




A Comparative Sampling of Canadian Pension Issues

**South African Pension Lawyers Association
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Agenda

1. Overview of Canadian Pension System
2. DC Pension Issues
 - ↪ Auto-enrolment
 - ↪ Auto-escalation of contributions
 - ↪ Lifecycle fund default investment options
3. Asset and Liability Transfers in M&A Transactions
 - ↪ DB and DC Plans
4. Vesting and “Locking-In” of Retirement Plan Benefits
 - ↪ Benefit settlement options
5. Adjudication Structure For Pension Disputes
6. Issues in Plan Member Communications
 - ↪ Member education vs. advice in DC Plans
 - ↪ Case law developments (DB and DC)
7. Democratizing Pension Funds
 - ↪ Jointly Administered Pension Funds (Employer and Employee)

Canadian Pension System: Overview

- ↪ 4 pillar system
 1. Old Age Security and Guaranteed Income Supplement
 2. Public Occupational Pension Plan
 3. Tax-Assisted Retirement Savings
 - ↪ employer sponsored plans
 - ↪ individual plans
 4. Personal savings
- ↪ Employer sponsored plans subject to
 1. Federal income tax rules
 2. Minimum pension standards rules (federal and provincial)
 - ↪ employer sponsored and administered plans
 - ↪ MEPPS -- jointly trustee/administered
 - ↪ Pension Committee in Quebec and Manitoba

DC Pension Issues – Auto-enrolment

Auto-enrolment, auto-escalation of contributions, and lifecycle fund defaults:

- ↪ address employee apathy
- ↪ are intended to increase employee retirement income security
- ↪ are promoted widely and extensively within the investment and consulting community

DC Pension Issues – Auto-enrolment ⁵ *(cont'd)*

All present serious legal risks for employers and plan administrators in Canada.

The legal risks can be addressed by understanding relevant risks and addressing them through design, implementation and governance.

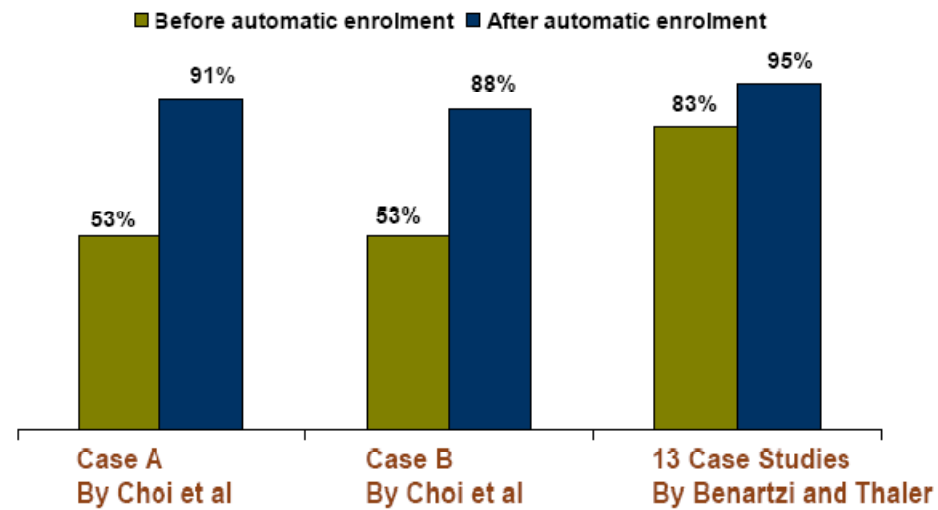
Most legal risks could also be addressed by legislative reform, but ... it may not be as easy as some have suggested.

Auto-Enrolment *(cont'd)*

An employee is made a member of an employer-sponsored pension arrangement automatically as a condition of employment, upon hire or upon attaining specified age or service levels, without any action on the part of the employee.

Auto-Enrolment *(cont'd)*

Good news: Automatic enrolment and participation rates



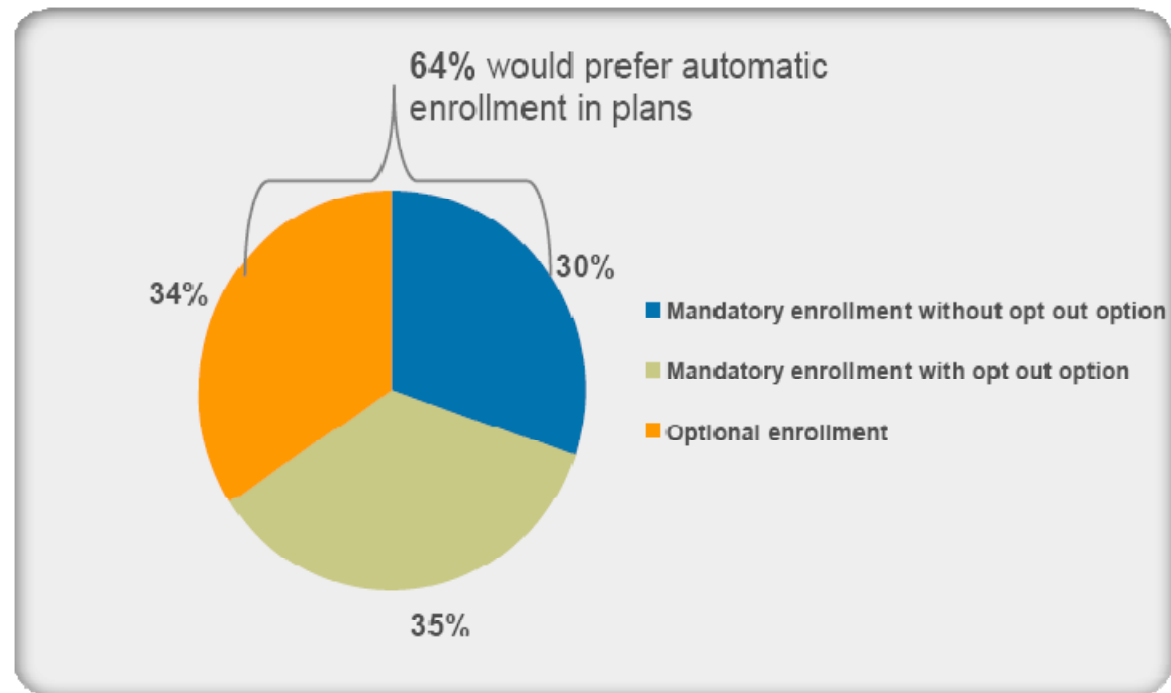
Source: Choi et al (2004)

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 Manulife Financial

Auto-Enrolment *(cont'd)*

Plan members prefer automatic enrollment



Source: Benefits Canada Survey of CAP Members, November 2008

Auto-Enrolment – Legal Risks *(cont'd)*

1. Enrolment Without Employee Consent

- ↪ federal and provincial laws to consider
 - ↪ contract
 - ↪ employment and labour
 - ↪ tax

- ↪ some jurisdictions specifically permit this
 - ↪ most, including ITA, generally permit compulsory participation
 - ↪ exception under ITA is Group RRSPs because ITA requires individual applications

- ↪ others are silent
 - ↪ term and condition of employment

Auto-Enrolment Legal Risks *(cont'd)*

2. Employee Contributions by Payroll Deduction

- ↪ principally an issue under federal and provincial employment and labour laws
- ↪ Ontario, Alberta, B.C. and Federal ESAs require express written consent to deduct pension plan contributions
- ↪ in Ontario, written authorization must refer to specific amount or formula
- ↪ consent not required in Quebec if RPP participation is compulsory
- ↪ Nfld, NS and NB allow “lawful” deductions that provide a “clear economic benefit” to the employee – not clear what this means
- ↪ Unionized Federal, Quebec and BC employees can be enrolled without direct consent if agreed to in collective bargaining
- ↪ rules generally apply to RRSPs, DPSPs and RPPs
- ↪ violations provide for substantial fines and may permit employees to obtain reimbursement of contributions made

Auto-Enrolment *(cont'd)*

3. *Automatic Escalation of Employee Contributions*

- ↪ same as payroll deduction issues
- ↪ a general consent may not be sufficient in all jurisdictions
 - ↪ escalation must be clearly contemplated with original consent

Auto-Enrolment *(cont'd)*

4. Beneficiary Designations

- ↪ pension standards, succession, and family law implications
- ↪ no designations
- ↪ uncertainty about personal status required for proper administration
 - ↪ is the person single or married?
 - ↪ e.g., pension standards laws require spousal survivor benefits to be paid unless waived in prescribed form
- ↪ enrolment allows members to designate beneficiaries other than their spouse or estate
 - ↪ to be effective must be in writing signed by member
 - ↪ electronic designations not generally affected

Auto-Enrolment *(cont'd)*

5. Unauthorized Use of Social Insurance Number

- ↪ ITA issue
 - ↪ SIN not to be used or communicated without individual's consent
 - ↪ except for completing tax reporting forms

Auto-Enrolment *(cont'd)*

6. *Investment Directions*

- ↪ less likely to obtain investment directions
 - ↪ more reliance on default options

- ↪ no safe harbour investment defaults for members who are auto-enrolled as there is in the US

- ↪ enrolment provides an opportunity to reduce risks associated with default options (see below)

Auto-Enrolment *(cont'd)*

7. “Mapping Over”

- ↪ change of employer resulting from M&A activity
- ↪ change of pension plan providers
- ↪ change in or merger of pension plans
- ↪ payroll deductions consents, beneficiary designations and investment directions given under “prior plan” may be subject to dispute

Auto-Enrolment *(cont'd)*

Risk Management:

- ↪ Provide clear disclosure prior to employment commencement
 - ↪ clear term and condition of employment
- ↪ Comply with legal obligations relating to payroll deductions in contributory plans, including AVCs
- ↪ Identify, understand and monitor legal obligations
- ↪ Provide clear, unequivocal and frequent disclosure
- ↪ Acknowledge all legal risk cannot likely be eliminated
- ↪ Lobby for legislative protections
 - ↪ as part of the coverage issue

Lifecycle Fund Default Options

What Is This?

A fund which typically performs an asset allocation in the underlying funds on the basis of the age/risk tolerance of the investor. Aggressiveness in the asset allocation of a portfolio is directly proportional to the time period left to retirement (or death) of the investor or the risk-taking capacity. In other words, a mix with more stocks at younger ages and more fixed income at older ages.

Lifecycle Fund Default Options *(cont'd)*

What Is This?



Lifecycle Funds

	Age 20	Age 30	Age 40	Age 50	Age 60	Age 60 +	
Foresight Prudent Path		Foresight 60/40		Foresight 50/50	Foresight 40/60	Foresight 30/70	
Foresight Balanced Path		Foresight 75/25	Foresight 60/40	Foresight 50/50	Foresight 40/60	Foresight 30/70	
Foresight Growth Path		Foresight 85/15	Foresight 75/25	Foresight 60/40	Foresight 50/50	Foresight 40/60	Foresight 30/70

As the participant ages, the asset allocation of the path becomes progressively more conservative

*Source: Desjardins

Lifecycle Fund Default Options (cont'd)

Diversification: The bedrock of target date funds

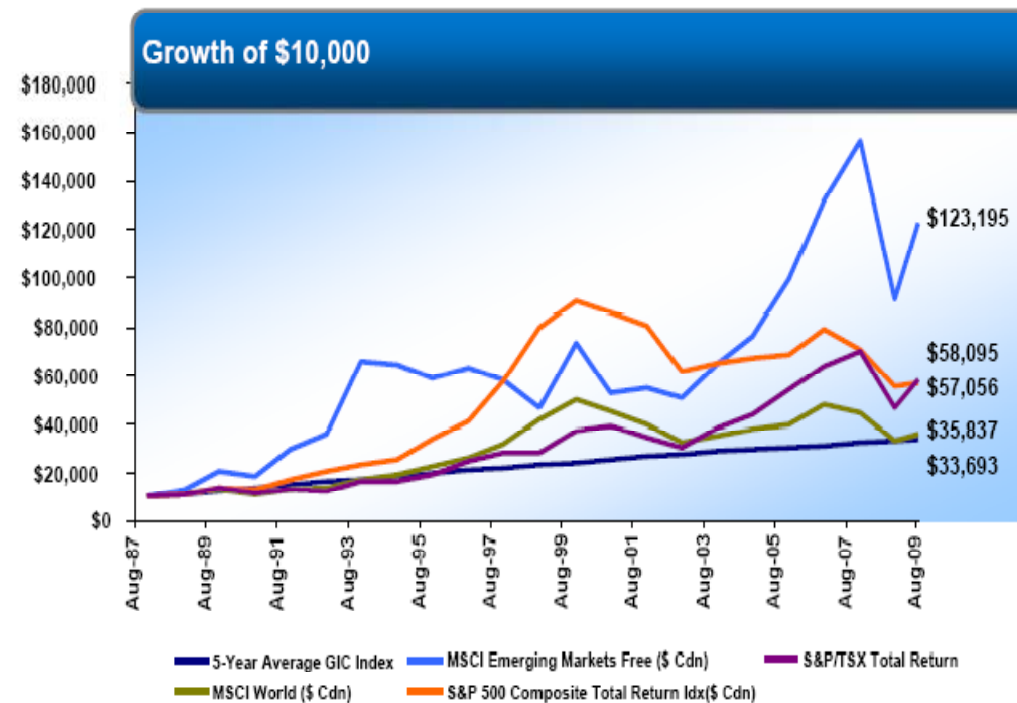


Based on Morningstar Research Inc., as of December 31, 2008

Lifecycle Fund Default Options *(cont'd)*

Why?

Evaluating options: Guaranteed Investment Accounts
Do they provide sufficient long-term growth?

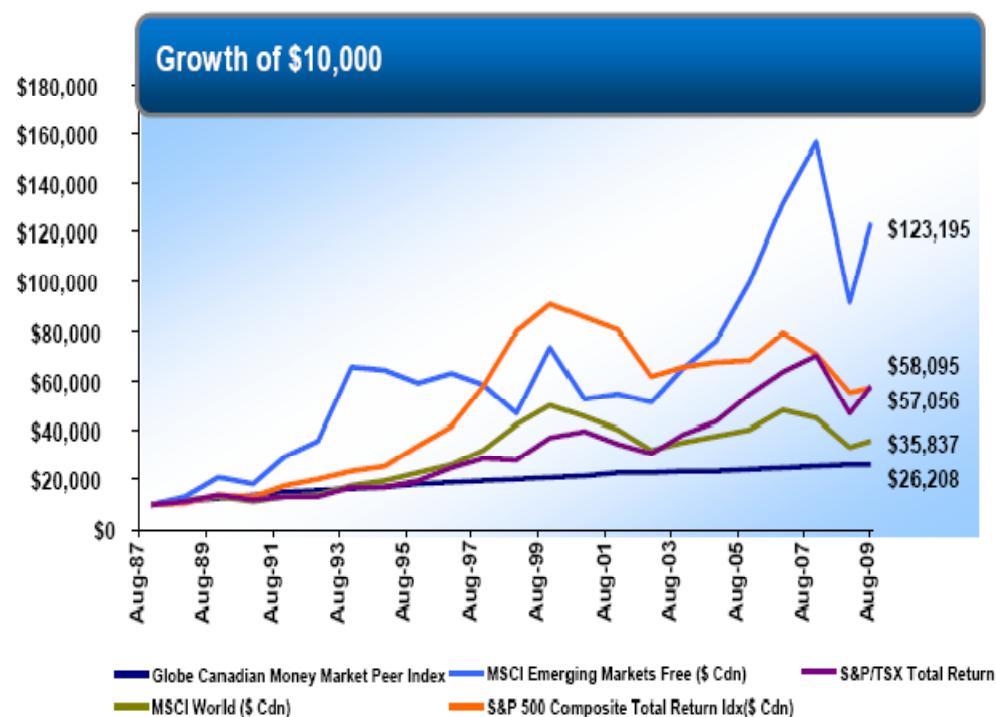


Source: Globe HySales, as of August 31, 2009. The graph represents the growth of \$10,000 from August 1980 to August 2009. These include reinvestment of all dividends but do not take into account sales, redemption, distribution, or optional charges or investing.

Lifecycle Fund Default Options *(cont'd)*

Why?

Evaluating options: Money Market Funds
Do they provide sufficient long-term growth?



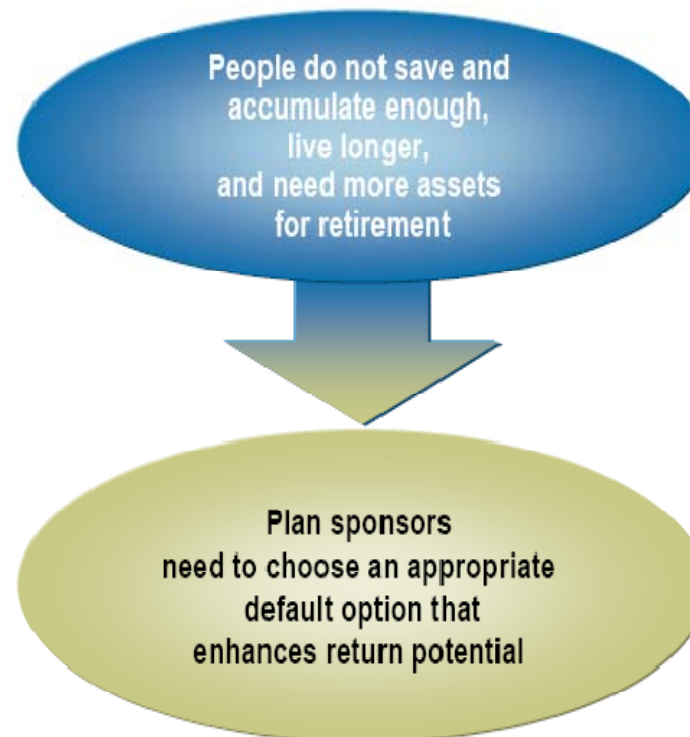
Source: Globe HySales, as of August 31, 2009. The graph represents the growth of \$10,000 from August 1990 to August 2009. These include reinvestment of all dividends but do not take into account sales, redemption, distribution, or optional charges or investing.

Lifecycle Fund Default Options *(cont'd)*

Why?

Conclusion: Default Options – What do they mean for your plan?

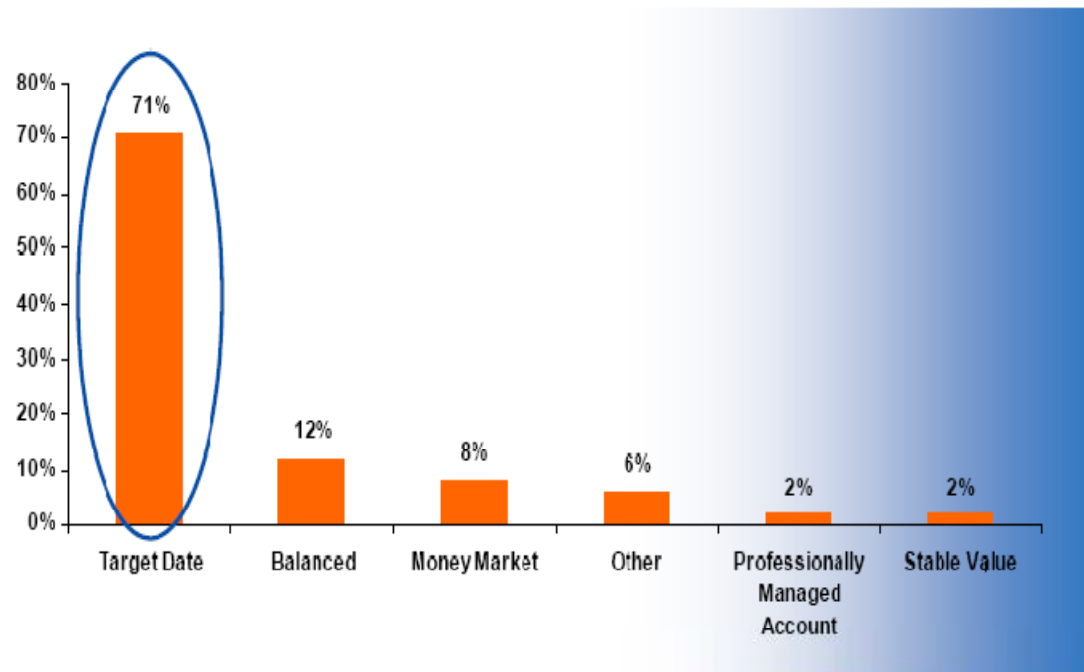
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Lifecycle Fund Default Options *(cont'd)*

Target date options are popular in the U.S.

- 93% of companies offer a default investment option in their DC plan – 71% of these offer a **target date fund** - based on U.S. data



Source: The New Reality of Pension Investment Strategies, August 2009, Watson Wyatt

Lifecycle Fund Default Options *(cont'd)*

Target Date Funds

Preliminary, Unaudited Stats from our 2009 Global DC Survey

Lifecycle/lifestyle funds (include target date funds in US/Canada)

	UK	US	Canada
Lifecycle/lifestyle funds used as your default fund?	80%	70%	21%
Current prevalence of lifecycle/lifestyle funds	90%	84%	35%

Lifecycle Fund Default Options *(cont'd)*

Misinformed Legal Reasons for Use In Canada

1. Must be offered to comply with fiduciary duty / CAP Guidelines (excerpts below).
2. Plan sponsors must choose a default to enhance their employees' potential to achieve the highest possible retirement assets.
3. Plan sponsors can feel confident in meeting their fiduciary responsibilities by using lifecycle or target date funds.
4. In the absence of legislation, there is no right or wrong answer for selection of the default investment option.
5. To meet fiduciary standards, the decision-making process for determining default characteristics should not be driven by preservation of capital.

Lifecycle Fund Default Options (*cont'd*)

Informed Legal Reasons for Use In Canada

1. *To comply with pension standards laws*

“The administrator of a pension plan shall exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person”

PBA, ss 22(1)

“The administrator of a pension plan shall use in the ... administration and investment of the pension fund all relevant knowledge and skill that the administrator possesses or, by reason of the administrator’s profession, business or calling, ought to possess”

PBA, ss22(2)

“Where it is reasonable and prudent in the circumstances so to do, the administrator of a pension plan may employ one or more agents to carry out any act required to be done in the administration of the pension plan and in the administration and investment of the pension fund”

PBA, ss22(5)

“investments shall be made with consideration given to the overall context of the investment portfolio without undue risk of loss or impairment and with a reasonable expectation of fair return or appreciation given the nature of the investment”

PBA Regs ss. 67(2)(1986-2001)

Lifecycle Fund Default Options (*cont'd*)

Informed Legal Reasons for Use In Canada

2. *To comply with common-law duty where pension standards or other statutory prescriptions are not clear*

“the lodestar which should guide [fiduciaries] is the promotion of the purposes of their trust, that is, the best interests of the beneficiaries”

↪ Lord Nicholls of Birkenhead

“the best interests of the beneficiaries are normally their best financial interests”

↪ Cowan v. Scargill [1985]

“a trustee’s primary duty is preservation of the trust assets, and the enlargement of recognized powers does not relieve him of the duty of using ordinary skill and prudence, nor from the application of common sense”

↪ Fales v. Canada Permanent Trust Company [1976] (S.C.C.)

“the importance of preservation of a trust fund will always outweigh success in its advancement”

↪ Nestle v. National Westminster Bank plc [1993]

Lifecycle Fund Default Options (*cont'd*)

Informed Legal Reasons for Use In Canada

Statute:

- ↪ act prudently
- ↪ take expert advice

Common-law:

- ↪ act prudently
- ↪ promote purpose of trust
- ↪ protect capital

Lifecycle Fund Default Options (*cont'd*)

Informed Legal Reasons for Use In Canada

Achieve the purpose(s) of the plan:

Plan documents and all communications should clearly state the purpose of the plan in terms that lend themselves to demonstrating that the lifecycle fund default option is the best option for achieving the purpose. Express investment powers ought to reflect this. As a governance issue, the design decision to use lifecycle funds as a default ought to be recorded in these terms also.

Plan purpose might, for example, be stated to supplement or provide post-retirement income security with savings that provide reasonable rates of long-term growth and inflation protection on the capital contributed, without undue risk to capital.

Lifecycle Fund Default Options (*cont'd*)

Informed Legal Reasons for Use In Canada

Adhere to industry standards and guidelines (as they are):

CAP Guidelines 2.2.1:

- ↪ ensure a range of options is available : taking into account the purpose of the CAP
- ↪ factors to consider in choosing investment options, including default option:
 - ↪ purpose of CAP
 - ↪ number of investment options
 - ↪ fees associated with the options
 - ↪ sponsor's ability to periodically review options
 - ↪ diversity and demographics of CAP members
 - ↪ degree of diversification among available investment options
 - ↪ liquidity of investment options
 - ↪ level of risk associated with investment options

Lifecycle Fund Default Options (*cont'd*)

Informed Legal Reasons for Use In Canada

Adhere to industry standards and guidelines (as they are):

CAP Guidelines 2.2.1:

“The CAP sponsor should establish a policy that outlines what happens if a CAP member does not make an investment choice. The policy should be provided to the member before any action is taken under the policy.

The policy may involve setting a default option to be applied if a member does not make an investment choice within a given period of time. If the policy includes imposing a default option, the CAP sponsor should provide the member with information about the default option (see section 4.2) when the policy is provided.”

Lifecycle Fund Default Options (*cont'd*)

Risk Mitigation Factors

1. Understand the Catch 22

- ↪ Failure to preserve capital
 - ↪ to avoid loss of investment earnings
 - ↪ note default options apply to early terminations as well as pensioners
- ↪ Inadequate retirement savings
 - ↪ failure to earn a reasonable rate of return without undue risk of loss

2. One size does not fit all

- ↪ Risk profiles of any two people with same retirement date is not necessarily the same
- ↪ Lifecycle target dates may not accommodate a person who changes his retirement date or terminates employment

3. Understand the power of suggestion

- ↪ The employer's default choice may be perceived as the best investment option
 - ↪ similar to investment advice

Lifecycle Fund Default Options (*cont'd*)

Risk Mitigation Factors

4. Communicate clearly and frequently

- ↪ purpose of plan
- ↪ nature of default option
- ↪ ability to switch

5. Provide transferability

- ↪ frequent opportunities to switch out

6. Monitor the fund

- ↪ difficult for sponsors to monitor underlying funds, asset allocation and reallocation

Lifecycle Fund Default Options (*cont'd*)

Risk Mitigation Factors

7. Fully disclose costs and expenses

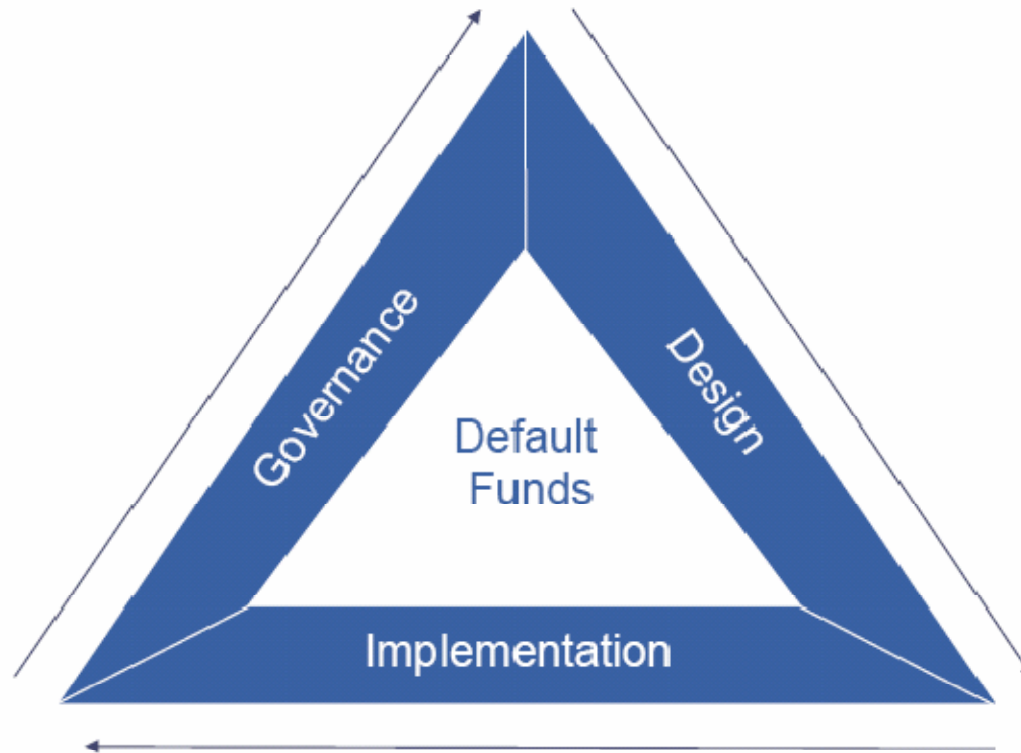
- ↪ usually highest cost alternative fund
- ↪ layering of fees causes the expense to be higher and makes it more difficult to be transparent

8. Service provider contracts

- ↪ allocation of responsibility
 - ↪ contractual assurance
 - ↪ responsibility for communications
 - ↪ fees and expenses
- ↪ exclusion of liability and indemnity provisions

Lifecycle Fund Default Options *(cont'd)*

Risk
Mitigation
for Target
Funds



Lifecycle Fund Default Options *(cont'd)*

Design:

Legal Obligations

Employers must understand the relevant legal requirements applicable to the jurisdiction in which members are employed.

Statement of Objectives

The default option should have a high-level objective which explains in broad terms the goal(s) of the default option and the strategy to be used to achieve the goal(s). This will be the yardstick by which to measure the appropriateness of the default option and design performance. It will facilitate decision-making (i.e., governance).

Lifecycle Fund Default Options *(cont'd)*

Suitability

Employers should be satisfied on reasonable (documented) grounds that the default option is likely to be suitable for the majority of members, having regard to all relevant criteria, including nature of the workforce, contribution levels, plan withdrawal rights, investment strategy, asset allocation, and prevailing economic trends affecting both the workforce as well as the investment environment. Identify appropriate accumulation and retirement periods and risk zones (5 to 10 years before and after retirement) based on retirement patterns of the members, and annuitization risk. Consider the turnover rate of members. Consider design features which mitigate investment volatility such as diversification strategy, hedging, insured capital and interest guarantees. Obtain contractual assurances from “experts”, providers and other professional intermediaries.

Lifecycle Fund Default Options *(cont'd)*

Transferability

Members should be able to transfer out of default at least as frequently as other options.

Reasonable Cost

The default option should be appropriately and competitively priced. Total charges should not increase risk, should be transparent, and should be subject to review.

Context

Because multiple default options are provided (i.e., targeted to a range of ages/lifecycle), there should be a manageable and targeted set of options, and each option ought to meet the foregoing design principles.

Lifecycle Fund Default Options *(cont'd)*

Asset Allocation and Rebalancing

The Employer should be satisfied that the portfolio of assets is and will continue to be appropriate to the objectives.

Understandable (Definable)

The design must be coherent and capable of full and clear communication to plan members.

Lifecycle Fund Default Options *(cont'd)*

Implementation:

Communication

Communication plays a vital role in legal risk mitigation and has several components:

Frequency of Communication

Members should receive notice at the time of enrolment (or employment in the case of auto-enrolment) and periodically thereafter, such as annually or bi-annually.

Content of Communication

Members should be provided with full and clear communication about the default option, including consequences, and all of their relevant rights and restrictions. Members should also receive “prospectus” information and educational information allowing them to assess the appropriateness of the default option to their own personal risk tolerance.

Lifecycle Fund Default Options *(cont'd)*

Style of Communication

Communication ought to be appropriate to the workforce. This means taking into account the diversity of the workforce in cultural as well as linguistic terms, in addition to general literacy and financial literacy levels. Consideration ought to be given to different media, including print, computer, one-on-one and group sessions.

Education

There is likely to be a legal duty to provide sufficient information to educate without providing investment advice per se.

Administration

There must be an ability to follow up and track members in default options. There must also be an ability to respond quickly to a member's decision to transfer out of the default option, or to make a positive choice to retain or confirm the default option.

Lifecycle Fund Default Options *(cont'd)*

Governance:

Understand Legal Obligations

Responsibility for overall governance of the default option lies with the administrator. Proper delegation, allocation of risk and documentation of delegation to service providers (i.e., contracts) is essential. Monitor changes to legislation and developments in case law, regulator activity and industry guidelines.

Monitor Service Provider(s)

Obtain regular reports. Conduct regular performance assessments. Monitor for changes in personnel of the service provider.

Lifecycle Fund Default Options *(cont'd)*

Monitor Suitability of Default Option

Review the default option on a regular basis and when certain events occur, e.g., when there are changes in the fund management personnel involved in running the default strategy, changes in fund manager ownership, consistent absolute or relative underperformance of the underlying funds used in the strategy against its objectives, or relevant benchmarks.

Monitor Expense Levels

Expense levels can affect member entitlements. Ensure they remain competitive with industry practices.

Lifecycle Fund Default Options *(cont'd)*

Monitor Investment Performance

This includes both absolute and relative performance of individual fund components and whether the performance of individual components is consistent with the overall objective of the default option. There are now more lifecycle or target date funds on the market with performance history.

Monitor Communications

Assess the efficacy of member communications: how often, member feedback, appropriateness of communication media ... etc

Monitor Industry Developments

Keep pace with industry best practices. This may be accomplished in many ways, including participation in continuing education programs and subscription to appropriate industry journals.

Lifecycle Fund Default Options *(cont'd)*

Continuously Review Design Objectives and Implementation Processes

Regularly review the objectives to assess continuing suitability and confirm or amend as required.

Regularly monitor and assess implementation.

Lifecycle Fund Default Options *(cont'd)*

Conclusion

Regulators do not prescribe any asset allocation structure for default investment options. They simply emphasize the importance of diversification in coping with risk by optimizing its trade-off with returns. This does not address legal concerns over capital preservation vs. retirement income adequacy. It also raises many practical and legal concerns about benefit diversification for very long-term investors like DC plan participants (who seem to have higher likelihood of being better off by concentrating their investments in stocks alone).

This is an issue that cries out for legislative clarity, namely safe harbour rules such as those set up in the U.S. or the U.K. In the absence of such legislative protections, there are only potentially wrong legal answers for default option selection.

Lifecycle Fund Default Options *(cont'd)*

In other words, employers can be sued for providing lifecycle funds as default options and they can be sued for imposing conservative options that simply preserve capital. Accordingly, and until governments respond, sponsors and administrators need to be continuously vigilant in all aspects of design, implementation and governance of default options, especially lifecycle defaults. There are many practical steps employers can take to help insulate themselves from lawsuits, such as setting legally appropriate written objectives, obtaining appropriate written agreements with service providers, monitoring costs, and regular ongoing evaluation. In this continuum, diligent plan member communication is likely to be the most vital aspect of legal risk mitigation.

Asset and Liability Transfers in M&A Transactions

DB transfers:

- ↪ subject to regulatory approval
- ↪ lengthy application process in most jurisdictions
 - ↪ legal support
 - ↪ actuarial support
 - ↪ plan member notice
 - ↪ are member benefits protected?

DC Transfers

- ↪ expedited process in most jurisdictions
 - ↪ tick box approval vs. report

Vesting and Locking-In

Vesting:

- period of employment or plan membership required to receive employer portion of accrued benefits
 - trend from 2 years to immediate

Locking In:

- accrued entitlement must be used to provide a lifetime retirement income
 - exceptions for:
 - small benefits
 - pre-1980s accruals (20%)
 - hardship applications to regulator

Adjudication Structure For Pension Disputes

1. Pension Regulator

- ↪ 1st Level
 - ↪ regulator initiated
 - ↪ complaint initiated
- ↪ 2nd Level
 - ↪ Administrative Tribunal
- ↪ 3rd Level
 - ↪ upper level court (usually three judges)
- ↪ 4th Level
 - ↪ Provincial or Federal Court of Appeal
- ↪ 5th Level
 - ↪ Supreme Court of Canada

Adjudication Structure For Pension Disputes

1. Labour Relations – Grievance Arbitration

- ↪ failure to reach collective bargaining agreement
- ↪ benefit or other issues arising under collective bargaining agreement
 - ↪ is plan part of collective agreement?
 - ↪ employee booklets or other communications?

2. Court Process

- ↪ Matters of entitlement involving claims unrelated to pension standards
 - ↪ contract
 - ↪ employer/employee
 - ↪ service providers/administrator
 - ↪ tort (including innocent, negligent and fraudulent misrepresentation)
 - ↪ breach of fiduciary duty

Issues in Plan Member Communications

- ↪ Legislated Disclosure
 - ↪ plan summaries
 - ↪ member statements and content
 - ↪ access to plan documents
- ↪ Case law
 - ↪ misrepresentation
 - ↪ *Deraps* and others
 - ↪ class actions
 - ↪ Gardner vs. GM and GD
 - ↪ contract
 - ↪ breach of fiduciary duty

Democratizing Pension Funds

Joint Trusteeship or Pension Committees

- recent reforms in Quebec and Manitoba
- presumption they will be better managed

Advisory Committees

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