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Canadian Pension Funds: Investments and Role in the Capital Markets and Corporate Governance

Poonam Puri* & P.M. Vasudev**

Most institutional investors have yet to seriously recognize the multiple implications of their universal owner status, and to then develop programs based on this understanding.

~ Hawley & Williams (2000)¹

The article analyzes Canadian pension funds from the perspectives of corporate governance and the capital markets. It reviews their investment allocations and revenue patterns since the 1990s and identifies significant changes. The article finds that pension funds, as shareholders, have turned more activist and they wield considerable influence on corporate governance. They also contribute to shaping public policy, as evident from the relaxation of the rules on foreign investment and the removal of restrictions on communications among shareholders. The paper predicts that the role of pension funds will likely further expand in the future, given the constant rise in their resources and increased awareness of the need for responsible shareholder activism. Pension funds are ideally suited to be responsible shareholders who can effectively engage with the corporations, particularly in the areas of director elections and promoting corporate accountability.

L'article traite des caisses de retraite canadiennes dans le contexte de la gouvernance d'entreprise et des marchés financiers. Les auteurs examinent la répartition de leurs placements et la source de leurs revenus depuis les années 1990, et ils présentent les principaux changements survenus à cet égard. Ils constatent que les caisses de retraite, à titre d'actionnaires, font désormais preuve de plus d'activisme et qu'elles exercent une influence considérable sur la gouvernance d'entreprise. Elles contribuent également à l'élaboration des politiques publiques, comme en témoignent l'assouplissement des règles visant les placements étrangers et l'élimination des restrictions sur la communication entre les actionnaires. Les auteurs affirment que le rôle des caisses de retraite devrait s'accroître encore davantage dans l'avenir, étant donné l'augmentation constante de leurs ressources et la sensibilisation croissante des actionnaires à l'activisme responsable. Les caisses de retraite sont idéalement placées pour être des actionnaires responsables, car elles peuvent agir de concert avec

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¹ James P. Hawley & Andrew T. Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make America More Democratic* (Philadelphia: University of Pennsylvania Press, 2000), Preface xvi.

les sociétés, notamment en ce qui a trait à l'élection des administrateurs et à la promotion de la responsabilisation de l'entreprise.

1. INTRODUCTION

Pension funds are large investors. Conventionally, they are understood as providers of long-term or “patient” capital, particularly for infrastructure and other project investments. Pension funds are a significant force in the capital markets, and contribute to the development of the markets and new investment products. Increasingly, pension funds also wield substantial influence over the governance of the corporations in which they hold investments.

This article reviews Canadian pension fund investments and practices in the recent decades.² The analysis covers:

- Trends in investment allocations of pension funds and their significance.
- Impact on capital markets, including private equity and venture capital.
- Influence on corporate governance and the increasing activism of pension funds as shareholders in corporations.
- Role in shaping public policy, evident from developments such as the relaxation of the rules on foreign investments and the restrictions on communications among shareholders.

The paper predicts that the role of pension funds is likely to further expand in the future, given the constant rise in their resources and increased awareness of the need for responsible shareholder activism. Pension funds are well-placed to play a more effective role in matters such as director elections and promoting corporate accountability. The analysis also reveals some gaps in the database of knowledge about pension funds and their role. Future research in these areas can enhance the capability of pension funds to contribute to the overall development of the capital markets and corporate governance along healthy lines.

The paper has six parts. Part 2 reviews the asset allocation patterns of pension funds and explains the changing contours of their investments. It notes the emerging trends in their investments growth of new avenues such as private equity and venture capital. Part 3 examines the participation of pension funds in the capital markets and their influence on the markets. It notes the recent trend increased reliance of the funds on securities trade in the market to fund their pension obligations.

Part 4 analyzes the role of pension funds in shaping corporate governance. It examines the initiatives taken by pension funds to foster good corporate governance and predicts the strengthening of this trend in the future. Part 5 examines how pension fund activity is shaping public policy and influencing regulatory changes. Part 6 concludes with a brief reference to the recent abortive effort of Ontario Teachers' Pension Plan (“OTPP”) and a group of investors to make a leveraged buyout of Bell Canada. Such instances strengthen the expectations of greater activism among pension funds which are, arguably, the single largest class of investors.

² The original research work for this article was done for the report “Pension Funds: Trends in Asset Allocation and Role in Capital Markets, Corporate Governance and Regulatory Policy” (2007), prepared for the Ontario Expert Commission on Pensions.

2. PENSION FUND INVESTMENTS — ASSET ALLOCATION PATTERNS

The investment patterns of pension funds have witnessed significant changes in the last two decades. These changes offer reasonably clear indications of the policy considerations and priorities of the funds. This part analyzes the patterns of asset allocation by Canadian pension funds during 1993–2006, and finds the following:

- Investment in the shares of public companies has remained more or less stable — around 40 percent of the total assets of the funds.
- Within this asset class, there has been a decline in Canadian holdings, which fell from 87 percent to 70 percent. Correspondingly, foreign holdings rose from 13 percent to 30 percent.
- Fixed-income securities — particularly, bonds — have declined from 41 percent to 32 percent of the assets of pension funds.

(a) Asset Allocations

In the 14 years between 1993 and 2006, the market value of the assets of trustee pension funds in Canada almost tripled from \$3.12 billion to \$9.14 billion. The investments were in six major classes of assets — namely, bonds, stocks, mortgages, real estate, short-term and other assets. Of these, bonds and stocks are the largest asset classes. The allocations among the different classes are presented in Table 1.

Table 1 Market Value of Trusteed Pension Funds' Assets, 1993–2006³ (\$Million)

Year	Total Assets	Bonds	Stocks	Mortgages	Real estate	Short-term	Other assets
1993	312,851	129,543	119,367	8,848	9,291	24,306	19,178
1994	310,720	121,588	119,962	8,210	10,458	25,212	23,161

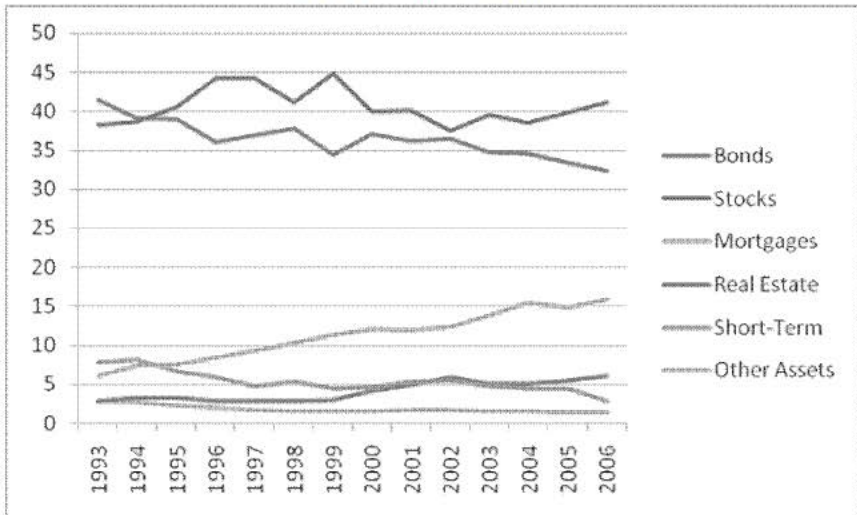
³ Statistics Canada. Table 280-0002 — Trusteed pension funds, market and book value of assets, by private and public sector category. CANSIM database, online: <http://estat.statcan.ca/cgi-win/cnsmcgi.exe?Lang=E&ESTATFile=ESTAT\English\CII_1_E.htm&RootDir=ESTAT/>. Statistics Canada has made a broad six-fold classification of assets by consolidating more detailed asset categories. The analysis in this paper is about the six assets classes used by Statistics Canada, which has provided the following notes to the data:

1. From 1993, funds with assets of less than \$5 million were exempted from providing details of their assets, and this limit was raised to \$10 million in 1998. Table 1 does not include the smaller funds for which asset breakup is not available.
2. The data cover all trustee pension funds registered with the provincial and/or federal regulatory authorities in Canada.
3. “Short-term” assets include cash, deposits, Guaranteed Investment Certificates (“GICs”) and short-term securities.

Year	Total Assets	Bonds	Stocks	Mortgages	Real estate	Short-term	Other assets
1995	358,023	139,387	144,938	8,175	12,084	23,909	27,251
1996	419,664	150,979	185,110	8,423	12,356	25,018	35,382
1997	467,201	172,144	205,811	8,217	13,622	22,351	43,228
1998	513,151	194,033	210,342	8,104	15,176	27,669	53,211
1999	564,464	194,297	252,274	8,612	17,521	25,600	63,573
2000	599,266	221,678	239,342	9,066	25,160	27,393	72,182
2001	581,529	209,854	232,675	9,750	28,962	31,490	69,142
2002	557,108	203,284	208,477	9,215	32,927	30,418	69,037
2003	625,896	216,599	247,224	9,540	31,633	30,348	86,155
2004	693,733	239,041	266,638	10,612	34,978	31,172	106,813
2005	799,649	266,685	317,540	11,515	44,403	36,442	118,878
2006	914,971	295,694	375,246	13,120	55,887	26,439	144,680

The investment patterns are much clearer when interpreted in percentage terms. The percentage trends of investment in the different asset classes are in Chart 1.

Chart 1
Trusteed Pension Funds' Asset Classes, 1993-2006 Asset Allocations as a Percentage of Total Assets



Equities, as an asset class, have been quite stable at about 40 percent of the total portfolio of pension funds in the 14-year period. This is less than half their total investments. The data is at variance with the common notion that pension funds are heavily invested in equities, which are believed to represent a large majority of their investments. Interestingly, the percentage of equity investments is significantly higher for larger pension funds. Benefits Canada's 2006 survey of the "Top 100" pension funds found that their equity investments were over 54 percent of the total value of their assets.⁴ Of this, Canadian equities were 26.4 percent and foreign equities stood at 27.6 percent.

Considering the average of 40 percent equity investments reported by Statistics Canada and the higher percentage for the large pension funds found in Benefits Canada's survey, possibly the equity investments of small funds were substantially lower than those of the large funds. Another explanation could be the consolidation of asset categories by Statistics Canada, which has six asset classes. Other agencies — Benefits Canada and Pension Investment Association of Canada — have more elaborate classifications of assets. Possibly, the consolidation of asset classes by Statistics Canada has resulted in the lower percentage of stocks. For instance, Statistics Canada has explained that "other assets" include miscellaneous pooled vehicles, which may include stocks.

Bonds, mortgages and short-term assets experienced a decline in the portfolio of pension funds. Bonds fell from about 41 percent of the total investments in 1993 to about 32 percent in 2006, and mortgages from 2.8 percent to 1.4 percent in this period. "Short-term assets," which is the third category of assets to diminish, shrank from 7.8 percent to 2.9 percent. These assets are of the "fixed-income" variety and their decline can be explained by the fall in interest rates in the recent years. The return on bonds, mortgages and short-term assets is calibrated to real interest rates and during this period, real interest rates were quite low. To illustrate, the yield on 6-months Treasury Bills of the Government of Canada fell from 6.78 percent in 1993 to 3.67 percent in 2006.⁵

(b) New Asset Classes — Recent Developments

The "other assets" of pension funds shown in Table 1 climbed from 6.1 percent in 1993 to almost 16 percent in 2006. Statistics Canada has explained that this class includes investments in foreign and miscellaneous pooled vehicles, as well as accruals and receivables. The increase in the "other assets" of pension funds has been quite steady during the 14-year period, as shown in Chart 1. There was no sudden jump in any year or block of years.

Pension Investment Association Canada ("PIAC") provides useful information on the investments of its member-funds. PIAC does not represent the full universe of Canadian pension funds; even among its members, the data provided by PIAC only cover those who reported the details of their investments. Statistics Canada's data, on the other hand, covers all trustee pension funds. PIAC has a membership

⁴ "Top 100 Pension Funds", online: Benefits Canada <http://www.benefitscanada.com/news/article.jsp?content=20060706_150017_3000>.

⁵ Bank of Canada. *Treasury Bills — Average Yields — 6 Months*, online: <http://www.bank-banque-canada.ca/pdf/annual_page5_page6.pdf>.

of 130 funds with over \$892 billion under their management. This is a significant part of the pension fund industry, and the data provided by PIAC are helpful in understanding the trends.

PIAC data are, in some respects, more detailed than those of Statistics Canada. PIAC has adopted a more elaborate classification of assets, which includes three significant asset classes — (a) venture capital and private equity, (b) hedge fund investments and (c) infrastructure. These have appeared in the recent years and PIAC members have made substantial investments in these classes.

PIAC classified “venture capital and private equity” as a separate asset class in 2000, and their value was about \$8 billion in that year. They have since grown almost four-fold — to over \$30 billion. Hedge-fund and infrastructure investments add up to another \$40 billion. Probably these asset classes, which are not a part of Statistics Canada classification, are a reason for the substantial growth in the “other assets” of pension funds reported by Statistics Canada.⁶ PIAC data on investments in the additional classes of assets are in Table 2. They are interpreted in percentage terms in Chart 2.

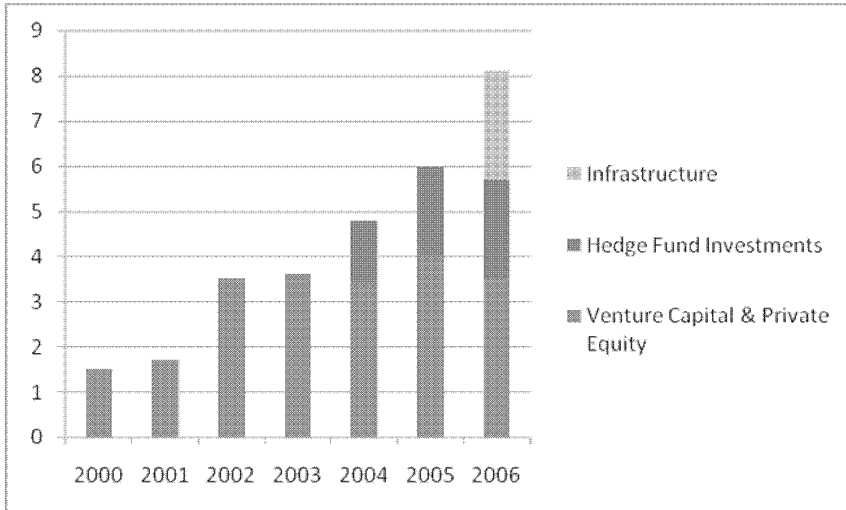
Table 2 New Asset Classes, 2000–2006 (\$Million)⁷

Asset Class	2000	2001	2002	2003	2004	2005	2006
Venture capital and private equity	8,004	8,470	18,010	18,123	22,045	27,756	30,473
Hedge fund investments					9,093	13,840	19,621
Infrastructure							20,964

⁶ *Supra*, Table 1.

⁷ Asset allocations of member-pension funds, online: Pension Investment Association of Canada <<http://www.piacweb.org/publications/index.html>>.

Chart 2
New Asset Class Values as % of Total Assets (PIAC Data)



The new asset classes have been growing, both in absolute terms and as a percentage of the total assets of pension funds. At over 8 percent in 2006, the new classes are a significant component in the portfolios of pension funds. Their value of over \$70 billion in 2006 is quite impressive. The steady growth in venture capital and private equity in the recent years suggests that the trend may continue in the future. These investments are, generally, not in market-traded securities of established corporations, and pension funds will likely have a closer relationship with the managements of the companies in which they make private equity or venture capital investments. Dividend income from these investments would be an important consideration and pension funds would likely have a greater engagement with the companies to ensure their profitability.

(i) Private Equity and Venture Capital — The Emerging Investment Trend

Pension funds have made substantial investments in private equity (“PE”) and venture capital (“VC”) in the recent years. “Private equity” is a generic term that refers to all forms of equity or quasi-equity investments where the securities are not traded in the public capital markets. This broad asset class generally has three sub-classes — namely, buyout capital, mezzanine capital and venture capital that have distinctive meanings.

- Buyout funds are specialized private equity invested in established firms undergoing a fundamental change in operations or strategy. Sometimes, this could be for taking a public company private — as was attempted in the leveraged buyout of Bell Canada by OTPP and other investors.
- Mezzanine capital is mainly subordinated debt or preferred stock convertible into equity, and the purpose of investment is similar to buyout funds — change in business strategy or operations.

- Venture capital, on the other hand, is meant for high-risk investment in new or young companies that promise significant growth.⁸

PE and VC investments are usually illiquid, as they are not traded in the stock market. Obviously, they require closer scrutiny and greater involvement of the pension funds, both in the pre-investment stage and subsequently. Available information and data suggest the following conclusions:

- Larger pension funds tend to be more active in PE and VC, which represent a move away from the more traditional “stocks and bonds” model of investments.
- Lack of liquidity and the need for greater involvement probably deter smaller pension funds, with their limited resources and expertise, from venturing into the new areas.
- There is evidence that PE investments are often more profitable. The higher returns from PE would be an incentive for pension funds to increase their investments in this segment. This is a likely explanation for the growing trend among large pension funds to invest in PE and VC.

An empirical study of 146 Defined Benefit (“DB”) pension plans in Canada, published in 2005, found that 39 of them had PE and VC investments.⁹ The average and median size of these 39 plans were significantly larger — more than twice that of the general pool of 146 plans. Quite obviously, PE and VC are preferred by the larger funds. The data are in Table 3.

Table 3 DB Pension Funds Investing in Private Equity and Venture Capital — A Comparison of Size (\$Million (US))

	Funds included in the Study	Funds Investing in Private Equity/Venture Capital
Number of funds	146	39
Average fund size	2,593	5,729
Median fund size	681	1,501

The relative median size of funds investing in PE and VC, at 2.2 times that of the general pool, is evidence of the preference of the large funds for the new investment classes. However, PE and VC were a relatively small part of the total investments of the 39 plans that had investments in these classes of assets. For private equity, the minimum allocation among the plans was 0.2 percent and the maximum was 7 percent. The average and median allocation are both less than 3 percent. The figures are even lower for venture capital. They ranged between a low of 0.2 per-

⁸ Glossary of Terms, online: Canadian Venture Capital and Private Equity Association <<http://www.cvca.ca/resources/glossary.aspx>>.

⁹ Gilles Chemla, “The Determinants of Investment in Private Equity and Venture Capital: Evidence from American and Canadian Pension Funds” (November 8, 2005), online: <<http://ssrn.com/abstract=556421>>.

cent and a high of just 3.7 percent, with median and average allocations of 1.4 percent and 1.3 percent respectively. The allocations in percentage terms are presented in Table 4.

Table 4 Pension Funds' Investment in Venture Capital and Private Equity — Relative Volume

Description	Venture Capital and Private Equity Investments as Percentage of Total Investments
Private Equity Allocation — Average	2.4
— Median	2.7
— Minimum	0.2
— Maximum	7.0
Venture Capital Allocation — Average	1.3
— Median	1.4
— Minimum	0.2
— Maximum	3.7

The study, which was comparative, found that Canadian pension funds had a smaller part of their assets in PE and VC than their American counterparts. Gilles Chemla has offered the following as explanations for the difference in the approaches of Canadian and American funds.

- In the perception of Canadian fund managers private equity, as an asset class, is complicated and difficult to evaluate. Also, the investments require extensive monitoring.
- The less vibrant market in Canada for initial public offerings makes it difficult to get the securities listed and make the investments liquid.

A 2007 survey of Canadian pension funds by MFC Global Investment Management is another source of information on their PE investments.¹⁰ The survey, which included PE under “real estate and alternative investments,” found that alternative investments were more popular among larger pension plans, defined as plans with assets of over \$1 billion.¹¹ This confirms the trend identified by Gilles Chemla.

Among the pension plans surveyed by MFC, 8 percent had investments under the alternative category, and these investments represented 8 percent of their total assets. Among the smaller pension plans with assets of less than \$1 billion, only 2 percent had alternative investments, and the value of this class was 3 percent of their total assets. The relatively minor position of PE and VC can be explained by

¹⁰ *Trend Watch 2007: Attitudes and Intentions of Canadian Defined Benefit Pension Plans Towards Foreign Investment* (Toronto, ON.: MFC Global Investment Management, 2007), at 3-4, online: <http://www.benefitscanada.com/pdfs/Reports_MFC.pdf>.

¹¹ *Ibid.*

the fact that they are late entrants. Hence, their value is not yet very significant in the larger picture of total asset values.

Looking to the future, MFC stated that “net increases are mainly expected for real estate and alternative investments using money shifting out of equities.” MFC has further reported that “[a]lmost no respondents expect a decrease in plan allocation” for PE or VC.¹² These asset classes are expected to benefit from the trend for reducing investments in publicly traded equity. If the current bear phase in the stock market continues, the preference for PE might strengthen in the future.

(ii) Private Equity and Venture Capital — Special Characteristics

Private equity and venture capital are significant new investment avenues for pension funds. PE and VC investments require more detailed analysis and a closer engagement of the pension funds. Pension funds that opt for such investments must have the expertise for making the investment decisions and the time and resources for active monitoring in the post-investment phase. The element of risk is also greater with PE and VC investments, which are generally not liquid in the initial stages.

These characteristics of PE and VC investments can explain the tendency of larger pension funds to be more active in these areas. Greater resources, increased need for diversified portfolios and availability of investment expertise are some factors that encourage the large funds to be more active in new investments. Enhanced risk and the need for closer engagement and greater oversight would not be as forbidding for large funds as they would be for smaller pension funds.

PE and VC investments are likely to engender significant attitudinal changes in pension funds. In dealing with the public corporations in which they hold shares, pension funds have generally confined their focus to governance issues that are structural. Investments in PE and VC, often for startup businesses, are a different story. The special features of these investments, discussed above, are likely to encourage the funds to be more actively engaged with business and strategy. Quite probably, the funds would play a greater role in matters like chief executive officer appointment, selection of directors and advice on strategy. This would be a departure from the conventional approach of pension funds towards corporate governance, which has been marked by a general sense of hesitation and reluctance in dealing with governance issues in public corporations.¹³

(iii) Comparative Returns

In 2006, David Mather found that 32 out of the top 100 pension funds in Canada have private equity investments.¹⁴ Among them, OTPP is most active in private equity. Mather analyzed the PE investments of three major pension funds — OTPP, Ontario Municipal Employees Retirement System (“OMERS”) and Caisse

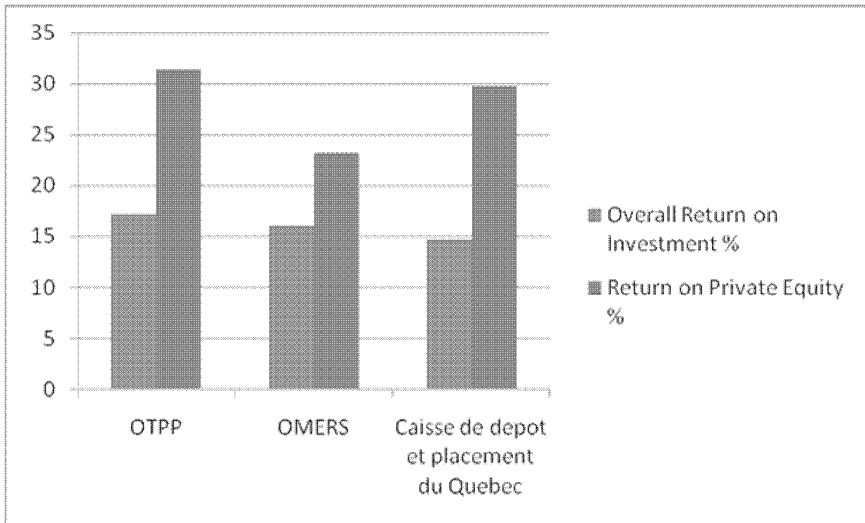
¹² *Ibid.*, at 2.

¹³ These are discussed in Part 4, *infra*.

¹⁴ David Mather, “The Inner Workings of Private Equity” (August 2006), online: Benefits Canada <http://www.benefitscanada.com/investments/alternative/article.jsp?content=20060831_152120_5084>.

de depot et placement du Quebec — and estimated that the return from PE has been significantly higher than the returns from other segments in their portfolios. The comparative returns estimated by Mather are presented in the graph below.

Chart 3
Comparative Returns from Private Equity and Other Asset Classes¹⁵



(c) Foreign Investments

Foreign holdings have increased, both in volume and importance, in the investments of pension funds. At 4.9 percent twenty years ago in 1988, foreign equity holdings represented a relatively minor part of the assets of pension funds.¹⁶ By 2006, this figure crossed 30 percent of the total assets. Foreign holdings of pension funds grew steadily during 1993–2006 as shown in Table 5 below.

¹⁵ *Ibid.*

¹⁶ Harry Weitz, *The Pension Promise: The Past and Future of Canada's Private Pension System* (Scarborough, Ontario: Carswell, 1992) at 278-279.

Table 5 Trusteed Pension Funds' Foreign and Canadian Holdings, 1993–2006¹⁷ (\$Million)

Year	Total Assets	Canadian Assets	% of Total Assets	Foreign Investments	% of Total Assets
1993	310,534	269,194	86.7	41,340	13.3
1994	308,591	263,428	85.4	45,163	14.6
1995	355,718	299,734	84.3	55,984	15.7
1996	417,269	347,912	83.4	69,357	16.6
1997	465,372	381,822	82	83,550	18
1998	508,535	406,160	79.9	102,375	20.1
1999	561,877	448,451	79.8	113,426	20.2
2000	594,821	471,112	79.2	123,709	20.8
2001	581,873	453,684	78	128,189	22
2002	553,358	428,782	77.5	124,576	22.5
2003	621,500	475,672	76.5	145,829	23.5
2004	689,255	521,724	75.7	167,531	24.3
2005	795,463	591,602	74.4	203,861	25.6
2006	911,066	632,959	69.5	278,107	30.5

¹⁷ Table 280-0003 — Trusteed pension funds, market value of assets, foreign and Canadian, online: Statistics Canada, CANSIM database <http://estat.statcan.ca/cgi-win/cnsmcgi.exe?Lang=E&ESTATFile=ESTat\English\CII_1_E.htm&RootDir=ESTAT/>. Statistics Canada has provided the following notes to the data:

1. Funds with assets less than \$5 million up to 1998 and less than \$10 million after 1998 do not report their asset allocations, and are not included in the table.
2. Data cover all trusteed pension funds registered with the provincial and/or federal regulatory authorities in Canada.
3. “Short-term” includes cash, deposits, Guaranteed Investment Certificates (GICs) and short-term securities. Some may mature in more than 12 months.
4. Canadian assets include investments in miscellaneous pooled vehicles, mortgages, real estate as well as accruals and receivables.
5. Other foreign investments include investments in foreign pooled funds only. Foreign investments consist of investments in foreign pooled funds, stocks, bonds and short-term assets.

Obviously, there was growing enthusiasm among the pension funds for foreign investments. Foreign assets increased two-and-half times between 1993 and 2006 — from 13.3 percent of total assets to 30.5 percent in 2006. Correspondingly, there has been a 17 percent decline in the holdings of Canadian assets, which fell from 86.7 percent in 1993 to 69.5 percent in 2006. This move away from domestic holdings to foreign holdings was enabled by the changes in the rules on foreign property.

A ceiling of 10 percent on foreign holdings was introduced in the early 1970s under what came to be known as the “Foreign Property Rule.”¹⁸ The ceiling was raised to 20 percent in 1994¹⁹ and to 30 percent in 2001. The rule was designed to make capital available for investment in Canada and, hopefully, reduce the cost of capital for domestic enterprises. The restrictions were opposed by many stakeholders as not serving its intended purpose.²⁰ Finally in 2005, the rule was abolished.

Globalization and economic liberalization in the developing countries since the 1990s can be cited as another factor that stoked the interest of pension funds in overseas investments. Financial liberalization and the ability to invest in the emerging markets were important developments of the 1990s, and they quite obviously influenced the course of pension fund investments.

In the early 2000s, pension funds were steadily moving towards the ceiling of 30 percent applicable to foreign holdings. In 2006, immediately after the Foreign Property Rule was abolished, their foreign investments crossed the 30 percent level. This is consistent with the fact that many pension funds and PIAC had campaigned with the federal government for the removal of the Foreign Property Rule.²¹ The relative allocations in the different classes of foreign and Canadian assets are presented in the Table 6 and the percentages are in Chart 4.

Table 6 Pension Funds’ Canadian and Foreign Holdings, 1993–2006 (\$Million)

Year	Bonds		Stocks		Short-term Assets		Other Assets	
	Canadian	Foreign	Canadian	Foreign	Canadian	Foreign	Canadian	Foreign
1993	128,224	1,319	89,789	29,578	23,862	444	27,319	9,999
1994	120,152	1,436	90,114	29,848	24,500	712	28,662	13,167
1995	137,484	1,903	109,195	35,743	23,372	537	29,683	17,801
1996	149,077	1,902	143,408	41,701	24,404	614	31,023	25,140

¹⁸ *Income Tax Act*, R.S.C. 1985 (5th Supp.), c. 1, s. 206(1) [ITA] and *Income Tax Regulations*, C.R.C., c. 945, s. 5000.

¹⁹ Weitz, *supra*, n. 16 at 314.

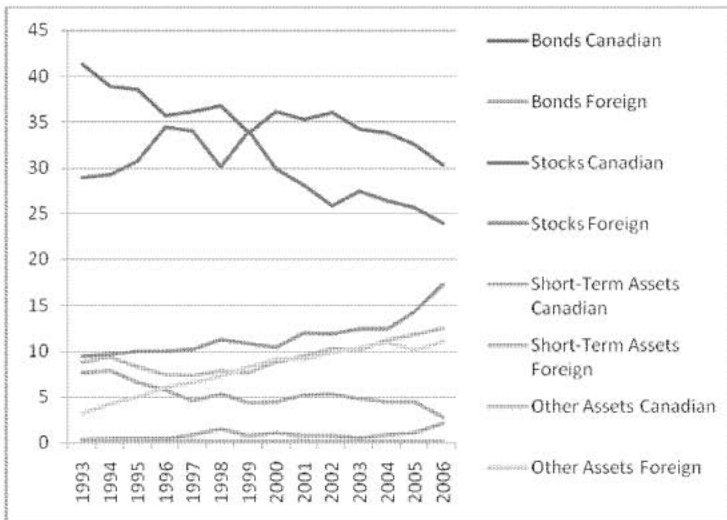
²⁰ For an analysis of the cost and benefits of the Foreign Property Rule, see David Burgess & Joel Reid, “The Foreign Property Rule: A Cost-Benefit Analysis” (2003), paper online: <<http://economics.uwo.ca/faculty/fried/papers/fried-burgess-iipf.pdf>>.

²¹ This is discussed in Part 5, *infra*.

Table 6 Pension Funds' Canadian and Foreign Holdings, 1993-2006 (\$Million)

Year	Bonds		Stocks		Short-term Assets		Other Assets	
	Canadian	Foreign	Canadian	Foreign	Canadian	Foreign	Canadian	Foreign
1997	168,090	4,054	158,331	47,480	21,234	1,117	34,167	30,899
1998	186,496	7,537	152,852	57,490	27,045	624	39,767	36,724
1999	189,960	4,337	190,840	61,434	24,861	739	42,790	46,916
2000	214,910	6,768	177,362	61,980	26,768	625	52,072	54,336
2001	205,377	4,477	163,039	69,636	30,500	990	54,768	53,086
2002	199,016	4,268	142,579	65,898	30,078	340	57,109	54,070
2003	212,763	3,836	170,394	76,830	29,844	504	62,670	64,659
2004	233,043	5,998	180,961	85,677	30,756	416	76,963	75,441
2005	258,320	8,365	203,561	113,979	35,656	786	94,065	80,731
2006	276,170	19,524	217,600	157,645	25,456	983	113,732	99,955

Chart 4
Pension Funds' Canadian and Foreign Investments, 1993-2006 Asset Allocations %



Pension funds have shown a preference for equity and bonds, in that order. In dollar terms equity investments, both Canadian and foreign, showed a surge between 1993 and 2006. This is consistent with the bull phase in the stock market during the period. In percentage terms, foreign equity holdings grew significantly while Canadian holdings declined. Pension fund investment in foreign stocks has almost doubled — from 10 percent of the total assets in 1993 to over 17 percent in 2006. In the same period, Canadian equity holdings declined from 29 to 24 percent.

Compared with equity, the growth in bond investments was slower. Holdings of foreign bonds exploded after the abolition of the Foreign Property Rule in 2005, more than doubling in 2006 — to over \$19 billion from less than \$9 billion in 2005. In percentage terms, foreign bond holdings remained quite stable hovering between 0.4 and 1 percent, except in 2005-06 when they crossed 2 percent. Canadian bond holdings declined from 41 percent in 1993 to 30 percent in 2006.

The foreign investments of pension funds rose in all asset classes except short-term assets. This suggests that the funds preferred to keep their liquid assets in Canada. Overall, there has been a steep fall in short-term assets, and this can also be traced to the buoyancy in the stock market. With strong share prices, the pension funds appear to have been less worried about liquidity and preferred to invest a greater part of their resources in the capital markets.

“Other assets” also saw steady and significant increases. This was especially true for foreign holdings, which rose from 3.2 percent in 1993 to 11 percent in 2006. Statistics Canada has noted that foreign investments included mainly pooled funds. This suggests that in investing overseas, Canadian pension funds preferred to be a part of larger arrangements rather than to act individually.

3. PENSION FUNDS — ROLE IN THE CAPITAL MARKETS

Pension fund holdings represented 21.7 percent of the domestic market capitalization of the Toronto Stock Exchange in 2004.²² This figure underscores their importance in the capital markets. This part of the paper examines the impact of pension funds on the capital market. The data and analysis draw the following conclusions.

- Pension fund investments and trading enhances the efficiency, depth and liquidity of the capital markets. The funds make substantial net purchases of securities in the Canadian capital markets every year. Between 1993 and 2006, they made incremental investments of over \$350 billion, net of the securities sold by them during this period. Of this, \$228 billion went into Canadian securities and the remaining \$122 billion were in foreign securities.
- Pension funds derive their revenue both from capital gains on sale of investments and income from dividends and interest. Both sources of income rose during 1990–2004. However, gains on sale of securities emerged as the more important part of pension funds’ revenue. Pension funds became more reliant on trade in securities than on the income from holding the securities. Although profits from the sale of securities moved in a fairly wide range, their enhanced importance in the revenue structure of pension funds is unquestionable. The gains from sales, which represented less than 3 percent of the revenue in 1990, rose to a high of almost 54 percent in 2000, before falling to about 30 percent in 2004. Investment

²² Gil Yaron, “Acting Like Owners: Proxy Voting, Corporate Engagement and the Fiduciary Responsibilities of Pension Trustees” (July 2005), Shareholder Association for Research and Education Research Paper, online: <http://www.share.ca/files/Acting_Like_Owners.pdf>.

income showed a trend of decline — from over 58 percent in 1990, it fell to less than 27 percent in 2004.

- The evidence is mixed when the performance of pension funds is compared with broader market indices or other investment pools such as mutual funds. There is no clear indication that pension fund investments significantly outperformed the benchmarks.
- The presence of pension funds in the markets and their engagement with the corporations can potentially enhance investor protection and public confidence in the capital markets.

(a) The Ideal Attributes of Capital Markets

The following have been identified as some key attributes that enhance the efficiency of the capital markets.²³

- Maximizing liquidity — the assurance that non-cash assets can be converted into cash with ease and certainty.
- Maximizing immediacy — the speed at which transactions can be completed in the market.
- Market visibility or transparency, as measures of the efficiency of the trading system.
- Efficient price discovery — the process by which the market determines trading prices for securities.
- Minimizing transaction costs for the investors in transactions of purchase and sale of securities.
- Ensuring fairness in the market arrangements and minimizing principal-agent conflicts between investors and market intermediaries.
- Ensuring the integrity and efficiency of the credit ring and settlement of trades by delivery of securities and payment of the price.
- Maximizing the integrity of the market in the investors' perception and enhancing their confidence in the market processes.

By and large, securities law also shares these goals — for example, by providing enforcement that is essential for market integrity and investor confidence.²⁴ Law and market institutions play complementary roles in promoting healthy and efficient capital markets and their liquidity, depth and transparency. Equally, they contribute to minimizing transaction costs and ensuring fairness and integrity in the marketplace. Pension funds are sizable holders of securities and active traders.

²³ Eric Kirzner, "Ideal Attributes of a Marketplace" in *Canada Steps Up*, final report of the Task Force to Modernize Securities Legislation in Canada, Vol. 4, at 99–125 (Toronto, ON.: Task Force to Modernize Securities Legislation in Canada, 2006), online: <[http://www.tfmsl.ca/docs/V4\(2\)%20Kirzner.pdf](http://www.tfmsl.ca/docs/V4(2)%20Kirzner.pdf)>.

²⁴ See generally Mark Gillen, *Securities Regulation in Canada*, 2nd ed. (Scarborough, ON.: Carswell, 1998).

They make an important contribution to the capital markets in Canada by strengthening the markets and their attributes.²⁵

(b) Pension Funds' Impact on Market Depth and Liquidity — Purchases of Stocks and Bonds, 1994–2006

As significant investors, pension funds quite naturally have a favourable impact on the liquidity of the markets. Market liquidity is important for a number of reasons — mainly, the ability of issuers of securities to raise capital and for investors to sell their investments and convert them into cash. Eric Kirzner has described liquidity and its significance in the capital markets:

In equity markets, liquidity may be defined as the market's capacity to absorb customers' buy and sell orders at or near the last sale price of a particular security. The greater the capacity to absorb customers' buy and sell orders and the greater the number of orders and volume of shares that orders at or near the last sale price of a market can trade with little or no change in market price, the greater the market's liquidity. Liquidity is measured by the depth of the bids and offers for a security in the market.²⁶

Pension funds receive regular and substantial cash inflows from ongoing contributions by employers and employees. A large part of these resources are deployed in the capital markets. Pension funds make substantial net additions to their portfolios of stocks and bonds, as evident from the annual book values of their assets published by Statistics Canada.²⁷ Interpreting the data, Table 6 presents the incremental investments of pension funds in stocks and bonds between 1994 and 2006. The incremental values have been computed by deducting the sales made during the respective years from the opening book values.²⁸

Table 6 Net Purchases of Bonds and Stocks by Pension Funds, 1994–2006 (\$Million)

Year	Net Acquisition of Bonds	Net Acquisition of Stocks
1994	6,334	9,413
1995	4,387	14,724

²⁵ For a discussion on how institutional investors, in particular pension funds, contribute to the culture and character of capital markets, see E. Philip Davis, *Pension Funds: Retirement-Income Security in Capital Markets — An International Perspective* (Oxford: Clarendon Press, 1995).

²⁶ Kirzner, *supra*, n. 23 at 109.

²⁷ Statistics Canada. Table 280-0002, *supra*, n. 3.

²⁸ The analysis here is subject to the caveat that there could be variations in the data reported by individual funds. For example, in some cases the book values of equity may be updated to reflect gains and losses, or the book value of bonds may be amortized.

**Table 6 Net Purchases of Bonds and Stocks by Pension Funds, 1994–2006
(\$Million)**

Year	Net Acquisition of Bonds	Net Acquisition of Stocks
1996	9,194	19,712
1997	19,939	17,759
1998	22,294	12,713
1999	14,141	9,199
2000	18,882	11,472
2001	-11,054	16,138
2002	-9,648	5,802
2003	11,928	-2,104
2004	19,392	8,579
2005	23,014	32,615
2006	32,198	36,411
<i>Total</i>	161,001	192,433
<i>Grand Total</i>		353,434

The net investment that pension funds made in stocks and bonds was over \$350 billion between 1994 and 2006. This amount represents the additional resources that pension funds brought into the market in this 13-year period. Pension funds made particularly large investments in stocks and bonds in the last two years — namely, 2005 and 2006. The purchases in these two years were over \$124 billion, or a third of the total for the 13-year period. These net figures have been computed by deducting the sales of stocks and bonds by the funds during the period. Therefore, the gross purchases are likely to be even higher.

Obviously, the large net purchases of securities by pension funds contribute significantly to the depth and liquidity of the capital markets. There is no data on the volume of trading by pension funds *vis-à-vis* overall trading volumes, as records of transactions by individual classes of investors are not maintained. In any event, pension funds are undeniably active traders in securities. Their trading activities contribute to market liquidity and benefit the entire securities industry infrastructure. They add to the revenues and profits of the dealers and other market intermediaries and the large group of professional agencies that cater to the investors.

Table 7 provides the Canadian and foreign breakup of the net investments made by pension funds in stocks and bonds during 1994–2006.

**Table 7 Pension Funds' Net Purchases of Bonds and Stocks —
Canadian and Foreign, 1994–2006²⁹ (\$Million)**

Year	Net Purchases of Bonds		Net Purchases of Stocks	
	Canadian	Foreign	Canadian	Foreign
1994	6,193	141	7,093	2,320
1995	3,991	397	12,028	2,696
1996	9,161	32	15,083	4,630
1997	17,851	2,088	14,817	2,941
1998	19,184	3,110	7,492	5,220
1999	16,619	-2,478	8,235	965
2000	17,002	1,880	3,517	7,957
2001	-8,731	-2,323	3,538	12,598
2002	-9,309	-340	-246	6,049
2003	11,980	-51	-2,800	694
2004	17,157	2,235	1,730	6,850
2005	20,520	2,494	5,490	27,125
2006	22,016	10,182	9,380	27,032
<i>Total</i>	<i>143,634</i>	<i>17,367</i>	<i>85,357</i>	<i>107,077</i>

There is a significant difference between the patterns for stocks and bonds. For bonds, pension funds showed a bias in favour of Canada and less enthusiasm for foreign bonds. This pattern continued until 2005 when the Foreign Property Rule was abolished and the pension funds were no longer subject to restrictions on foreign investments. In the next year — 2006 — their net purchase of foreign bonds leaped to over \$10 billion from \$2.5 billion in the previous year. Even after considering this, the overall net purchase of foreign bonds by pension funds was still less than 13 percent of their purchases of Canadian bonds.

The story is quite different with stocks. Net purchases in Canadian stocks were significantly less than those of foreign stocks. Foreign stock purchases exceeded Canadian purchases for the first time in 2000, and this pattern continued in each subsequent year. In 2006, following the abolition of the Foreign Property Rule,

²⁹ Statistics Canada. Table 280-0003, *supra*, n. 17. Online: <http://estat.statcan.ca/cgi-win/CNSMCGI.EXE?regtk=&C2Sub=&ARRAYID=2800003&C2DB=EST&VEC=&HILITE=PENSION+FUNDS&LANG=E&SrchVer=&ChunkSize=50&SDDSLOC=%2F%2Fwww.statcan.ca%2Fenglish%2Fsdds%2F*.htm&ROOTDIR=ESTAT/&RESULTTEMPLATE=ESTAT/CI_PICK&ARRAY_PICK=1&SDDSID=&SDDSDESC>.

pension funds' purchase of Canadian stocks was just about a third of their purchases of foreign stocks.

The trend in favour of foreign investments finds support from the 2007 survey of Defined Benefit plans by MCF, referred to earlier. The survey found that most funds planned to reduce their holdings of Canadian equities, and correspondingly increase their foreign equity holdings. However, the volume of change was expected to be less than 5 percent.³⁰ The survey, conducted in the pre-credit crisis world, indicated further reductions in the holdings of Canadian equity by pension funds and rise in their foreign investments. It is not clear what impact the ongoing financial crisis and the instability in the stock markets worldwide will have on the habits of pension funds, particularly with respect to foreign investments.

(c) Pension Funds' Revenue Patterns — Trading Results and Investment Income, 1990–2004

This section analyzes the data on the income of pension funds. There were significant changes in their revenue mix between 1990 and 2004. The period saw a decline in investment income³¹ — mainly interest and dividends — and a greater reliance on gains from sale of securities. Table 8 has the details of pension funds' revenues from 1990 to 2004, and they clearly illustrate the trends that developed during the period.

Table 8 Trusteed Pension Funds' Revenues, 1990–2004 (\$Million)³²

End of year	Contributions	Investment income	Net profit on sales of securities	Other revenue	Total revenue
Millions of dollars					
1990	10,294	15,908	664	417	27,282
1991	11,675	15,683	2,360	332	30,050
1992	12,657	15,639	3,643	759	32,699
1993	14,008	16,124	9,559	828	40,519
1994	13,646	16,858	7,080	834	38,417
1995	14,064	18,009	9,790	582	42,445
1996	13,482	18,888	18,889	3,490	54,750
1997	13,314	19,185	29,847	1,295	63,641

³⁰ *Trend Watch 2007*, *supra*, n. 9 at 3-4.

³¹ The investment income of pension funds would also include income from real estate and short-term assets. The entire amount cannot be attributed to dividend and interest on securities traded in the capital markets.

³² Robert Anderson, "Trusteed Pension Plans and Funds, 1990 to 2004" in *Canada's Retirement Income Programs* (Ottawa: Statistics Canada, 2005).

End of year	Contributions	Investment income	Net profit on sales of securities	Other revenue	Total revenue
	Millions of dollars				
1998	12,949	20,416	23,466	3,835	60,666
1999	13,713	21,778	25,439	1,386	62,316
2000	12,296	23,670	47,219	4,436	87,621
2001	16,568	21,901	8,309	17,080	63,858
2002	19,409	20,892	1,697	7,444	49,441
2003	26,189	24,361	10,499	1,935	62,984
2004	29,674	25,463	28,193	12,289	95,589

Net profit on sale of securities, with all its instability, became increasingly more important in the revenue structure. From less than 5 percent of the investment income in 1990, the profit on sale of securities grew steadily. But the growth until 1995 was not as remarkable as it later became. In 1996, the gains from sale of securities surpassed investment income and this happened in five of the remaining eight years. Indeed in 2000, in the market peak before Enron and other corporate scandals and failures pulled down the market, the profit from sale of securities was almost double the investment income. Pension funds earned net profit of over the \$226 billion from sale of securities during 1990–2004. The total investment income in this period was about \$273 billion, which indicates the slight edge that investment income had.

The pattern of pension funds' revenue and rise in gains from trade in securities points towards greater turnover in the portfolios of pension funds. This is a significant shift, which weakens the conventional notions about pension as investors for the long-term and providers of "patient capital." If pension funds place increasing emphasis on trade in the market, that would make them more responsive to short-term movements in share prices. This may have important implications for their role as shareholders and for the governance of the investee-corporations. A shorter investment focus by the pension funds would undermine their incentive for engagement with the corporations.

Table 9 provides the details of the profits and losses of pension funds from trade in securities during 1990–2004.

Table 9 Results of Pension Funds' Securities Trade, 1990–2004³³
 (\$Million)

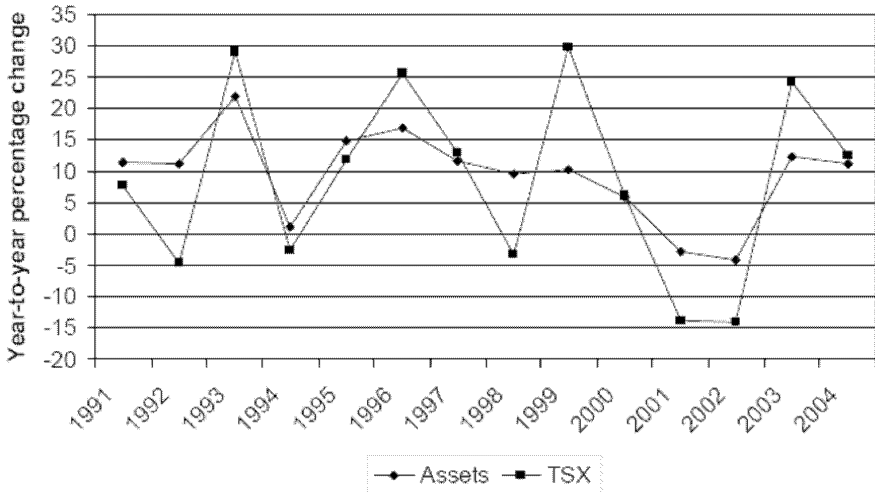
Year	Profit from Trade	Loss on Trade	Net Profit/(Loss)
1990	1,490	826	664
1991	2,714	354	2,360
1992	3,882	239	3,643
1993	9,576	17	9,559
1994	8,127	1,047	7,080
1995	10,161	371	9,790
1996	18,890	1	18,889
1997	29,938	91	29,847
1998	23,803	337	23,466
1999	26,218	779	25,439
2000	47,276	57	47,219
2001	16,529	8,220	8,309
2002	14,644	12,947	1,697
2003	17,621	7,122	10,499
2004	28,333	140	28,193
<i>Total</i>	<i>259,202</i>	<i>32,548</i>	<i>226,654</i>

The trading operations of pension funds have been generally profitable. This is not surprising considering that the market was in a bull phase. During the 15-year period, pension funds did not suffer net losses in any year. On the contrary, their profits rose consistently and substantially year after year until 2001. The profits earned by pension funds from trade in the market raise questions about the relative performance of their investments *vis-à-vis* other investors or benchmarks such as the TSX Composite Index. Tracking the movements in the total asset values of pension funds against the TSX Composite Index for the period 1991–2004, Robert Anderson found mixed results. Chart 5 brings out the comparison.³⁴

³³ *Ibid.*

³⁴ *Ibid.* The assets considered by Robert Anderson included capital market investments as well as other investments — namely, pooled, mutual and investment funds, mortgages, real estate, cash and short term. Anderson has relied, mainly, on the data from the Census of Trusteed Pension Funds which is comprehensive. He has supplemented them with the Quarterly Estimates of Trusteed Pension Funds, which is based on a smaller sample of the Census population.

Chart 5
Trusteed Pension Fund Asset Value versus TSX Composite Index A
Comparison of Percentage Change, 1991-2004



Out of the 14 years for which the data was compared, pension fund assets outperformed the TSX Index in 7 years. In particular, the losses of pension funds were significantly lower in 2001 and 2002 — years in which the stock market suffered steep declines. Among the remaining 7 years, there was a tie in 2000 and the TSX Index was higher in the other 6 years. The analysis does not suggest any clear-cut efficiency or superiority in the performance by pension funds. Active management of investments by pension funds does not appear to lead to results that are significantly superior to more passive varieties, such as indexed investments. Taking a more generous view, pension fund investments appear to be less volatile than the general market index and less subject to short-term fluctuations. This can be cited as a positive feature of active investment management by pension funds.

Studies of U.S. pension fund investments and their efficacy *vis-à-vis* general index benchmarks reveal interesting results. Two studies, which considered the period 1973–1982, concluded that DB plans underperformed the S&P 500 by 1.10 percent³⁵ and by 0.44 percent³⁶ per year. Pension plans' performance apparently worsened in the subsequent years; an analysis of data from 1983 to 1989 determined that the plans underperformed the S&P 500 by 2.5 percent a year.³⁷

³⁵ G. P. Brinson, R. Hood & G. L. Beebower, "Determinants of portfolio performance" (1986) 44 *Fin. Analysts J.* 231.

³⁶ R.A. Ippolito & J. A. Turner, "Turnover, fees and pension plans performance" (1987) 43 *Fin. Analysts J.* 16.

³⁷ J. Lakonishok, A. Schleifer & R W. Vishny, "The structure and performance of the money management industry" 1992 *Brookings Papers on Economic Activity: Macroeconomics* 339, online: <http://www.economics.harvard.edu/faculty/shleifer/files/structure_performance.pdf>.

Another set of studies show the opposite result. These studies found that pension funds outperformed index benchmarks. Early on in 1977, it was estimated that the average DB portfolio outperformed the S&P 500 by 1.44 percent per year.³⁸ This pattern was confirmed in a later work published in 1998.³⁹ More recently in 2006, it has been found that the average pension fund outperformed the market by 1.24 percent after expenses.⁴⁰ The recent years have seen a significant increase in the analysis of pension funds' investment performance.⁴¹

Either way, the two sets of analysis discussed above do not point towards sharp or significant deviation in the performance of pension fund investments from the index benchmarks. While one of them points towards a marginally superior performance by the pension funds, the other strand affirms an equally marginal inferiority on their part. Also, much of the data relate to periods in which share prices were generally rising. In the last two years, the stock market has seen considerable deflation, and this has important implications for pension funds. This is discussed a little later.

The decline in the position of investment income, shown in Table 8 above, was matched by the increase in the gains from sale of securities. The relative significance of gains from trade in securities and investment income become more obvious when interpreted as percentages of the total revenues of pension funds. The percentage figures are shown in Chart 6 below.

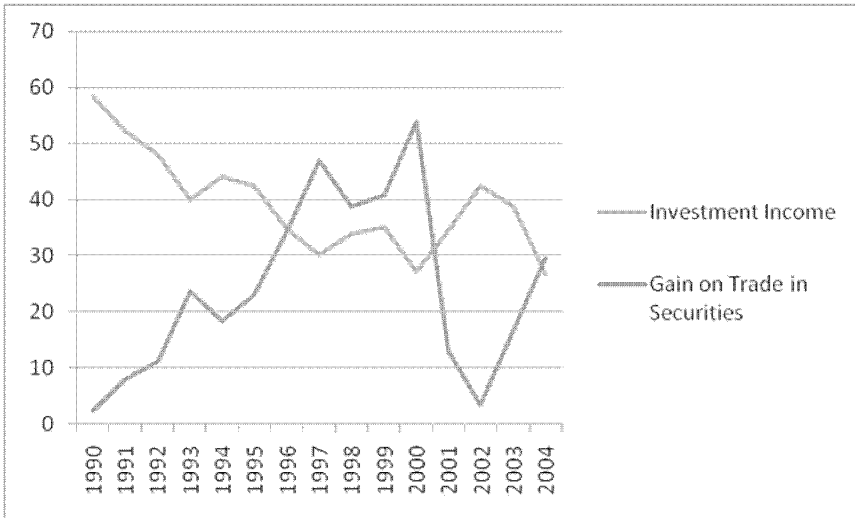
³⁸ G. L. Beebower & G. L. Bergstrom, "A performance analysis of pension and profit-sharing portfolios: 1966–1975" (1977) 33 *Fin. Analysts J.* 31.

³⁹ J. A. Christopherson, W. E. Ferson & D. A. Glassman, "Conditioning manager alphas on economic information: Another look at the persistence of performance" (1998) 11 *Rev. Fin. Studies* 111.

⁴⁰ J. Busse, A. Goyal & S. Wahal, "Performance persistence in institutional investment management" (July 2006), online: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890319>.

⁴¹ See *e.g.*, K. Ambachtsheer, *Pension Revolution: A Solution to the Pension Crisis* (Toronto: John Wiley & Sons, 2007) at 236–238; W. Ferson & K. Khang, "Conditional performance measurement using portfolio weights: evidence for pension funds" (2002) 65 *J. Fin. Econ.* 249; R. Wermers, "Mutual fund performance: An empirical decomposition into stock-picking talent, style, transactions costs, and expenses" (2000) 55 *J. Fin.* 1655; A. Khorana, H. Srvaes & P. Tufano, "Mutual Fund Fees Around the World" (2007) *HBS Finance Working Paper* No. 901023, online: <<http://ssrn.com/abstract=901023>>.

Chart 6
Investment Income and Profit on Sale of Securities as a Percentage of Revenues, 1990-2004⁴²



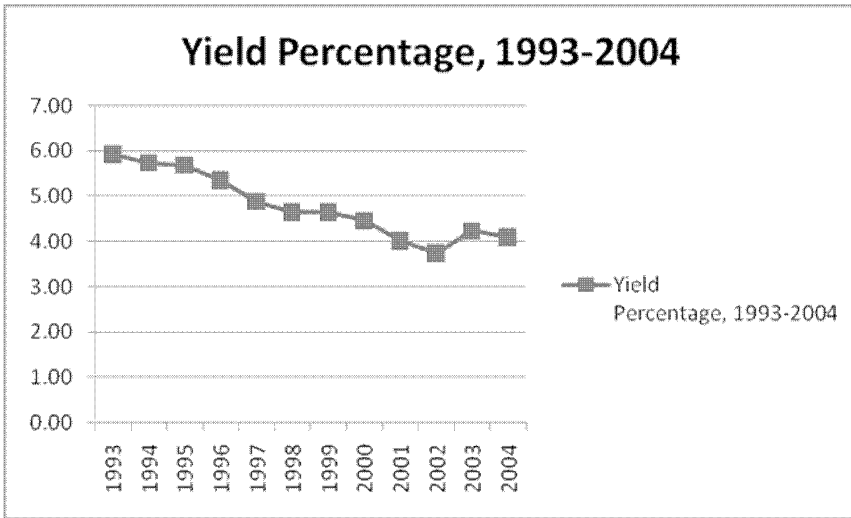
The trend in investment income is clear. While increases in investments have led to higher income in dollar terms, the relative importance of investment income has been in decline. From over 58 percent of the total revenue in 1990, investment income fell to just over twenty-five percent in 2006. The decline can be attributed, at least in part, to fall in interest rates and reduced holdings of bonds by pension funds discussed earlier.⁴³ Another explanation could be the trend of falling dividend payouts that has been identified in the United States.⁴⁴ The yield on investments, or income as a percentage of the book value of the assets, declined from 5.94 in 1993 to 4.1 in 2004, as shown in the following graph.

⁴² Based on data in Anderson, *supra*, n. 32.

⁴³ *Supra*, n. 5.

⁴⁴ See for example, Eugene Fama & Kenneth French, "Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay" (2001) 60 *J. Fin. Econ.* 3. In Canada, this trend draws support from a recent study by Stephen R. Foerster & Stephen Sapp, "The Changing Role of Dividends: A Firm-Level Study from the Nineteenth to the Twenty-First Century" (2006) 39 *Can. J. Econ.* 1316. Foerster and Sapp found that investors' perception of dividends has changed over time, allowing managements to pay smaller dividends and reinvest funds in the corporations. There does not appear to be any empirical study of the trend on dividend payment among Canadian corporations in the recent decades.

Chart 7
Yield on Trusted Pension Fund Assets — 1993-2004⁴⁵



(d) Recent Decline in Share Values — Implications for Pension Fund Solvency

Decline in the importance of investment income was accompanied, as noted earlier, by a rise in the significance of gains from trade in securities. Trade gains emerged as a major source of revenues for pension funds. In 2000 at the height of a long bull market, the gains from the sale of securities, at 53.9 percent, represented over half the total revenues of pension funds. They fell to lows of 13 percent and less than 4 percent in the next two years in which the market deflated and share prices fell. By 2004 however, the bull market had resumed and the gains from sale of securities recovered to a level of almost 30 percent of the total revenue.

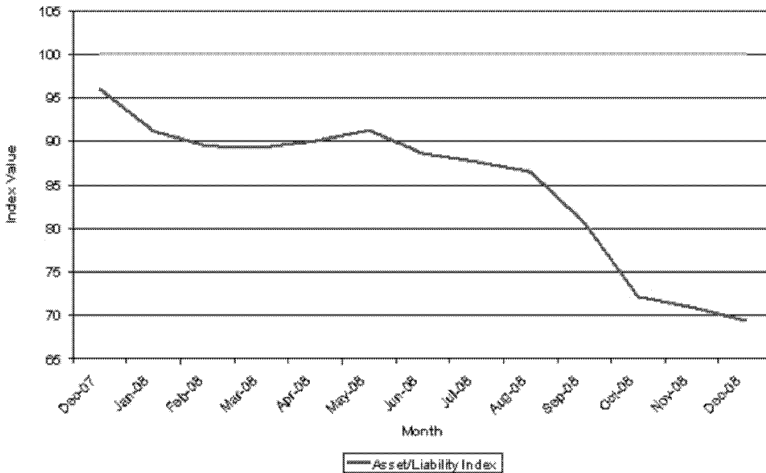
The recent instability in the stock market and swings in share prices are pointers to the perils in placing excessive reliance on trading transactions to derive revenue. The unsteady course of the indexes is fresh evidence of the systemic risks in the financial markets. From a high of 15,128 in May 2008, the TSX Composite Index fell more than 47 percent to a low of 7,997 in March 2009. By June 2009, it had recovered to an average high of 10,374.⁴⁶

The recent decline in share values in the stock market placed pension funds under considerable stress. The problem has been especially acute for DB plans whose payment obligations are fixed. A recent survey of DB plans found a worsening of the gap between their asset base and pension liabilities. The solvency gap for DB plans since December 2007 is shown in the graph below.

⁴⁵ Yield has been computed by measuring the investment income of pension funds against the book value of their assets for the respective years, per Statistics Canada, Table 280-0002, *supra*, n. 3.

⁴⁶ Data from Yahoo Canada Finance, online: <<http://ca.finance.yahoo.com>>.

Chart 8
Solvency of Defined Benefit Plans⁴⁷
 Solvency: Growth Portfolio, 50% Active Liabilities



From over 95 percent in December 2007, the solvency ratio plummeted to less than 70 percent a year later in December 2008. According to a latest estimate, the position has since improved and the solvency is 75 percent at the end of June 2009.⁴⁸ It is not clear whether share prices will regain the lost ground and help the pension funds in reaching the condition of near-complete solvency that existed at the end of 2007. The bear phase in the stock market has come as a “double-whammy” for the pension funds, which have been hit by fall in the yield on their investments.

4. PENSION FUNDS AND CORPORATE GOVERNANCE

As large shareholders, pension funds have tended to expand their role in the governance of the corporations in which they hold investments. This part reviews pension fund engagement in corporate governance and finds the following:

- Canadian pension funds have attempted systemic and concerted action to promote good governance of public corporations. The CCGG, which was launched by the large pension funds in 2002, is a prominent example of this trend. The CCGG regularly tracks issues related to pension fund investments and provides policy guidelines to its members. PIAC is another agency that plays a similar role and enhances the capability of its members to be effective shareholders.

⁴⁷ Watson Wyatt Worldwide. “The Solvency of Canadian Pension Plans Plummet in 2008, Watson Wyatt’s Pension Barometer Finds” (8 January 2009), online: <<http://www.watsonwyatt.com/news/press.asp?ID=20364>>.

⁴⁸ Janet McFarland, “Pension funds turn the corner” *The Globe and Mail* (9 July 2009) B4.

- The involvement of institutional investors, including pension funds, in corporate governance has myriad implications, both positive and negative. On the positive side, funds are in a position to effectively influence corporate managements and promote accountability. Consultation is the common instrument used by pension funds; more confrontational methods such as threat of litigation and exit are less prevalent. The negatives include the tendency of some funds to free-ride on the initiatives of others and conflicts of interests for pension fund managers who are dependent on corporate managers for business. There is also the “agency problem” that arises from the fund managers’ lack of proprietary interest in the funds under their control.⁴⁹
- Pension funds in Canada rely more on informal discussions with corporate managers for resolving governance issues. The general preference is to avoid confrontational methods such as negative voting, litigation or proxy campaigns. This trend has continued substantially in the recent years. However, there are instances of more activist intervention, including litigation by the funds against managements.
- Seeking directorship in corporations has not been high on the agenda of pension funds. This might, however, see some changes with the increasing investments in private equity and venture capital discussed earlier.
- The available data on shareholder proposals do not suggest that pension funds actively use this instrument for intervention in corporate governance.
- Pension funds normally delegate the task of proxy voting to their fund managers. There is, however, an increasing trend for the funds to provide instructions to the managers on proxy voting. Consistent with their preference to avoid confrontations, most funds cast their votes with the managements of the corporations.

(a) Pension Fund Initiatives to Promote Good Corporate Governance

The last few years have seen increased pension fund activism to promote good governance in the corporations in which they hold shares. This section reviews the initiatives taken by Canadian pension funds in this regard. Pension funds, in particular OTPP and its chief executive officer Claude Lamoreux, were instrumental in

⁴⁹ The earliest exposition of the agency problem in corporate organizations — namely, control of the resources of a large number of persons by a small group, was by Adam Smith, *An Enquiry into the Nature and Causes of the Wealth of Nation* (1787) (New York: The Modern Library, 1937) at 700. The same theme animated Adolf A. Berle & Gardiner C. Means’ *The Modern Corporation and Private Property* (New York: Macmillan Company, 1932). More recently, the agency discourse is traced to Michael C. Jensen & William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” (1976) 3 J. Fin. Econ. 305.

launching the CCGG in 2002. The CCGG, which encourages pension funds to engage with the corporations, has defined its mission in the following terms:

Representing the interests of institutional shareholders, the Canadian Coalition for Good Governance promotes good governance practices in Canadian Public Companies and the improvement of the regulatory environment to best align the interests of boards and management with those of their shareholders, and to promote the efficiency and effectiveness of the Canadian capital markets.⁵⁰

The CCGG currently has 41 members with assets of over \$1 trillion.⁵¹ The membership of CCGG has a large presence of fund managers. The CCGG has developed guidelines on corporate governance practices, executive compensation and majority voting.⁵² Significantly, CCGG has also prepared a discussion paper on the “break fees” or “termination fees” payable by target corporations to unsuccessful bidders in friendly takeover bids that have the support of target companies’ managements. This is, perhaps, a pointer to pension funds becoming more active in takeovers and change of corporate control.⁵³

In November 2006, David Beatty, the Managing Director of CCGG, stated that the efforts of the CCGG to promote good corporate governance have been effective, and that governance risk ratings for corporations declined from over 35 percent in 2002 to 26 percent in 2005.⁵⁴ CCGG has gained significantly in stature since its launch and is active in promoting institutional investor engagement with corporations.

PIAC is a much older alliance, specifically comprising pension funds. It was established in 1977 and has over 130 members representing \$892 billion in assets.⁵⁵ PIAC, which also encourages its members to engage with the corporations, has developed its own set of Corporate Governance Principles and Guidelines.⁵⁶

The governance initiatives of CCGG and PIAC represent the efforts of pension funds, at the industry-level, to promote shareholder engagement and good corporate governance. Other than such collective efforts, individual pension funds — in particular, large funds such as the OTPP — have been actively engaged with the

⁵⁰ Canadian Coalition for Good Governance, Mission and Mandate, online: <<http://www.cggg.ca/about-the-cggg/mission-and-mandate/>>.

⁵¹ The membership of CCGG is quite mixed. Other than mainstream pension funds such as Canada Pension Plan (“CPP”) and Ontario Pension Board (“OPB”), there are a large number of fund managers — for example, CIBC Global Asset Management and TD Asset Management. Online: CCGG <<http://www.cggg.ca/membership/members-list/>>.

⁵² *Ibid.* Guidelines and principles, online: <<http://www.cggg.ca/guidelines/>>.

⁵³ A prominent example is the recent high-profile efforts made by OTPP for a leveraged buyout (“LBO”) of Bell Canada.

⁵⁴ Online: CCGG <<http://www.cggg.ca/media/files/speeches/David%20Beatty%20%2D%20Luncheon%20Address.pdf>>.

⁵⁵ Pension Investment Association of Canada, online: <<http://www.piacweb.org/>>.

⁵⁶ PIAC Corporate Governance Principles and Guidelines, online: <<http://www.piacweb.org/files/PIAC%20Corporate%20Governance%20Principles%20and%20Guidelines%20may%209%2007.pdf>>.

corporations in recent years. For a number of reasons discussed here, pension fund activism in corporate governance is likely to strengthen in the future.

(b) Pension Funds and Corporate Governance — An Overview

The role of institutional investors in corporate governance has been a prominent issue at least since the 1970s. Interest in the role of Institutional investors, among whom pension funds are a preeminent group,⁵⁷ was triggered by judicial decisions in the United States, such as *Blankenship v. Boyle* (1971),⁵⁸ and literature on the subject. Peter Drucker published *The Unseen Revolution: How Pension Fund Socialism Came to America*⁵⁹ in 1976 and Rifkin and Barber's *The North Will Rise Again: Pension, Politics and Power in the 1980s*⁶⁰ appeared in 1978. These works turned the focus on pension funds, which continued to be a topic of interest through the 1980s. Significant contributions came from scholars such as John Langbein and Richard Posner (1981).⁶¹ There were also calls for federal regulation of pension fund investments.⁶²

In the 1990s, the enthusiasm about institutional investors was even greater.⁶³ A mood of optimism was dominant, and scholars such as Bernard Black (1990⁶⁴ and 1992⁶⁵), John C. Coffee, Jr. (1991)⁶⁶ and Ronald Gilson and Reinier Kraakman (1991)⁶⁷ expected that institutional investors would contribute significantly to the governance of public corporations. They pointed out that institutional investors were well-placed to effectively monitor corporate managements, and that would

⁵⁷ There are, however, significant differences between pension funds and other institutional investors such as mutual funds. By definition, pension funds must take a medium and long-term view of their investments and their concern for the short-term ought to be less. These considerations would, normally, result in the differences between the approach of pension funds and many other categories of institutional investors.

⁵⁸ 329 F. Supp. 1089 (D.D.C.) (1971).

⁵⁹ (New York: Harper & Row, Publishers, 1976).

⁶⁰ (Boston: Beacon Press, 1978).

⁶¹ See for example, John H. Langbein & Richard A. Posner. "Social Investing and the Law of Trusts" (1981) 79 Mich. L. Rev. 72. The authors were essentially critical of "social investments" by institutional investors, but their work is evidence of the growing interest in institutional investors and their practices.

⁶² Kathleen Paisley, "Public Pension Funds: The Need for Federal Regulation of Trustee Investment Decisions" (1985) 4 Yale L. & Pol'y Rev. 188.

⁶³ Some of the studies discussed below were about institutional investors in general, and not pension funds in particular. Pension funds have always been a major part of institutional investors and the findings are quite relevant for them.

⁶⁴ "Shareholder Passivity Re-examined" (1990) 89 Mich. L. Rev. 520.

⁶⁵ "The Value of Institutional Investor Monitoring" (1992) 39 U.C.L.A. L. Rev. 895; "Agents Watching Agents: The Promise of Institutional Investor Voice" (1992) 39 U.C.L.A. L. Rev. 813.

⁶⁶ "Liquidity v. Control: The Institutional Investor as Corporate Monitor" (1991) 91 Colum. L. Rev. 1277.

⁶⁷ "Re-inventing the Outside Director: An Agenda for Institutional Investors" (1991) 43 Stan. L. Rev. 863.

lead to better value for the corporations — both business profits and higher share prices in the stock market. The writings reflected the concerns of the law and economics movement that was particularly influential during the 1980s and 1990s. It was the “shareholder value” era, and quite understandably, capital markets and share prices dominated the discourse on institutional investors and their impact on corporate governance.

There were, however, other voices that were less sanguine about institutional investors and their ability to play a meaningful role. William O’Barr and John M. Conley (1992), who studied nine large pension funds, found that their fund managers were quite conservative and preferred to avoid personal responsibility for decisions.⁶⁸ The eagerness of the managers to adopt investment strategies like indexing meant that there was little need for individual assessment of investment opportunities and selection based on the assessment. Roberta Romano (1993) was also skeptical of the institutional investors being effective shareholders.⁶⁹

Sunil Wahal (1996) questioned whether pension fund activism led to higher valuations for the target companies.⁷⁰ Wahal studied the corporations in which nine large pension funds, including California Public Employee Retirement System and Colorado Public Employee Retirement System were active between 1987 and 1993. On reviewing the mechanisms used by pension funds used for intervention, the study found that the funds were reasonably successful in ushering in changes in the governance structure of the corporations. The success rate of the pension funds was determined at 40 percent. On another note, Wahal found no “abnormal” share price returns in these corporations that pension funds targeted for activism. Bernard Black, who was earlier optimistic about institutional shareholder activism, concluded in 1998 that the effect of institutional investors on performance is not significant.⁷¹ The concern of Black was with share prices as the barometer of corporate performance.

In Canada, Jeffrey MacIntosh (1993) shared the contemporary optimism of Bernard Black (1990) and John Coffee (1992) that institutional investors would have a positive effect on corporate governance.⁷² MacIntosh predicted that the “rise of the institutional investor is likely to improve monitoring of corporate managers.”⁷³ To facilitate them to play an activist role, he proposed a number of regulatory measures, such as protecting fund managers against pressure from corporate

⁶⁸ *Fortune and Folly: The Wealth and Power of Institutional Investing*, (Homewood, Illinois: Business One Irwin, 1992); “The Culture of Capital: An Anthropological Investigation of Institutional Investment” (1992) 70 N.C.L. Rev. 823.

⁶⁹ “Public Pension Fund Activism in Corporate Governance Reconsidered” (1993) 93 Colum. L. Rev. 795.

⁷⁰ Sunil Wahal, “Pension fund activism and firm performance” (1996) 31 J. Fin. & Quantitative Analysis 1.

⁷¹ Bernard S. Black, “Shareholder Activism and Corporate Governance in the United States” in *The New Palgrave Dictionary of Economics and the Law*, vol. 3, at 459–465, 1998, online: SSRN <<http://ssrn.com/abstract=45100>> or DOI: <10.2139/ssrn.45100>.

⁷² “The Role of Institutional and Retail Investors in Canadian Capital Markets” (1993) 31 Osgoode. Hall L. J. 371.

⁷³ *Ibid.*, at 371.

managers and facilitating shareholders to communicate among themselves without triggering proxy procedures.⁷⁴

In 1992, a survey of over 100 institutional investors in Canada found increased awareness about corporate governance.⁷⁵ In particular, large public sector pension funds tended to be activist. The case was quite different with smaller private sector ones, which were more likely to be passive.

Writing about institutional investors again in 1996, Jeffrey MacIntosh concluded that, by and large, experience affirmed his earlier optimism that they would make a positive difference to corporate governance. Recounting the experience, MacIntosh identified some positives in activism by the institutional investors and the negatives associated with it.⁷⁶

(i) Institutional Investor Activism — Positive Factors

- Acting in unity, institutional shareholders can act as a check against controlling shareholders. Even if the institutional shareholders are unable to pass or defeat ordinary resolutions that require a simple majority of votes, they could still be effective in dealing with special resolutions that require two-thirds majority.
- Institutional investors have significant powers of moral suasion and are well-fitted to play the role of diplomats and critics.
- Institutions, with their resources, are more likely to sue erring managements than private or retail investors.
- Through the exercise of dissent rights and the exit option, institutional investors can send strong signals to managements and act as a restraining force.
- Institutional investors can play a significant role in spurring legislative change.

(ii) Institutional Investor Activism — Negative Factors

- Activist institutional investors might be deterred by the problem of free-riding by other investors.
- Agency problem and the lack of proprietary interest are equally applicable to institutional investors that are themselves managed by professionals under fiduciary duties. They would be less effective in overseeing corporations managed by another set of fiduciaries.

⁷⁴ The difficulties created by the restrictive proxy rules were a longstanding issue, and they have since been amended. This is discussed in Part 5 below.

⁷⁵ Kathryn E. Montgomery, “Survey of Institutional Investors” (1992) 4 Corp. Gov. Rev. 5. See also Jeffrey Larsen, “Institutional Investors, Corporate Governance and Proxy Voting Disclosure” in Puri & Larsen, eds., *Corporate Governance and Securities Regulation in the 21st Century* (Toronto: Butterworths, 2004).

⁷⁶ Jeffrey MacIntosh, “Institutional Shareholders and Corporate Governance in Canada” (1996) 26 Can. Bus. L.J. 145.

- Fund managers are usually dependent on corporate managers for business. Fear of losing business could make them reluctant to be seen as overactive in their monitoring role.
- Corporate managers and directors often act as trustees or directors of pension funds. The resulting conflicts of interests might tempt the corporate executives to invest the funds in their own companies.
- Nonvoting shares and lack of voting rights are another issue. Institutional investors holding nonvoting shares would be less effective monitors.
- Sometimes, institutional investors could be under political pressure not to take certain actions — for example, on the ground that they would weaken the economy. This could inhibit the funds from taking action they might consider appropriate in the interests of the investee-corporation and the beneficiaries of the fund.
- The monitoring capability of institutional investors is subject to systemic limitations, human and financial.
- The imperatives of liquidity would place institutional investors — in particular, mutual funds — under conflicting pressures.⁷⁷
- Legal restraints on institutional activism, such as the rule on proxies (which has since been amended), discourage communication among the shareholders and weaken their efficacy.
- The dominant culture of passivity among institutional investors makes it difficult for them to achieve changes.
- A fear of political backlash in the form of greater regulation of institutional investors could deter activism.
- By sending negative signals about particular corporations, institutional investors could trigger a “race for exit” among the shareholders.
- Systemic difficulties such as lack of contact details might hamper the ability of institutional investors to communicate with other shareholders.
- Institutional managers are as vulnerable to short-termism as their counterparts in the corporations.

The discourse on shareholder activism by pension funds started on a note of strong optimism. It has since been tempered by the reality of experience over the last two decades. It would be unrealistic to expect pension funds to radically transform the position and role of shareholders in contemporary corporate governance. Yet it is obvious that pension funds and other institutional investors have produced a favourable impact on the governance climate. This much is conceded by scholars like Allan Hutchinson who complain that institutional investors have not lived up

⁷⁷ This would not be equally relevant for pension funds, which are supposed to be more concerned with the medium and long term. However, their increased reliance on gains from trade transactions, discussed earlier, exposes their vulnerability in this regard.

to their potential.⁷⁸ More empirical research on shareholder activism by pension funds can be valuable in understanding the recent trends.

(c) Institutional Investor Activism in Canada

The shareholding patterns in public corporations in Canada are distinctive. They are different from the United States which is characterized by widely-held public corporations in which no single shareholder or an identifiable group of shareholders have controlling power. This is quite unlike the situation in Canada.⁷⁹ In 1998, the latest year when the subject was examined, it was found that almost half the top 100 listed corporations in Canada were under the control of a family or an identifiable group of shareholders. Another quarter was foreign-controlled, and only the remaining quarter comprised widely-held corporations that had no controlling shareholders.⁸⁰ This fact must inform any study institutional on investor activism in the Canadian context.

The presence of a controlling group of shareholders, which is often the case in Canada, would be a significant factor. It can have an impact on activism by other shareholders including institutional investors. Outside shareholders would likely be less effective in such corporations than in the typical widely-held corporations that have no controlling shareholders. In a confrontation, the controlling shareholders can override the wishes of the institutional investors.⁸¹

Culture is another factor. Jeffrey MacIntosh (1993) has pointed out the preference in Canada for less confrontational approaches:

In Canada's tightly knit financial community, much institutional "activism" has taken the route of quiet, behind-the-scenes, diplomacy, whereby institutions meet privately with managements in order to make their views known.⁸²

⁷⁸ *The Companies We Keep: Corporate Governance for a Democratic Society* (Toronto: Irwin Law, 2005), Chapter 9, "The Age of Institutions: Rise and Ruse?"

⁷⁹ For a summary of the characteristics of the capital markets in Canada and important statistics, see Chris Nicholls, "The Characteristics of Canada's Capital Markets and the Illustrative Case of Canada's Legislative Regulatory Response to *Sarbanes-Oxley*" (June 2006) in *Canada Steps Up*, (Final report of the Task Force to Modernize Securities Legislation in Canada, Toronto, ON.), Vol. 4: *Maintaining a Competitive Capital Market in Canada*, online: <[http://www.tfmsl.ca/docs/V4\(3A\)%20Nicholls.pdf](http://www.tfmsl.ca/docs/V4(3A)%20Nicholls.pdf)>.

⁸⁰ Randall Morck & Bernard Yeung, "Some Obstacles to Good Corporate Governance in Canada and How to Overcome Them" (August 2006) in *Canada Steps Up*, (Final report of the Task Force to Modernize Securities Legislation in Canada, Toronto, ON.), Vol. 4: *Maintaining a Competitive Capital Market in Canada*, online: <[http://www.tfmsl.ca/docs/V4\(5\)%20Morck.pdf](http://www.tfmsl.ca/docs/V4(5)%20Morck.pdf)>.

⁸¹ In such cases, the outvoted minority can invoke the oppression remedy (*Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 241). However, the oppression remedy is designed for remedying specific grievances, rather than an instrument for promoting inclusive corporate governance on an ongoing basis.

⁸² MacIntosh, *supra*, n. 72 at 381.

More recent evidence of the preference for a relational approach and dialogue is seen in the statements of the CCGG. In its 2004 annual report, CCGG cautioned against aggressive or confrontational methods:

We [the Coalition] will continue to “walk softly and carry a big stick”. We walk softly, preferring to do our work outside of the media glare. The “stick” we carry really belongs to our members who, should they be unhappy about the governance progress at any particular company, may choose to speak publicly or vote their shares accordingly.⁸³

This is not to suggest that there has not been any confrontation by pension funds. Jeffrey MacIntosh (1996) explained how institutional investors were instrumental in defeating dual class recapitalizations proposed in Crownx, Seagrams and Canadian Tire, and the poison pill provision in Labatt.⁸⁴ More recently, important lawsuits were filed by OTPP against Nortel Networks Corporation (“Nortel”) and OMERS against Ford Canada.⁸⁵

There are reports pension fund managers are holding discussions with the corporations. Such meetings provide an informal mechanism for intervention in issues,⁸⁶ and they support the thesis about the preference of pension funds for non-confrontational approaches. Claude Lamoureux, former chief executive officer of OTPP, reportedly commanded substantial respect when he raised governance issues and was usually able to get them resolved.⁸⁷ Another instance of pension fund activism is seen in the practice of Canada Pension Plan Investment Board (“CPPIB”) to seek information from corporations on environmental issues and risks.⁸⁸

(d) Shareholder Activism by Pension Funds — Its Dimensions

Pension funds have a number of avenues for engaging with the corporations and being active shareholders. Representation on corporate boards, litigation against managements, initiating and/or supporting shareholder proposals and proxy voting would be the major instruments for shareholder activism. These are discussed below. The analysis reveals an increase in activism by pension funds in recent years, a trend that will probably continue.

⁸³ Corporate Governance Principles and Guidelines (May 2007) at 3, online: Canadian Coalition for Good Governance <<http://www.ccg.ca/media/files/annual-reports/CCGGAnnualReport2005.pdf>>.

⁸⁴ MacIntosh, *supra*, n. 76 at 173.

⁸⁵ Litigation by pension funds is discussed a little later.

⁸⁶ See for example, the statements of Claude Lamoureux, chief executive officer of OTPP in Elizabeth Church, “Cleaning up corporate governance, one company at a time” *The Globe and Mail* (27 June 2005) B5.

⁸⁷ See for example, Derek Decloet, “Why teachers won’t be preachers” *The Globe and Mail* (6 September 2007) B2.

⁸⁸ Shawn McCarthy, “Assess climate risks, firms urged” *The Globe and Mail* (31 October 2007) at B3.

(i) *Representation on Boards of Directors*

Representation on boards is a direct form of activism. Board position provides a vantage point and the opportunity to participate in governance. Equally, it entails significant responsibilities — at least in theory.⁸⁹ There is empirical evidence that pension fund managers tend to be quite conservative.⁹⁰ Consistent with this, generally pension funds have been not enthusiastic about board positions in corporations. The 1992 survey of Canadian institutional investors, referred to earlier, found that “most institutions shied away from board representation, citing the conflict-of-interest that could arise from ‘wearing two hats.’”⁹¹

The Memotec episode of early 1990s can be cited as another instance of pension funds’ reluctance to seek positions on corporate boards. Caisse de depot et placement du Quebec and OMERS, which are both public sector funds and regarded as more activist, had a dispute with the management of Memotec. In the efforts to put an end to the dispute, the two funds helped Gordon Capital Corp., another institutional shareholder, to place independent directors on Memotec’s board.⁹² Significantly, the pension funds did not play a more direct role — such as placing their nominees on the board of Memotec.

Some signs of change are visible in the recent years. Large pension plans, notably OTPP and OMERS, have started making outright acquisitions of companies,⁹³ and this gives them direct responsibility for the business. The new culture was visible in 2007 when Jim Leech, the incoming chief of OTPP, made the announcement about the appointment of George Cope as the chief executive officer of Bell Canada.⁹⁴ In October 2008 when OTPP announced the acquisition of Aquilex, its chief executive officer stated that the management is “excited to have Teachers’ on board and . . . look[s] forward to working together to further increase Aquilex’s long-term value.”⁹⁵

⁸⁹ The efficacy of the directors has always been controversial. A number of American studies found significant weaknesses in the theory and reality of the directors of public corporations. See *e.g.*, Myles Mace, *Directors: Myth and Reality* (Boston, MA.: Harvard Business School, 1971) and more recently, Paul W. MacAvoy & Ira M. Millstein, *The Recurrent Crisis in Corporate Governance* (Stanford, CA.: Stanford Business Books, 2004).

⁹⁰ O’Barr & Conley, *supra*, n. 68.

⁹¹ Montgomery, *supra*, n. 75, cited in Kathryn E. Montgomery, “Market Shift — The Role of Institutional Investors in Corporate Governance” (1996) 26 *Can. Bus. L. J.* 189 at 195.

⁹² See MacIntosh, *supra*, n. 72 at 378.

⁹³ For example in 2008, OTPP announced two business acquisitions — an American service company, Aquilex and an electricity business in Chile. Ontario Teachers Pension Plan, news releases, online: <http://www.otpp.com/wps/wcm/connect/otpp_en/Home/Newsroom/News+Releases/2008/>.

⁹⁴ Wojtek Dabrowski, “Cope tapped to be BCE’s post-buyout CEO” (17 October 2007), online: Reuters <<http://www.reuters.com/article/innovationNews/idUSWNAS679720071017>>.

⁹⁵ Ontario Teachers Pension Plan, news release “Teachers’ Private Capital acquires Aquilex, U.S.-based industrial cleaning, repair service company,” Toronto, 6 October

Greater involvement in business and strategy appears to be the trend for the future, given the increasing investments in venture capital and private equity. In these investments, pension funds would not have ready liquidity and would rely more on business profits and dividends. Even for public corporations, the recent decline in share prices would encourage the funds to pay greater attention to business profits and the stream of income from dividends.

(ii) *Litigation by Pension Funds*

As large investors with sizable resources, pension funds are better placed than retail investors to litigate with corporate managements on specific issues. The recent experience with pension funds suggests that they are now more ready to take the litigation route. The case was different earlier. In 1995, the Allen Committee on Corporate Disclosure established by Toronto Stock Exchange described the prevailing attitudes:

Institutional investors admitted that they would be loath to sue a company for misleading disclosure. Several reasons were cited for this stance. Institutions are reluctant to draw attention to investment “mistakes.” Institutions do not wish to pour extensive resources (management time, money and expertise) into a lengthy litigation process when resources can be more fruitfully employed targeting new investment opportunities. Finally, institutions prefer to deal with sensitive issues such as disclosure practices in a far less confrontational and more private manner. Often discussions with the management on such issues are productive.⁹⁶

The number of significant cases that institutional investors have filed against corporations since 1996 has been estimated at 12.⁹⁷ Of these, one was filed by OMERS against Ford Motor Co.⁹⁸ OMERS invoked the oppression remedy to assail Ford’s pricing system by which most of the profits of the Canadian subsidiary were transferred to the American parent. The court recognized oppression, but OMERS was denied relief on a technical ground — namely, the oppressive practices had occurred before OMERS bought shares in the company. Recently, Ironworkers Ontario Pension Fund filed a suit against Research in Motion (“RIM”)

2008, online: <http://www.otpp.com/wps/wcm/connect/otpp_en/home/newsroom/news+releases/2008/aquilex>.

⁹⁶ TSE Committee on Corporate Disclosure (Thomas I.A. Allen, Chair), cited in John Chapman, “Institutional Activism: Current Trends and Emerging Legal Issues” (2007) 44 Can. Bus. L. J. 327, at 333.

⁹⁷ Chapman, *ibid.*, at 335–338.

⁹⁸ *Ford Motor Co. of Canada v. Ontario (Municipal Employees Retirement Board)* (2006), 2006 CarswellOnt 13, [2006] O.J. No. 27, 12 B.L.R. (4th) 189, 79 O.R. (3d) 81, 263 D.L.R. (4th) 450, 206 O.A.C. 61 (Ont. C.A.); additional reasons at (2006), 2006 CarswellOnt 1526, [2006] O.J. No. 990, 208 O.A.C. 125, 17 B.L.R. (4th) 169 (Ont. C.A.); leave to appeal refused [2006] S.C.C.A. No. 77, 2006 CarswellOnt 5134, 2006 CarswellOnt 5135, [2006] 2 S.C.R. x, 267 D.L.R. (4th) ix, 225 O.A.C. 400 (note), 358 N.R. 393 (note) (S.C.C.).

assailing the stock options granted by the company. The suit, which was filed in Ontario in January 2007, was settled in a matter of months in October 2007.⁹⁹

There has been a practice among Canadian pension funds to file lawsuits against Canadian corporations in United States courts. They were able to do so since the securities were listed on American stock exchanges. OTTP, which appears to be particularly fond of action in the United States, has stated that it trades securities on New York Stock Exchange, rather than Toronto Stock Exchange, as that would enable it to litigate in the United States if necessary. The following are some examples of the OTTP's legal action in the United States.

- Suit against Nortel — settled by Nortel with a payment of nearly \$2.5 billion to the investors including OTTP.¹⁰⁰
- Suit against Biovail Corporation — settled in December 2007 for \$138 million.¹⁰¹

The preference for United States courts can be potentially explained by the perception that Canadian courts are less effective in dealing with misconduct in the capital markets. This can make investors reluctant to file actions in Canada.¹⁰² There is evidence of similar reservations about Canadian regulators and effective enforcement by them.¹⁰³

John Chapman (2007) expects significant changes in the litigation scene in the coming years. A variety of factors, Chapman argues, are likely to alter the picture and lead to increased investor litigation in Canada. Among the factors noted by Chapman are the increased presence of American institutional investors in Canada, the rise of entrepreneurial lawyers and success fee engagements and the oppression remedy in Canadian corporate law.¹⁰⁴

American studies on litigation by institutional investors and its efficacy have found divergent results. According to Keith Johnson (1997), institutional investors are best suited for the task of deterring corporate fraud through securities litigation.¹⁰⁵ Their large shareholdings provide a powerful incentive for taking action, and institutional investors also have the advantages of sophistication and expertise. Michael Perino (2006) found that securities class actions initiated by pension funds

⁹⁹ Catherine McLean, "RIM suit settled; stock surges 11%" *The Globe and Mail* (6 October 2006) B9.

¹⁰⁰ Catherine McLean, "Nortel pays big to settle lawsuits" *The Globe and Mail* (9 Feb. 2006) B1.

¹⁰¹ Ontario Teachers' Pension Plan, news release, "Teachers' announces \$138 million Biovail settlement" (December 11, 2007), online: <http://www.otpp.com/wps/wcm/connect/otpp_en/home/newsroom/news+releases/2007/teachers+announces+%24138+million+biovail+settlement>.

¹⁰² See *e.g.*, Madelaine Drohan, "Canada's corporate crime capers" *The Globe and Mail* (23 June 2005) A23.

¹⁰³ Poonam Puri, "Enforcement Effectiveness in the Canadian Capital Markets" (June 2005) Capital Markets Institute, Joseph Rotman School of Business, University of Toronto.

¹⁰⁴ Chapman, *supra*, n. 96.

¹⁰⁵ Keith L. Johnson, "Deterrence of corporate fraud through securities litigation: the role of institutional investors" (1997) 60 *Law. & Contemp. Probs.* 155.

were more effective in procuring settlements than those initiated by other classes of plaintiffs.¹⁰⁶ The higher success rate of institutional investors in litigation affirms Keith Johnson's thesis about their ability to bring effective action.

On the flip side, a study by James Cox and Randall Thomas (2002) detected negligence and apathy in many institutional investors. Their managers failed to file claims in the securities class actions initiated by others.¹⁰⁷ This suggests that institutional investors did not keep track of the lawsuits brought by others and did not take action to ensure that their funds benefited from the suits. This is a signal to the pension funds to keep track of events in their investee-corporations. It is not adequate if they bring legal action in cases they consider appropriate; they must also participate in the lawsuits brought by other shareholders.

(iii) *Shareholder Proposals*

The mechanism of shareholder proposals enables shareholders to raise the issues they consider important and have them voted on.¹⁰⁸ This part of the article reviews how pension funds have used the facility. Shareholder Association for Research and Education ("SHARE") maintains a database of shareholder resolutions from 2000.¹⁰⁹ Five pension funds figure in the database as filers of shareholder proposals. The pension funds and the number of proposals filed by them since 2000 are given below.

- American Federation of State, Municipal and Federal Employees (1)
- Carpenters Local 27 Pension Trust (82)
- Pension Plan for the Employees of Ontario Public Service Employees Union (2)
- Public Service Alliance of Canada Staff Pension Fund (1)
- United Association of Canadian Pipeline Industry National Pension Trust (1)

Arguably, Carpenters Local 27 Pension Trust is the most activist. It has been quite prolific in submitting shareholder proposals, and the issues have ranged from auditor independence (George Weston Ltd. 2003) and executive compensation (Nortel, 2007) to majority vote for director elections (Nexen Inc., 2008) and enhanced voting rights for long-term shareholders (Sun Life Financial Inc., 2008).¹¹⁰

Carpenters Local was able to achieve the highest level of support, between 38 to 42 percent, for its proposals on executive pay in 2007. For other proposals, the

¹⁰⁶ Michael A. Perino, "Institutional Activism through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions" (October 2006). St. John's Legal Studies Research Paper No. 06-0055, online: <<http://ssrn.com/abstract=938722>>.

¹⁰⁷ James D. Cox & Randall S. Thomas, "Leaving money on the table: do institutional investors fail to file claims in securities class actions?" (2002) 80 Wash. U. L. Q 855.

¹⁰⁸ *Canada Business Corporations Act*, Section 137.

¹⁰⁹ Shareholder Association for Research and Education (SHARE), Shareholder Resolution Database, online: <<http://www.share.ca/en/shareholderdb>>.

¹¹⁰ The proposals for enhanced voting rights for long-term shareholders in companies with multiple voting structures were withdrawn by the Carpenters Pension Trust. *Ibid.*

level of shareholder support has been quite low — usually less than 30 percent. Shareholder support was as little as 0.6 percent for a proposal that Carpenters Local submitted to Loblaw's Companies Ltd. for adopting a “common sense executive compensation program.” Carpenters Local also withdrew a number of proposals it submitted.

In comparison with Carpenters Local, the other pension funds found in SHARE database have not been very active.

- The proposal submitted by American Federation of State, Municipal and Federal Employees to Merrill Lynch Canada in 2006 was for shareholder approval of compensation committee reports. Level of shareholder support for the proposal was 35.6 percent.
- In 2003, Pension Plan for the Employees of Ontario Public Service Employees Union proposed that Sears Canada must adopt ILO labor rights principles and separation of the chair and chief executive officer. The level of shareholder support was 7.70 percent and 10 percent, respectively.
- Public Service Alliance of Canada Staff Pension Fund submitted a proposal in 2008 to Goldcorp Inc. seeking a human rights impact assessment, but later withdrew the proposal.
- United Association of Canadian Pipeline Industry National Pension Trust's proposal to Sun Life Financial Inc. in 2003 was about index stock options, which garnered 27.8 percent shareholder support.

SHARE data do not suggest that pension funds have actively used the shareholder proposal mechanism. None of the resolutions were able to generate majority support. The data support the view of Gil Yaron (2005) that pension funds are not generally active in initiating shareholder proposals.¹¹¹ Yaron (2005) also noted that most pension funds do not explicitly state their policy on engagement with the corporations.¹¹² Here again, a possible explanation is the preference for resolving issues through informal negotiations.

A study of shareholder proposals initiated by pension funds provides interesting results. It found that their impact on share prices was negative; there was decline in the prices of the shares of corporations with which pension funds engaged. The fall was transitory prices for corporations that were only targeted once during the sample period, but more enduring for corporations subject to repeated shareholder proposals from pension funds.¹¹³ If these results are any indication, it would be unwise for pension funds to engage with the corporations lest they trigger a slide in share prices.

Examining shareholder proposals from a different lens — namely, human rights and social responsibility, Aaron Dhir was optimistic about pension fund in-

¹¹¹ Yaron, *supra*, n. 22.

¹¹² *Ibid.*

¹¹³ Andrew K. Prevost & Ramesh P. Rao, “Of What Value are Shareholder Proposals Sponsored by Public Pension Funds?” (1999), online: <<http://ssrn.com/abstract=177268>>.

tervention.¹¹⁴ Reviewing the experience with shareholder proposals and their potential to encourage responsible corporate behavior, Dhir concluded:

At the level of pressure and engagement, there is cause to be optimistic given the increased use of the shareholder proposal mechanism in the post-Canada *Business Corporations Act* (“CBCA”)¹¹⁵ amendment period. While the trend is still in its infancy, it appears that the submission process, and the resulting dialogue between proposing shareholders and management, has begun to play a role in the formulation of corporate policy with respect to HRSP issues. This is especially the case where shareholders have withdrawn their proposals after concluding successful negotiations with management.¹¹⁶

In Canada, shades of social concerns are visible in the proposals initiated by some pension funds referred to earlier.

(iv) Proxy Voting

Voting rights are an essential attribute of shareholding, and this part examines how pension funds deal with their voting rights. The evidence from a recent survey reveals that although most funds issue instructions to their fund managers on proxy voting, the trend is to vote with the managements.

The guidelines developed by the CCGG and PIAC do not deal directly with the issue of proxy votes and their use. In the recent years, SHARE has conducted annual Proxy Vote Surveys, which examine the how fund managers deal with the votes attached to the investments under their management. According to SHARE, the survey “is intended to give pension fund trustees information that will help them carry out their fiduciary duty to oversee how the votes attached to their funds’ equity assets are voted.”¹¹⁷

Out of the 62 fund managers that SHARE approached, 32 participated in the survey. The participating firms had a total of \$452.7 billion under their management.¹¹⁸ This is a sizable part of the universe of pension funds and the results of the survey provide useful information on the current trends. Viewed from the lens of shareholder activism, the latest survey provides mixed results. On the one hand, there is a decline in pension fund passivity. Progressively, there has been a fall in the percentage of pension funds that leave their fund managers free to vote according to their choice. This is evident from the chart below.¹¹⁹

¹¹⁴ Aaron Dhir, “Realigning the Corporate Building Blocks: Shareholder Proposals as a Vehicle for Achieving Corporate Social and Human Rights Accountability” (2006) 43 *Am. Bus. L. J.* 365.

¹¹⁵ *Canada Business Corporations Act*, R.S., 1985, c. C-44, s. 1; 1994, c. 24, s. 1(F).

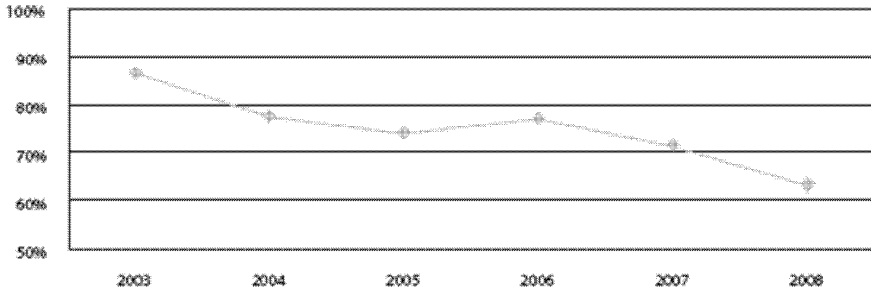
¹¹⁶ *Supra*, n. 114 at 412.

¹¹⁷ Key Proxy Vote Survey (2008) at 5, online: Shareholders Association for Research and Education (SHARE) <http://www.share.ca/files/SHARE_2008_Key_ProxyVote_Survey.pdf>.

¹¹⁸ *Ibid.*, at 10. Significantly, the value of Canadian equities component in the funds of the participating managers was just \$44.8 billion, or less than 10 percent of the total.

¹¹⁹ *Ibid.*, at 6.

Chart 9
Fund Managers with Freedom to Determine Voting, 2003-08



The trend is quite consistent. The percentage of pension funds that do not provide instructions to their managers has fallen from almost 90 in 2003 to just over 60 in 2008. Still, there is a large majority of pension funds that simply do not get involved with voting their shares. A possible explanation could be lack of resources and expertise, especially for the smaller funds. Gil Yaron (2005) identified a number of legal and other barriers that impede the effective exercise of voting rights by pension funds. These include lack of confidential proxy voting, the practice of selling voting rights, free-rider problems and rational apathy. To address these problems, Yaron has advocated a five-step fiduciary process to oversee proxy voting.¹²⁰

Another significant trend revealed in the SHARE survey of 2008 is that “participating firms appear to be voting according to the recommendations of corporate management more often than they have in the recent past.”¹²¹ This suggests that the interest of the pension funds in voting their shares is mostly of the passive variety. SHARE has added a caveat that “no definitive interpretation of these results [that is, voting with managements] can be made without a better understanding of firms’ reasons.”¹²² In any case, the result is consistent with the preference of the funds for a relational approach that eschews confrontations.

The SHARE survey provides information on the level of interaction between fund managers and pension fund trustees on proxy voting. The following data suggest the trends.¹²³

¹²⁰ Yaron, *supra*, n. 22.

¹²¹ SHARE, *supra*, n. 116 at 6.

¹²² *Ibid.*

¹²³ *Ibid.*, at 11.

Table 10 Proxy Voting — Interaction between Pension Funds and Fund Managers (Percentage)

	2008	2007	2006
Fund managers with proxy voting guidelines	94	97	91
Fund managers that consult clients in developing voting guidelines	39	55	53
Firms that report to clients about their proxy voting	94	100	97

An overwhelming majority of fund managers have proxy voting guidelines. Similarly a huge majority of managers report to their clients about proxy voting. But the evidence on client participation in the development of voting guidelines is weak. At the peak in 2007, just 55 percent of the fund managers consulted their clients in formulating the proxy guidelines. This suggests a lack of serious concern, both among pension fund trustees and fund managers, for the issue of proxy voting.

5. PENSION FUNDS — ROLE IN SHAPING POLICY AND REGULATORY CHANGES

Pension funds have been increasingly active in shaping policy and influencing regulatory changes. This part of the article reviews recent experience and draws the following conclusions.

- As large investors, pension funds have been both active and effective in campaigning for changes in corporate and securities regulation. The amendments made to the proxy rules in the CBCA in 2001 and the removal of the Foreign Property Rule from the *Income Tax Act*¹²⁴ in 2005 are prominent examples of successful campaigns by pension funds.
- Pension fund campaigns for policy and regulatory changes are conducted at the collective level by agencies such as CCGG and PIAC. Other than this, large pension funds such as CPPIB and OTPP undertake individual efforts.

The trend for pension fund involvement in shaping policy and stimulating regulatory changes is likely to continue. An important ongoing campaign is for the removal of the investment rules applicable to pension funds under the federal *Pension Benefits Standards Regulations, 1985*.¹²⁵

¹²⁴ ITA, *supra*, n. 18.

¹²⁵ SOR/87-19, s. 6.

(a) Pension Fund Activism in Shaping Policy — A Review

In the recent years, pension funds have actively campaigned with government authorities and the stock exchange and influenced policy on a number of issues. Between November 1997 and October 2007, PIAC submitted a total of 44 representations to various governmental bodies, public agencies and self-regulating organizations — mainly, stock exchanges.¹²⁶ At this writing in July 2009, PIAC has made another 23 submissions since October 2007.¹²⁷ This indicates an increase in activism by PIAC in the recent years. The agencies to which PIAC has made submissions include Bank of Canada, Federal Department of Finance, Canadian Securities Administrators, United States Securities and Exchange Commission and Toronto Stock Exchange.

PIAC's submissions cover a broad range of subjects related to the capital markets. The following is a sample of the issues covered by PIAC:

- The role of institutional investors (November 1997).
- Statutory remedy for investors in the secondary market (November 1998).
- Small business investment (December 1999).
- Foreign Property Rule (January 1999 and November 2002).
- Income trusts (December 2005).
- Executive compensation, continuous disclosure and corporate governance practices (June 2007).
- Toronto Stock Exchange rules on dilution of shares (December 2007).
- Securities regulation (July 2008).
- Solvency relief for pension plans (February 2009).

CCGG ranks second in the number of submissions. Since 2003, it has made a total of 31 submissions on issues relevant for corporate governance, securities markets and investors. The representations were submitted to agencies such as Industry Canada, Canadian Securities Administrators and Toronto Stock Exchange.¹²⁸

Other than collective submissions by the networks, large pension funds have made individual efforts. A good example is submission of responses to regulatory proposals mooted by Ontario Securities Commission ("OSC"). Between 2005 and 2007, CPPIB and OTPP made five submissions to OSC. Statement of executive compensation and registration requirements were among the issues covered in the representations.

The data are evidence of pension fund activism in the formulation of policy on issues that affect them as shareholders in corporations, investors in the capital markets and providers of pension. Two prominent examples of pension funds' success in achieving regulatory change are the amendments to proxy rule in the *CBCA* in

¹²⁶ List of submissions made by Pension Investment Association of Canada from November 1997 till October 2007, online: Pension Investment Association of Canada <<http://www.piacweb.org/submissions.html>>.

¹²⁷ *Ibid.*

¹²⁸ Complete submissions of Canadian Coalition for Good Governance, online: <<http://www.ccg.ca/submissions/>>.

2001 and the deletion of the Foreign Property Rule in 2005. These are discussed below.

(i) Proxy Rules

Before 2001, the proxy rules in the *CBCA* discouraged communication among shareholders. The rules were not clear whether communications among the shareholders would trigger the complex proxy procedures that required the shareholders to send out, at their expense, proxy circulars to all other shareholders. The ambiguity in the proxy rules, which had been a prominent and longstanding issue, hampered pension funds from coordination in casting their votes in corporations. A good example of the difficulties is seen in the case of OTPP. OTPP had adopted the practice of announcing how it planned to cast its votes — a practice that would enhance its effectiveness as a large shareholder. But it was advised against doing so, and discontinued the practice.¹²⁹

When Industry Canada proposed amendments to the *CBCA*, *inter alia*, to relax the proxy rules and encourage communications among shareholders, PIAC supported the amendments.¹³⁰ The proxy rules were amended in 2001.¹³¹ The regulations introduced subsequently set out the conditions under which shareholders can communicate among themselves without triggering the dissident proxy circular requirement. They also define the circumstances in which a person may solicit proxies by public broadcast without sending a dissident's proxy circular.¹³² The new regime is designed to facilitate shareholder communication and coordination, which in turn can promote shareholder participation in corporate governance. There would be no difficulty for pension funds to work in unison and coordinate the exercise of their voting rights.

(ii) Foreign Property Rule

The limit on foreign assets, which had been increased from 10 percent to 20 percent in 1994, was raised to 30 percent in 2001. Since 1999, PIAC actively campaigned for the deletion of the Foreign Property Rule. It engaged scholars to provide a cost-benefit analysis of the rule, and published their study in November 2002.¹³³ The study showed that there was hardly any net benefit from the Foreign Property Rule. The sustained efforts of pension funds bore fruit in 2005 when the Foreign Property Rule was finally abolished. This is an illustration that pension funds pay close attention to the policy issues that affect them and are willing to devote energy and resources to bring about regulatory changes.

¹²⁹ See Church, *supra*, n. 86.

¹³⁰ *Regulatory Impact Statement — Canada Business Corporations Act (CBCA)*, Bill S-11 (September 2005), online: Industry Canada <<http://www.ic.gc.ca/epic/site/cd-dgc.nsf/en/cs01381e.html#consultations>>.

¹³¹ *CBCA*, Sections 147 to 153.

¹³² *Canada Business Corporations Regulations*, SOR/2001-512, Sections 54 to 69.

¹³³ Burgess & Reid, *supra*, n. 20.

(iii) *Investment Rules — An Unfinished Task*

The federal *Pension Benefits Standards Regulations, 1985*¹³⁴ lay down quantitative limits for individual investments by pension funds. They impose a ceiling of 30 percent on pension funds' holding of voting stock in corporations. This defines the position of pension funds as passive investors who cannot have a decisive say in the corporations.¹³⁵

The quantitative limits on shareholding have been viewed with increasing disfavour by pension funds who have called for the removal of the limits. This is consistent with the trend for new investment such as private equity and venture capital and business acquisitions by pension funds. At least since 2007, pension funds have been campaigning for the removal of the restrictions on holding voting shares in corporations. According to a report "several of Canada's biggest pension funds [were] urging the government to scrap a two-decades-old rule that they say puts them at a disadvantage in takeovers, complicates investing strategies and has forced them to walk away from deals."¹³⁶ Referring to the investment trends among the funds, the report added:

Over time, pension funds have developed complex financial structures to get around the control limit imposed by the 30-per-cent rule so that they can protect their investments. But creating these structures is time consuming, costly to set up and can make the funds less competitive in bids because rival bidders in other countries don't come to the table with the same baggage, which one pension fund manager described as akin to attaching conditions to an offer on a house.

Deborah Allen, a spokesperson for OTPP, is reported to have stated:

[The restrictive rule] means we have to put resources against managing around [the rule] rather than using the resources to increase our investment value.

The report noted that the call for removal of investment limits came "at a time when Canada's public sector pension funds, the custodians of hundreds of billions of retirement dollars, are becoming active, heavyweight investors in both public and private equity markets."¹³⁷ In this climate, it is understandable that pension funds find the ceilings on investments suffocating. OMERS also supported the demands for the removal of the rule and sought its suspension while the issue is under

¹³⁴ *Supra*, n. 125.

¹³⁵ This was the theme of the policy recommendations dated July 4, 1986 published by the Pension Commission of Ontario for the regulation of pension fund investments. These recommendations played a role in the present regime of portfolio investments by pension funds, and are cited in the submissions made by the Canadian Bar Association on the recommendations. Canadian Bar Association-Ontario, "Submission to the Pension Commission of Ontario Respecting Policy Recommendations for the Regulation of Pension Fund Investments" September 16, 1986, Toronto.

¹³⁶ Nicole Mordant, "Pension funds want 'bizarre' rule retired" *The Globe and Mail* (17 July 2007) B4.

¹³⁷ *Ibid.*

consideration.¹³⁸ OMERS argued that the rule resulted in loss of investment opportunities for Canadian pension funds and that the opportunities instead went to foreign investors.

At this writing in July 2009, the investment rules are still on the statute book. Given the current climate of recession and developments such as the failure of OTPP's effort to takeover Bell Canada, it is not clear how actively the pension funds are pursuing their agenda for abolition of the restrictions on their investments. In any event, pension fund participation in shaping policy and regulation continues. Indeed, it has strengthened in the recent years if one is to be guided by the number and frequency of submissions that CCGG and PIAC have made to public authorities.

6. CONCLUSION

It is now more than 30 years since Peter Drucker proclaimed the socialist revolution by pension funds. Around the same time activism by pension funds started, albeit in a small way. Pension funds have gradually increased their engagement with business corporations and made efforts to promote good governance. As investors with long-term perspectives and large shareholders, pension funds occupy a significant position in the economic framework.¹³⁹ Given their increased engagement with the corporations and their special advantages, pension funds are well-placed to play the role of responsible shareholders.¹⁴⁰ Responsible shareholder activism by pension funds can be valuable in promoting the twin objectives of good governance and long-term value.

The deflation in share prices, if it persists, is likely to goad pension funds towards greater shareholder activism and deeper engagement with the corporations. The turbulence in the stock market underscores the risks in relying excessively on trade in securities for funding pension obligations. To strengthen their revenue base, an option for pension funds would be to strive for a better revenue mix from sources such as dividends. This shift would necessarily mean greater involvement in the governance, business and strategy of the investee-corporations.¹⁴¹

Recently, there is evidence of more innovation in pension fund investments. Pension funds were among the sellers of credit default swaps that were prominent

¹³⁸ Janet McFarland, "OMERS wants restrictions lifted" *The Globe and Mail* (20 October 2007) B9.

¹³⁹ Recently, calls for deliberated and enhanced activism by pension funds have come from Hawley & Williams, *supra*, n. 1, and Gordon L. Clark, *Pension Fund Capitalism* (Oxford: Oxford University Press, 2000).

¹⁴⁰ See generally Tessa Hebb, *No Small Change: Pension Funds and Corporate Engagement* (Ithaca, N.Y.: Cornell University Press, 2008).

¹⁴¹ Hutchinson, *supra*, n. 78, has categorized the shareholder practices of OTPP, OMERS and Caisse de depot et placement du Quebec as "constrained activism." Given the reality of deficits, share price deflation and the imperatives of meeting pension liabilities, it would be a challenge for the pension funds to balance them with other equally valid issues — social, environmental and the like.

in the credit crisis.¹⁴² During the spike in oil prices during 2008, speculation was considered an important factor. Here again, pension fund investments in the oil futures market were cited among the reasons for the spurt in oil prices.¹⁴³ It is not clear if Canadian funds invested in default swaps or oil futures.

This paper will be incomplete without a reference to the recent high-profile, abortive effort of OTPP to lead a consortium of investors for a leveraged buyout of Bell Canada. The episode affirms the trend of large pension funds seeking increasingly active roles as investors. Ironically, this trend might strengthen if the bear phase in the stock market continues. With a fall in the gains from share price increases, pension funds would likely pay greater attention to investment income. Perforce, their interest in acquisition and management of businesses would be higher.

This paper is concerned with the impact of pension funds on the capital markets and corporate governance. The literature and data clearly suggest that pension funds are becoming more activist — both in venturing into new classes of assets and in engaging with the investee-corporations. In particular larger pension funds, with their advantages of greater resources and expertise, are more dynamic in making new investments and in engaging with the corporations. It would be useful to explore policy initiatives that can facilitate smaller pension funds also to play a more active and meaningful role. As a major force in the capital markets, pension funds are also proactive in shaping policy and regulation.

The impact of pension funds on the general economy is a significant area for future research. This article has not ventured into that. More specifically, the impact of pension funds on vital issues such as innovation in the economy, training of the workforce — semi-skilled, skilled and elite — and employment generally are green fields for further research and analysis. Yet another area that can be fruitfully explored is the role of pension funds in encouraging financial services innovation.

¹⁴² “The great untangling,” *The Economist* (6 November 2008), online: <http://www.economist.com/businessfinance/displaystory.cfm?story_id=12552204>.

According to the report, pension funds provided 4 percent of the outstanding swaps whose total was estimated at US\$62.2 trillion.

¹⁴³ See e.g., Moira Herbst, “Are Pension Funds Fueling High Oil?” *Business Week* (21 May 2008), online: <http://www.businessweek.com/bwdaily/dnflash/content/may2008/db20080520_524455.htm>.