and responsibilities and accountability and reporting relationships (i.e., chain of delegation) are clearly documented and communicated to all participants in the pension plan governance process.

When the same person performs both pension plan governance and corporate functions, there must be a clear recognition and understanding of the different roles and responsibilities of each function. Good pension governance requires clear documenting of each action and the role under which an action was taken.

Principle 7: Risk Management

The plan administrator should provide for the establishment of an internal control framework, commensurate with the plan's circumstances, that addresses the pension plan's risks.

a. Internal control framework.

The internal control framework should ensure that risks are addressed and appropriate controls are in place. The plan administrator should understand and approve the framework and the written internal control policies. While the framework may vary depending on the plan type, it should include policies on documentation, record keeping, costing, funding, fund investment, expense control, benefits, administration, outsourcing, compliance and communication.

b. Fees

A plan administrator should monitor and assess the reasonableness and competitiveness of any fees charged to the plan or paid by members.

c. Delinquency Control

The plan administrator should establish a delinquency control program with procedures for collecting unpaid contributions and data and solutions for non-compliance.

Principle 8: Oversight and Compliance

The plan administrator should provide for the establishment of appropriate mechanisms to oversee and ensure compliance with the legislative requirements and the pension plan documents and administrative policies.

Every pension plan needs documented processes and standards to enable compliance with legislative requirements. This also ensures all administrative functions, including calculating, paying and receiving contributions and pension benefits or values, fall within plan terms, plan administrative policies, and legislative requirements.

Where to Find More Information

CPA Canada Publications on Governance

(available at www.cpacanada.ca/governance)

Director Series

Framework Series

- A Framework for Board Oversight of Enterprise Risk
- Overseeing Strategy: A Framework for Boards of Directors
- Overseeing Mergers and Acquisitions: A Framework for Boards of Directors

20 Questions Series

- 20 Questions Directors Should Ask about Internal Audit
- 20 Questions Directors Should Ask about Building and Sustaining a Board
- 20 Questions Directors Should Ask about Directors' and Officers' Indemnification and Insurance (2nd ed)
- 20 Questions Directors Should Ask about Special Committees (2nd ed)
- 20 Questions Directors Should Ask about IT (2nd ed)
- 20 Questions Directors Should Ask about Strategy (3rd ed)
- 20 Questions Directors Should Ask about Executive Compensation (2nd ed)
- 20 Questions Directors Should Ask about Insolvency
- 20 Questions Directors Should Ask about Governance Committees
- 20 Questions Directors Should Ask about Codes of Conduct (2nd ed)
- 20 Questions Directors Should Ask about the Role of the Human Resources and Compensation Committee
- 20 Questions Directors Should Ask about Responding to Allegations of Corporate Wrongdoing

- 20 Questions Directors Should Ask about CEO Succession
- 20 Questions Directors Should Ask about Crisis Management

Director Briefings

- Board Oversight of Tax Risk—Questions for Directors to Ask
- Climate Change Briefing—Questions for Directors to Ask
- Controlled Companies Briefing—Questions for Directors to Ask
- Diversity Briefing—Questions for Directors to Ask
- Guidance for Directors: Disclosure and Certification—What’s at Stake
- Guidance for Management: Disclosure and Certification—What’s at Stake
- Long-term Performance Briefing—Questions for Directors to Ask
- Shareholder Engagement—Questions for Directors to Ask
- Small Company Boards—Questions for Potential Advisors and Directors
- Sustainability: Environmental and Social Issues Briefing—Questions for Directors to Ask

Statutes and Accounting Requirements

- Federal *Pension Benefits Standards Act*
<http://laws-lois.justice.gc.ca/eng/acts/P-7.01>
- Equivalent provincial acts—see provincial acts
- The *Income Tax Act (Canada)*
<http://laws-lois.justice.gc.ca/eng/acts/I-3.3>
- CPA Canada Handbook
www.cpacanada.ca/en/business-and-accounting-resources/cpa-canada-handbook-the-standards-and-guidance-collection/cpa-canada-handbook-accounting

About the Author

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Since 1990, Scott has focused his practice on pensions, benefits, executive compensation and related tax and trust law. For over 15 years he worked as a senior consultant with two major multi-national actuarial and accounting firms. In 2007 and 2008 Scott was Co-Chair of the Alberta-British Columbia Joint Expert Panel on Pension Standards working with five of Alberta's and B.C.'s leading experts in pensions to review pension legislation in the two provinces and make recommendations to both governments for fundamental reforms to pension legislation. Scott is past national and regional Chair of the Canadian Pension & Benefits Institute and is on the Board of Directors of NAV Canada, Canada's national private sector civil navigation services provider. He also serves as Chair of NAV's Pension Committee which has pension plan assets in excess of \$5 billion and a member of NAV Canada's Corporate Governance Committee.

Scott is recognized in *The Best Lawyers in Canada* in the area of Employee Benefits Law (2011-2017) and is consistently recommended by *The Canadian Legal Expert Directory*, Pensions and Employee Benefits. He is also recognized by *Chambers Global* as a leading lawyer in the area of Pensions and Benefits (2013-2017). He has been practising law since 1987.



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