

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**

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EXECUTIVE SUMMARY

This paper examines the investment patterns of pension funds in Canada and their impact on capital markets and corporate governance. The analysis made in the paper is under the following five heads:

1. Asset allocation patterns of Canadian pension funds.
2. Pension funds' impact on capital markets.
3. Recent trends in pension fund investments – private equity and venture capital.
4. Pension funds' influence on corporate governance.
5. The role of pension funds in policymaking and regulatory changes.

For the purpose of analysis, the paper uses a combination of data, for which the main source is Statistics Canada, scholarly literature on the subject, field surveys and reports of current events. The conclusions drawn in the paper with reference to the five heads listed above are summarized below.

1. Asset Allocation Patterns of Canadian Pension Funds

Pension funds are large investors in various assets, such as stocks, bonds, private equity and other securities and assets, and the asset allocation patterns in the investments of Canadian pension funds are examined. The following are the major conclusions drawn from the study:

- (i) Over the period 1994-2006, stocks traded in the public capital markets have remained more or less stable at about 40 percent of the total assets of pension funds and are an important asset class for the funds;
- (ii) Foreign holdings by pension funds have more than doubled to 30 percent, while holdings of Canadian securities have correspondingly fallen during the period;
- (iii) Holdings in fixed-income securities – namely, bonds – have declined by a quarter, from 41 percent to 32 percent of the assets of pension funds during the period;
- (iv) There appears to be a small, but steady, interest for new varieties of investments such as venture capital and private equity. According to available data, the value of such investments was over \$70 billion in 2006; and
- (v) The data available on the asset allocation patterns of Ontario pension funds reveals that the pattern of asset allocation by Ontario pension funds is more or less in line with their non-Ontario counterparts. The pension funds in Ontario jurisdiction do not display significantly different trends in asset allocation.

2. Pension Funds and Capital Markets

Most of the investments of pension funds are in securities traded in the capital markets, and this makes pension funds a powerful force in these markets. The paper examines how the presence and operations of pension funds impact the capital markets, and draws the following conclusions.

- (i) Pension funds are important players in the capital markets. The trading activity of pension funds is significant to the functioning of the capital markets in that it enhances the efficiency of the public market and adds liquidity. Pension funds are regular purchasers and sellers of securities, and they make regular and overall net substantial purchases of securities in the Canadian capital markets every year. In the 13-year period between 1994 and 2006, pension funds have made investments of over \$350 billion in the stock market, net of the sales of securities made by them during this period.
- (ii) Pension funds earn significant profits on the sale of securities and also derive considerable investment income by way of dividends and interest. Both sources of income have been proportionately greater sources of revenues over the period 1990-2004. However, profits on sale of securities have emerged as the more important source of revenue for pension funds. Investment income has shown a trend of consistent decline, and it fell from over 58 percent in 1990 to less than 27 percent in 2004. Net profits from the sale of securities, which represented less than 3 percent of the revenue of pension funds in 1990, rose to a high of almost 54 percent in 2000, and were about 30 percent in 2004. Although the trend with profits on sale of securities is quite variable during the period, it is undeniable that their importance in the revenue structure of pension funds has been gaining in significance. This indicates that pension funds tend to rely more on trading operations in securities than on income from holding securities.
- (iii) There is mixed evidence about the performance of pension funds relative to each other (e.g., DB vs DC) and relative to market benchmarks.
- (iv) Pension funds have some influence on the corporate governance practices of public issuers, and their presence in the capital markets enhances investor protection and public confidence in the capital markets

3. Recent Trends in Pension Fund Investments – Private Equity and Venture Capital

Since the 1990s, there has been a trend for some pension funds to make investments in private equity and venture capital, which marks a break from their traditional practice of investing in securities that are traded in the capital markets. The paper analyzes the significance of the trend for private equity and venture capital investment by pension funds, and the conclusions reached in the paper on this subject are summarized below.

- (i) Larger pension funds exhibit greater interest in new varieties of investments such as venture capital or private equity, which are a move away from the more traditional “stocks and bonds” model of pension fund investments. Thirty-two of the 100 largest pension funds have assets in venture capital and private equity, and these assets represent 8 percent of their total asset value. In comparison, only 2 percent of smaller funds have invested in private equity and venture capital, and their assets in this category, including real estate, are just 3 percent of their total.

- (ii) Investments in private equity and venture capital require greater scrutiny and involvement, both at the pre-investment stage as well as in the post-investment phase. This could be the explanation for the reluctance of smaller pension funds, with their limited resources and expertise, to venture into these areas.
- (iii) Empirical data indicate that private equity investments are often more profitable for pension funds. For example, Ontario Teachers Pension Plan (OTPP) earned a return of 31.4 percent on its investments in this category while its overall rate of return was 17.2 percent. Such higher returns are likely to be an incentive for the pension funds to invest more in this segment. There is also some indication that the trend for large pension funds to invest in private equity and venture capital will be greater in the future.

4. Pension Funds and Corporate Governance

The holdings of equity of corporations by pension funds are sizable, and pension funds are significant shareholders in public corporations. This raises the question of their role in influencing the governance of the corporations. The paper examines the issue and draws the following conclusions.

- i. Canadian pension funds have undertaken systemic efforts to promote good governance among corporations, and the Canadian Coalition for Good Governance (CCGG), which was launched mainly by pension funds, is an important vehicle in this endeavour. CCGG has been active in its efforts to promote good corporate governance. Its activities include regularly examining current issues and preparing policy guidelines for its members. In addition, Pension Investment Association of Canada (PIAC) also provides guidance to its members on playing an effective role in their capacity as shareholders in corporations. These are the systemic efforts undertaken by the pension funds sector to promote good governance in corporations.
- ii. The literature on the subject finds that the involvement of institutional investors, including pension funds, in corporate governance has myriad implications, both positive and negative. The positive ones are mainly the size of the holdings of pension funds and their ability to influence corporations, their ability to hold corporations to account through litigation and effective use of the threat of exit. Important among the negative aspects of pension fund involvement in corporate governance include free-riding by other shareholders, conflicts of interest situations for pension fund managers who are dependent on the support of corporate managers and absence of proprietary interest on the part of pension fund managers.
- iii. In general, pension funds in Canada place reliance on informal discussions with corporate managers for resolving corporate governance issues, and prefer to avoid more confrontational methods, such as negative voting, litigation or proxy campaigns. This trend has continued in recent years, but litigation and other forms of active governance appears to be considered more often as a viable alternative.

- iv. Pension funds have generally not been keen on seeking representation on the boards of directors of corporations. Although too early to state definitively, this may change with increasing private equity investments.
- v. Data on shareholder proposals is insufficient to arrive at clear conclusions on the use of this instrument by pension funds to intervene in corporate governance.
- vi. A minority of pension funds (about 30 percent) surveyed in 2006 delegated the task of voting to their investment managers. Of these, about 70 percent gave freedom to the investment managers to decide on how to vote. This may indicate the constraints of lack of resources and expertise on the part of smaller pension funds to effectively exercise their voting rights as shareholders of corporations.

5. Pension Funds' Role in Policy Making and Regulatory Changes

Pension funds operate in a complex regulatory environment, and have an important stake in the formulation of policy and legislation with respect to corporations, corporate governance, securities markets and pension fund investments. The last part of the paper examines the role of pension funds in influencing policy and bringing about regulatory changes, and the following are the important conclusions.

- (i) Pension funds play an active role and appear to be quite effective in campaigning for regulatory changes in which they are interested as investors in the capital markets. The amendments made to the *Canada Business Corporations Act* in 2001 with respect to proxies and shareholder communications, as well as the removal of the Foreign Property Rule from the *Income Tax Act* in 2005 are prominent examples of the efficacy of pension fund activism in bringing about policy and regulatory changes.
- (ii) Campaigning for policy and regulatory changes is done both at the collective level – through organizations such as the Canadian Coalition for Good Governance (CCGG) and Pension Investment Association of Canada (PIAC), and by larger pension funds such as Canada Pension Plan Investment Board (CPPIB) and Ontario Teachers' Pension Plan (OTPP).

* * * * *

Author's Biography:

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Honoured as one of “Canada’s Top 40 under 40” in 2005 by The Caldwell Partners, the Globe and Mail, Certified General Accountants of Canada, Air Canada and Privilege Magazine, Professor Puri's research expertise lies in corporate law, securities law, corporate governance, and corporate and white-collar crime. Governments and regulators in Canada and internationally including Industry Canada, the Ontario Securities Commission (OSC), the Canadian Senate, the Wise Persons Committee on Securities Regulation and the International Finance Corporation of the World Bank have sought

Professor Puri's expertise. In 2005, she was appointed one of two research directors for the Task Force to Modernize Securities Legislation (which published its report in October 2006), and she was also chosen as a member of the OSC's newly created Investor Advisory Committee. She is currently President of the Canadian Law and Economics Association for the 2006-08 period. A recipient of the Osgoode Hall Law School Teaching Award, Professor Puri's teaching and research interests encompass corporate law; securities law; corporate governance; corporate and white collar crime; bankruptcy law; the economics of litigation and legal fees; and law and economics. Along with numerous published articles, Professor Puri is co-author/co-editor of three books: Corporate Governance and Securities Regulation in the 21st Century (with J.Larsen)(Butterworths, 2004); Canadian Companies' Guide to the Sarbanes-Oxley Act (with L. McCallum)(Butterworths, 2004); and Cases and Materials on Partnerships and Canadian Business Corporations (with D. Harris, R.Daniels, E.Iacobucci, I.Lee, J.MacIntosh, and J.Ziegel)(Carswell, 2004).

The research assistance of P.M. Vasudev is gratefully acknowledged.

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Pension Funds: Trends in Asset Allocation and Role in Capital Markets, Corporate Governance and Regulatory Policy

Part 1 - Introduction

The mandate of the Ontario Expert Commission on Pensions provides that it will “examine the legislation that governs the funding of defined benefit pension plans in Ontario, the rules relating to pension deficits and surpluses, and other issues...” and “the importance of pension plans in supporting a competitive economy”. This research project focuses on the second aspect of the Commission’s mandate.

Pension plans are a significant source of investment capital in Ontario. Over the past 20 years there have been major developments in both capital markets, and the relationship of pension funds to capital markets. Some pension funds have become more active investors in at least two senses: they are a source of long-term or “patient” capital, particularly for infrastructure investments and other alternative investment classes, and they have attempted to influence the governance of their investments. Pension funds have also influenced the development of capital markets and their products.

The objectives of this paper are three-fold. First, it examines the existing academic literature on the impact of pensions on economic activity, and in particular, the capital markets and corporate governance. Second, the paper analyzes the relevant issues in the context of Ontario (and Canada where a provincial analysis is not possible or appropriate). Third, this paper outlines directions for future research, both as a general matter and specific to Ontario.

Part 2 of the paper reviews existing data and literature on asset allocations. It analyzes the (primarily empirical and descriptive) data on the investments behaviour of pension funds in Canada, with a particular focus on Ontario.

Part 3 of the paper focuses on the impact of pension funds on the capital markets, including public capital markets, private capital, and venture capital. Asset allocations, investment strategies and relative performance are considered here.

Part 4 of the paper focuses on the impact of pension funds on corporate governance. The academic literature as well as available data are reviewed to assess the incentives that pension funds have to engage in governance interventions. The particular strategies, approaches and interventions that are used by pension funds are also explored. The relationship between these interventions and economic performance is also considered.

Part 5 of the paper explores whether there is any evidence that pension funds drive or contribute to regulatory reform. This part proceeds by case-study – namely, changes made to the *CBCA* to enable shareholder communications, deletion of the Foreign Property Rule and the ongoing campaign for the removal of the investment rules applicable to pension funds.

Part 6 concludes and offers some suggestions for further areas for research. Since this

paper focuses primarily on the impact of pension funds on the capital markets and corporate governance, it provides a possible future research agenda for further study in these areas as well as the impact of pension funds on the economy more generally.

Part 2 - Asset Allocation Patterns of Pension Funds

(a) Introduction

This part of the paper explores the trends in the investment patterns of pension funds over the last two decades. An analysis of the data for 1993-2006 suggests five trends:

- (i) Stocks traded in the public capital markets have remained more or less stable at about 40 percent of the total assets;
- (ii) Foreign holdings by pension funds have more than doubled to 30 percent, while holdings of Canadian securities have correspondingly fallen;
- (iii) Holdings in fixed-income securities – particularly, bonds – have declined from 41 percent to 32 percent of the assets of pension funds; and
- (iv) There appears to be a small, but steady, interest in new varieties of investments such as venture capital and private equity. According to available data, the value of such investments was over \$70 billion in 2006.
- (v) Available data suggests that there are not significant differences in the asset allocation patterns of Ontario pension funds as compared to those that are not Ontario-based.

(b) Basic Data on Asset Allocations

The data on the asset allocations of pension funds for the period 1993-2006 are provided in Table 1 in dollar figures and in Table 2 in percentages.

Table 1

Asset Classes of Trusteed Pension Funds, 1993-2006¹

Market Value
\$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
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

¹ Tables 1 and 2 are based on data taken from Statistics Canada. Table 280-0002 – Trusteed pension funds, market and book value of assets, by private and public sector category. CANSIM database. Available online: http://estat.statcan.ca/cgi-win/cnsmcgi.exe?Lang=E&ESTATFile=EStat\English\CIL_1_E.htm&RootDir=ESTAT/, accessed November 13, 2007. The 6 asset categories used in Tables 1 and 2 are the ones published by Statistics Canada; however they are the result of the collapsing together of a more precise set of categories. Our analysis is therefore limited to the categorization published by Statistics Canada. The notes added by Statistics Canada to the data are extracted below:

1. Starting in 1993, funds with assets of less than \$5 million were exempted from providing any detail of their assets. In 1998, this limit was raised to \$10 million. Hence, only total asset figures are reported for these smaller funds, and the asset break-up in the table does not include the smaller funds.
2. The estimates are for 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.

Table 2

Trusteed Pension Funds 1993-2006
Asset Allocations as a Percentage of Total Assets

Year	Bonds	Stocks	Mortgages	Real Estate	Short-term	Other Assets
1993	41.4	38.2	2.8	3.0	7.8	6.1
1994	39.1	38.6	2.6	3.4	8.1	7.5
1995	38.9	40.5	2.3	3.4	6.7	7.6
1996	36.0	44.1	2.0	2.9	6.0	8.4
1997	36.8	44.1	1.8	2.9	4.8	9.3
1998	37.8	41.0	1.6	3.0	5.4	10.4
1999	34.4	44.7	1.5	3.1	4.5	11.3
2000	37.0	39.9	1.5	4.2	4.6	12.0
2001	36.1	40.0	1.7	5.0	5.4	11.9
2002	36.5	37.4	1.7	5.9	5.5	12.4
2003	34.6	39.5	1.5	5.1	4.8	13.8
2004	34.5	38.4	1.5	5.0	4.5	15.4
2005	33.4	39.7	1.4	5.6	4.6	14.9
2006	32.3	41.0	1.4	6.1	2.9	15.8

It is evident from this Table that equities, as an asset class, have been more or less stable at about 40 percent of the total portfolio of pension funds during the 17-year period. This finding may be surprising for readers since equities are generally thought to make up 50 or 60% of pension fund portfolios.² This discrepancy may possibly be attributed to the use of asset categories that have been collapsed by Statistics Canada in their published data from a set of more precise categories, which may have the effect of under-representing the percentage of stocks held by pension funds. In addition, categories such as “other assets” includes within it miscellaneous pooled vehicles, which may include stocks.

It is interesting to note that the Table shows that bonds have fallen from approximately 41 percent to about 32 percent. Similarly, holdings in mortgages also fell from 2.8 percent of the holdings of pension funds in 1993 to 1.4 in 2006. Connected with these, the class of “short-term assets” also fell during the period, from 7.8 percent to 2.9 percent. The decline in these assets classes could be attributed to the real return on these assets during the time period, compared to equities. The return on bonds, mortgages and

² The latter statistics finding *very roughly* corresponds well to Benefit Canada’s annual survey of the “Top 100” pension funds in Canada. For example, in 2006, Benefits Canada reported that Canadian equities in the Top 100 averaged 26.4%, US equities 11.9%, Europe, Australia, Far East equities 11.4% and global equities 4.3%. Benefits Canada, “Top 100 Pension Funds”, online: http://www.benefitscanada.com/news/article.jsp?content=20060706_150017_3000.

short-term assets is correlated to real interest rates and during this time period, real interest rates were relatively low.³

(c) New Asset Classes

Significantly, the class “other assets” in Tables 1 and 2 rose from a low of 6.1 percent in 1993 to almost 16 percent in 2006. According to Statistics Canada, this category 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 period, and there was no sudden jump in this asset class during any one year or a block of years.

The Pension Investment Association Canada (PIAC) also releases data on the asset allocation of the investments of its members. This data are more detailed than that of Statistics Canada in terms of asset classification. However, PIAC does not represent the full universe of Canadian pension funds; even among the members of PIAC, the data are restricted to those who reported the details of their investments. Statistics Canada’s data, on the other hand, cover all trusted pension funds.

The PIAC data shows three new asset classes – (i) venture capital and private equity, (ii) hedge fund investments and (iii) infrastructure, which have been added in the recent years. The investment figures for member-funds provided by PIAC for these asset classes are provided in the Table 3 below in dollar figures and Table 4 in percentages.

Table 3

Pension Fund Investments
New Asset Classes 2000-2006 (\$Million)⁴

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

³ 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. Bank of Canada. *Treasury Bills – Average Yields – 6 Months*, available online: http://www.bank-banque-canada.ca/pdf/annual_page5_page6.pdf, accessed November 14, 2007.

⁴ Pension Investment Association of Canada (PIAC). Asset allocations of member-pension funds available online: <http://www.piacweb.org/publications/index.html>, accessed November 13, 2007.

Table 4

Pension Fund Investments
New Asset Class Values as % of Total Assets (PIAC Data)

Asset Class	2000	2001	2002	2003	2004	2005	2006
Venture capital and private equity	1.5	1.7	3.5	3.6	3.4	4.0	3.5
Hedge fund investments					1.4	2.0	2.2
Infrastructure							2.4

Venture capital and private equity were first classified as a separate asset class in 2000, and they had about \$8 billion in market value 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. From these figures, it would be quite reasonable to conclude that these new asset classes, which are not included in Statistics Canada classification, account for the substantial growth in the “other assets” of pension funds reported by Statistics Canada presented in the earlier tables.

As Table 4 above highlights, the new asset classes do not, as yet, represent significant parts of the portfolios of pension funds, but in terms of absolute numbers their importance is growing. Also, there has been a steady trend of increase in venture capital and private equity investments by pension funds and it is quite probable that they will be significantly more important in the years to come. This is discussed in Part 5 of the paper below.

(d) Foreign Investments

Another important component of pension fund investments is their holdings of foreign securities. In 1988, foreign equity holdings accounted for 4.9 percent of the total assets.⁵ Foreign holdings of pension funds increased steadily and significantly during the period 1993-2006 as evident from the data set out in Table 5 below.

⁵ Harry Weitz, *The Pension Promise, The Past and Future of Canada's Private Pension System* (Scarborough, Ontario: Carswell, 1992) at p. 278-279.

Table 5**Trusteed Pension Funds' Foreign and Canadian Holdings 1993-2006⁶**
(\$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	82.0	83,550	18.0
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	78.0	128,189	22.0
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

There has been a 17 percentage point increase in the holdings of foreign assets, from 13.3 percent in 1993 to 30.5 percent in 2006. Correspondingly, there has been a 17 percentage point decline in the holdings of Canadian assets, from 86.7 percent in 1993 to 69.5 percent in 2006. This substitution seen during this time period from domestic holdings to foreign holdings can reasonably be attributed to changes in the regulatory rules relating to foreign property. A ceiling of 10 percent on foreign holdings was introduced in the early 1970s, and it was raised to 20 percent in 1990.⁷ In 2001, the ceiling was further raised to

⁶ Statistics Canada. Table 280-0003 – Trusteed pension funds, market value of assets, foreign and Canadian. CANSIM database. Available online: http://estat.statcan.ca/cgi-win/cnsmcgi.exe?Lang=E&ESTATFile=EStat\English\CII_1_E.htm&RootDir=ESTAT/, accessed November 13, 2007. Notes to the data provided by Statistics Canada are extracted below.

1. Funds with assets less than \$5 million up to 1998 and less than \$10 million thereafter do not report their asset allocation, and are not included in the table.
2. The estimates are for 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.

⁷ Harry Weitz, note 4 above, at p. 314.

30 percent.⁸ The original rationale for the rule was to deploy available capital in Canada and possibly reduce the cost of capital for domestic enterprises. It was opposed by many stakeholders as not serving its intended purposes.⁹ In 2005, the rule was finally abolished.

The data in Table 5 show that pension funds were inching towards the ceiling of 30 percent applicable to their foreign holdings under the Foreign Property Rule, which was in force until 2005. In the very next year after its elimination – namely, 2006, the foreign holdings of pension funds crossed that level. This is significant, given the fact that many pensions funds and PIAC had actively campaigned with the federal government for the removal of the Foreign Property Rule, as will be discussed in Part 6 below. The relative asset allocations within the two categories – foreign and Canadian assets – are presented in the Tables 6 and 7 below, in terms of market value and percentage changes respectively.

Table 6

Pension Funds’ Canadian and Foreign Holdings 1993-2006
Asset Allocations – Market Value (\$Million)

Year	Bonds Canadian	Bonds Foreign	Stocks Canadian	Stocks Foreign	Short-term Assets Canadian	Short-term Assets Foreign	Other Assets Canadian	Other Assets 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
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

⁸ For an analysis of the cost and benefits of the Foreign Property Rule, see David Burgess and Joel Reid, “The Foreign Property Rule: A Cost-Benefit Analysis” (2003), paper available online: <http://economics.uwo.ca/faculty/fried/papers/fried-burgess-iipf.pdf>, accessed November 14, 2007.

⁹ See e.g. Burgess and Fried (2003), *ibid.*

Table 7

Pension Funds' Canadian and Foreign Holdings 1993-2006
Asset Allocations %

	Bonds	Bonds	Stocks	Stocks	Short-term	Short-term	Other Assets	Other Assets
Year	Canada	Foreign	Canada	Foreign	Canada	Foreign	Canada	Foreign
1993	41.3	0.4	28.9	9.5	7.7	0.1	8.8	3.2
1994	38.9	0.5	29.2	9.7	7.9	0.2	9.3	4.3
1995	38.6	0.5	30.7	10	6.6	0.2	8.3	5
1996	35.7	0.5	34.4	10	5.8	0.1	7.4	6
1997	36.1	0.9	34	10.2	4.6	0.2	7.3	6.6
1998	36.7	1.5	30.1	11.3	5.3	0.1	7.8	7.2
1999	33.8	0.8	34	10.9	4.4	0.1	7.6	8.3
2000	36.1	1.1	29.8	10.4	4.5	0.1	8.8	9.1
2001	35.3	0.8	28	12	5.2	0.2	9.4	9.1
2002	36	0.8	25.8	11.9	5.4	0.1	10.3	9.8
2003	34.2	0.6	27.4	12.4	4.8	0.1	10.1	10.4
2004	33.8	0.9	26.3	12.4	4.5	0.1	11.2	10.9
2005	32.5	1.1	25.6	14.3	4.5	0.1	11.8	10.1
2006	30.3	2.1	23.9	17.3	2.8	0.1	12.5	11

The data show that there has been an increase in foreign holdings in all categories except short-term assets, which makes sense given that pension funds would prefer to concentrate their liquid assets within Canada. Although there has been a steep fall in this category of assets – namely, short-term, pension funds clearly prefer to hold them in Canada rather than in foreign assets.

The increases in the holdings of other varieties of foreign assets is, however, both steady and significant. As we noted earlier in Part 2(a) above, the net holdings of fixed-income securities has been on the decline, but there have been increases in the holdings of foreign bonds from 0.4 percent in 1993 to over 2 percent in 2006. The holding of foreign stocks by pension funds has almost doubled, from 9.5 percent in 1993 to over 17 percent in 2006, but it has not been fully substituted from Canadian stocks, but rather other assets.

The increase in the “other assets” sub-category has also been quite high for foreign holdings, rising from 3.2 percent in 1993 to 11 percent in 2006. The notes added by Statistics Canada clarify that foreign investments include primarily pooled funds, which indicates that most pension funds do not make individual foreign investments.

(e) Pension Funds – Data for Ontario

This section analyzes the data available on the asset allocations of Ontario pension funds and compares them with the figures for pension funds in Canada that are not based in Ontario. It concludes that there are no significant differences in the asset allocation patterns of the two groups of pension funds, except equities weighting, which in this sample show “Ontario” funds with about 7.4% lower weighting than other funds. The following data are available on pension funds in Ontario and other provinces/territories, and the values of their assets averaged over the period 2000-2006.¹⁰

Table 8

Asset Components of Ontario and Non-Ontario Pension Funds
Average Value between 2000 and 2006
Amounts in \$billion

Assets	Total	Non-Ontario Pension Funds	Assets %	Ontario Pension Funds	Assets %
Number of Pension funds	3,649	2,776		873	
Bonds – Canadian	165	97	35.0	68	35.8
Bonds – foreign	4	1	0.4	3	1.6
Bonds – total	169	98	35.4	71	37.4
Equity - Canadian	130	83	30.0	47	24.7
Equity – foreign	102	63	22.7	39	20.5
Equity – total	232	146	52.7	86	45.3
Cash & other short-term	19	8	2.9	11	5.8
Mortgages	7	6	2.2	1	0.5
Real estate	24	11	4.0	13	6.8
Other miscellaneous and pooled funds	16	8	2.9	8	4.2
Total	467	277	100.0	190	100.0
Canadian assets	359	213	76.9	146	76.8
Foreign assets	108	64	23.1	44	23.2

¹⁰ Data provided by Ontario Expert Commission on Pensions based on Survey of Trusteed Pension Funds (TPF), Statistics Canada. For the purpose of constructing this sample, “Ontario Funds” are funds in the TPF Survey that are related to one or more pension plans registered in Ontario. Note that the 7.4% difference in equities weighting between Ontario and non-Ontario funds.

Within the Trusteed Pension Funds survey population, there are 873 trusteed pension funds related to at least one pension plan registered in Ontario, which represents about 25 percent of the total population of the survey (3,649). However, the assets of these Ontario pension funds represent about 41 percent of the total asset value of all pension funds, and this translates into an average pension fund size of about \$217 million for Ontario pension funds. As against this, the average asset value for non-Ontario pension funds is about \$100 million. Therefore, the average size of Ontario pension funds is more than double that of non-Ontario pension funds. The probable explanation for this is the fact many of the largest pension funds in Canada are based in Ontario, which also suggests the average size is probably skewed by a small number of large plans in the survey. For example, four major public sector plans, the Ontario Teachers Pension Plan (OTPP), Ontario Municipal Employees Retirement System (OMERS), the Hospitals of Ontario Pension Plan (HOOPP) and the Public Service Pension Plan (PSPP) represent a substantial percentage of the total assets of trusteed pension funds in Canada and they are based in Ontario.

When the asset-mix or asset allocation patterns of Ontario and non-Ontario pension funds are compared, there are no significant differences and the two groups of pension funds – Ontario and non-Ontario – have made their investments in different categories of assets in roughly the same proportions. One exception to this general pattern is mortgages; here, the Ontario pension funds' investment, at 0.5 percent of the total, is much lower than the corresponding percentage for non-Ontario funds which is 2.2 percent. However, this cannot be termed as a significant or major difference, given the small presence of the asset category of mortgages in both the groups of pension funds.

In conclusion, based on this sample of the data, it can be stated that the asset allocation patterns of Ontario pension funds are more or less in line with their non-Ontario counterparts. The pension funds in Ontario jurisdiction do not display significantly different trends in asset allocation.

(f) Conclusion

This part of the paper has attempted to extract some highlights from the basic data on pension fund investments. The analysis of this data reveals the following trends:

- (i) According to CANSIM data, stocks traded in the public capital markets have remained more or less stable at about 40 percent of the total assets of pension funds, and were an increasingly important asset class for pension funds;
- (ii) Foreign holdings by pension funds have more than doubled to 30 percent, while holdings of Canadian securities have correspondingly fallen;
- (iii) Holdings in fixed-income securities – namely, bonds – have declined from 41 percent to 32 percent of the assets of pension funds; and
- (iv) There appears to be a small, but steady, interest for new varieties of investments such as venture capital and private equity, and their value was over \$70 billion in 2006.

- (v) Available data suggests that there are not significant differences in the asset allocation patterns of Ontario pension funds as compared to those that are not Ontario based.

Part 3 – Pension Funds and Capital Markets

(a) Introduction

The holdings of pension funds amounted to 21.7 percent of the domestic market capitalization of the Toronto Stock Exchange in 2004.¹¹ This underscores the importance of pension funds in the capital markets. This part of the paper examines the impact of pension funds on the capital market. An analysis of the data suggests the following conclusions:

- (i) Pension funds are important players in the capital markets. The trading activity of pension funds is significant to the functioning of the capital markets in that it enhances the efficiency of the public market and in some sense, adds liquidity. Pension funds are regular purchasers and sellers of securities, and they make regular and overall net substantial purchases of securities in the Canadian capital markets every year. In the 13-year period between 1993 and 2006, pension funds have made investments of over \$350 billion in the stock market, net of the sales of securities made by them during this period.
- (ii) Pension funds earn significant profits on the sale of securities and also derive considerable investment income by way of dividends and interest. Both sources of income have been on the rise from 1990 to 2004. However, profits on sale of securities appear to have emerged as the more important source of revenue for pension funds during this time period. Investment income has shown a trend of consistent decline; it fell from over 58 percent in 1990 to less than 27 percent in 2004. In contrast, net profits from the sale of securities, which represented less than 3 percent of the revenue of pension funds in 1990, rose to a high of almost 54 percent in 2000 and were about 30 percent in 2004. Although the profits on the sale of securities are quite variable during the period, it is undeniable that their importance in the revenue structure of pension funds has been gaining in significance. This indicates that pension funds revenues tend to be rely more on buying and selling securities than on income from holding securities.
- (iii) There is mixed evidence about the performance of pension funds relative to other funds (e.g., mutual funds) and broader market indices.
- (iv) Pension funds have influence on the corporate governance practices of public issuers, and their presence in the capital markets would appear to enhance investor protection and public confidence in the capital markets.

¹¹ Gil Yaron, “Acting Like Owners: Proxy Voting, Corporate Engagement and the Fiduciary Responsibilities of Pension Trustees” (July 2005). Shareholder Association for Research and Education (SHARE) Research Paper, available online: http://www.share.ca/files/Acting_Like_Owners.pdf, accessed November 21, 2007.

(b) The Ideal Attributes of Capital Markets

Capital markets need to be efficient and protect investors. They also need to inspire confidence. Professor Eric Kirzner sets out some key factors that are relevant in enhancing the efficiency of the stock exchanges or marketplaces:¹²

- (i) Maximizing liquidity – meaning the ease and certainty with which a non-cash asset can be converted into cash.
- (ii) Maximizing immediacy – which refers to the speed at which transactions can be completed in the market at reasonable cost.
- (iii) Maximizing market visibility or transparency – this refers to the efficiency with which information on orders and trades is entered in the trading system.
- (iv) Maximizing price discovery – the efficiency of the process by which trading prices are determined in the market.
- (v) Minimizing transaction costs – this refers to the burden placed on investors in terms of the costs incurred for executing transactions of purchase and sale of securities.
- (vi) Ensuring fairness – meaning the arrangements in place for minimizing principal-agent conflicts between investors and market intermediaries in executing transactions.
- (vii) Ensuring the integrity of the credit ring – this measures the efficiency of the process of settlement of trades consisting of delivery of securities and payment of the price.
- (viii) Maximizing integrity of the marketplace – this refers to the investors’ perception of the integrity of the market and their confidence in the market processes.

While Eric Kirzner’s focus in his research was on stock exchanges and marketplaces, the above list of market functions can, to some extent, also be more generally applicable to the capital markets. Law and market institutions have a role to play in maximizing liquidity and transparency for example. They also have a role to play in minimizing transaction costs and ensuring fairness and the integrity of the marketplace. Securities laws rules attempt to further these goals, by, for example, providing strong public enforcement to enhance investor confidence and market integrity.¹³ In some cases, this may increase transaction costs for issuers and other market players, but, on balance, the regulatory intervention is seen as necessary and appropriate. Institutional investors, such

¹² Cited in 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 p. 99-125 (Toronto, ON.: Task Force to Modernize Securities Legislation in Canada, 2006), at p. available online: [http://www.tfmsl.ca/docs/V4\(2\)%20Kirzner.pdf](http://www.tfmsl.ca/docs/V4(2)%20Kirzner.pdf), accessed November 19, 2007.

¹³ See generally Mark Gillen, *Securities Regulation in Canada*, 2d ed. (Scarborough, ON.: Carswell, 1998).

as pension funds, also play a part in furthering these factors.¹⁴ Pension funds hold sizable volumes of securities which they trade in the capital markets, and this part of the paper is concerned with the question of how far the presence and operations of pension funds in the capital markets in Canada contribute to the strengthening of some of the market attributes listed above.

Based on the analysis of available literature and data, this paper reaches the conclusion that pension funds have a favourable impact on some of these factors and therefore on the overall functioning of the capital markets.

(c) Impact on Debt and Liquidity of the Market: Net Purchases of Stocks and Bonds by Pension Funds: 1994-2006

An analysis of the data on net purchases of stocks and bonds shows that pension funds are significant investors in the capital markets. They would appear to have a favourable impact on liquidity. Eric Kirzner describes “liquidity” in the following terms:

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.¹⁵

Pension funds receive substantial inflows of funds every year from ongoing contributions of employers and employees, and much of these funds are deployed in the capital market.

In preparing this paper, it was not possible to obtain data on the total volume of trading by pension funds (purchases and sales in the public capital markets) from sources such as the Toronto Stock Exchange because the confidentiality of parties is maintained in the transactions, and there are no records of transactions that disclose the identity of parties. However, it is possible to compute the net additions to the portfolios of pension funds' stocks and bonds by using the annual book values of assets reported by Statistics Canada.¹⁶ Pension funds purchase and sell securities on an ongoing basis, and Table 9 below sets out net incremental investments of pension funds in stocks and bonds during 1994-2006. The net figures are the value of purchases after considering the sales made during the respective years.

¹⁴ There is also some explicit literature on how institutional investors, including pension funds, contribute to these characteristics in capital markets. See for example, E. Philip Davis, *Pension Funds: Retirement-Income Security in Capital Markets - An International Perspective* (Oxford: Clarendon Press, 1995).

¹⁵ Eric Kirzner, note 11 above, at p. 109.

¹⁶ Note 1 above. As stated previously, in this survey, reporting differs for each fund such that book values may be updated to reflect gains and losses, and book value of bonds may be amortized values.

Table 9

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
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
Total	161,001	192,433
Grand Total		353,434

As noted earlier, pension funds made a net investment of over \$350 billion in stocks and bonds during the 13 years from 1994 to 2006. It must also be remembered that these figures are net – in that they deduct the sales of stocks and bonds made by the pension funds during the period. As such, gross purchases of securities by pension funds would be even higher.

It is seen from the above data that the net resources committed by pension funds for the purchase of stocks and bonds were particularly high in the last two years – 2005 and 2006. The purchases made in these two years alone were over \$124 billion, or one-third of the total net purchases made in the 13-year period.

The large volume of purchases of securities by pension funds makes a significant contribution to the depth and liquidity of the stock market. Trading by pension funds contributes to the liquidity of the market – but it also contributes to the profitability of the securities industry infrastructure (traders, dealers, stock exchanges) that has been created to allow for trading by investors.

It is important to note that Table 9 does not provide a breakup between Canada and foreign investments. Table 10 below provides such a breakup.

Table 10

Net Purchases of Bonds and Stocks by Pension Funds: 1994-2006¹⁷
Canadian and Foreign Investments (\$Million)

Year	Net Purchase of Canadian Bonds	Net Purchase of Foreign Bonds	Net Purchase of Canadian Stocks	Net Purchase of Foreign Stocks
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
Total	143,634	17,367	85,357	107,077

The data in Table 10 disclose a significant difference in the investment patterns of pension funds with respect to stocks and bonds. Pension funds have shown a consistent bias in favour of Canada in relation to bonds, but have not been enthusiastic about purchasing foreign bonds. Their net purchase of foreign bonds is about one tenth of their purchases of Canadian bonds, but is increasing.¹⁸

The picture is quite different when stocks are considered. Net purchases in Canadian stocks are significantly less when compared to foreign stocks. Net purchases of foreign stocks exceeded the net purchases of Canadian stocks for the first time in 2000, and this pattern has continued in each subsequent year. Indeed, in 2006, following the abolition of the Foreign Property Rule in 2005, purchase of Canadian stocks by pension funds was just about a third of their purchase of foreign stocks.

¹⁷ Based on book values of assets of trustee pension funds reported by Statistics Canada. Table 280-0003, Trustee pension funds, market and book value of assets, by foreign and domestic holdings. Available 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/CII_PICK&ARRAY_PICK=1&SDSID=&SDDSDESC=, accessed November 26, 2007.

¹⁸ Access to foreign bond markets may also have been another reason to lift the “30% rule”. This is discussed in the next section.

In 2007, MFC Global Investment Management, which is an investment management company, conducted a survey of 148 Defined Benefit pension plans in Canada on their attitude towards investing in foreign securities. The survey found that most of them planned to reduce their holdings of Canadian equities, and correspondingly increase their holdings of foreign securities. However, the volume of change was expected to be less than 5 percent.¹⁹

The survey results indicate that the future will see reductions in the holdings of Canadian equity by pension funds, and increases in their foreign equity holdings. However, these reductions are not likely to diminish the importance of pension funds as important investors in the capital markets of Canada.

(d) Trading Results and Investment Income of Pension Funds: 1990-2004

In this section, data on the income of pension funds through their investments in capital markets is analyzed. Pension funds earned a net income of over \$226 billion from sale of securities during 1990-2004, which is relatively high, compared to their returns on other assets. Table 11 provides data on the profits and losses arising from the purchase and sale of securities by pension funds in the capital markets during 1990-2004.

¹⁹ Survey report, *Trend Watch 2007: Attitudes and Intentions of Canadian Defined Benefit Pension Plans Towards Foreign Investment* (Toronto, ON.: MFC Global Investment Management, 2007), at p. 3-4. Available online: http://www.benefitscanada.com/pdfs/Reports_MFC.pdf, accessed November 16, 2007.

Table 11**Results of Securities Trade Operations of Pension Funds: 1990-2004²⁰**

Year	Profit from Securities Trade	Loss on Securities Trade	Net Profit/ (Loss)
	(\$Million)	(\$Million)	(\$Million)
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
Total	259,202	32,548	226,654

During the entire 15-year period, pension funds have not suffered net losses in any year; rather, their profits from sales have been consistently and substantially higher than the losses incurred. The trading operations of pension funds have, therefore, been generally profitable.

However, these absolute numbers alone cannot lead to the conclusion that the trading operations of pension funds have added significant value for their beneficiaries because one needs to compare the results with a benchmark. Have the return of pension funds capital markets investments outperformed the TSX benchmarks?

Robert Anderson tracked the movements in the total asset values of pension funds (including those invested in capital markets as well as other investments, which includes pooled, mutual and investment funds, mortgages, real estate, cash and short term.) *vis-à-vis* the Toronto Stock Exchange Composite Index for the period 1991- 2004, and the results are mixed. Chart 1 brings out the comparison.²¹ It should be noted that Anderson uses primarily data from the Census of Trusteed Pension Funds, however he supplements this with Quarterly Estimates of Trusteed Pension Funds where census information is not

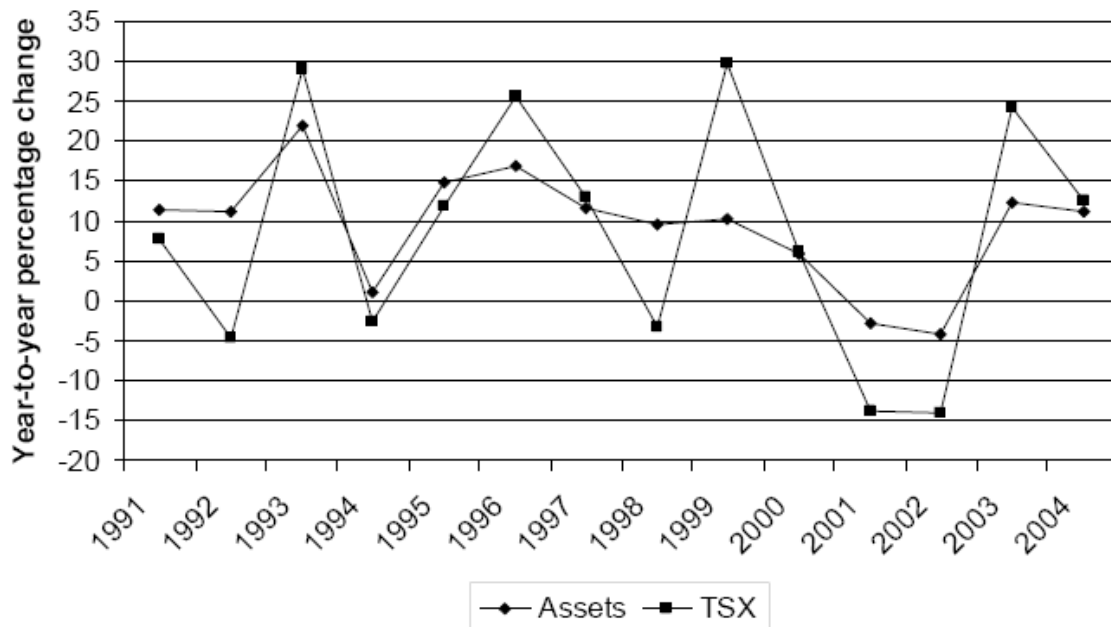
²⁰ Robert Anderson, "Trusteed Pension Plans and Funds, 1990 to 2004" in *Canada's Retirement Income Programs* (Ottawa: Statistics Canada, 2005).

²¹ *Ibid.*

available to complete the data, which is based on a smaller sample of the Census population.

Chart 1

Year- to- year Percentage Change in Trusteed Pension Fund Asset Value compared to the TSX Composite Index



Out of the 14 years for which data has been compared, the total value of pension fund assets outperformed the TSX Index in 7 years. In particular, the losses of pension funds were significantly lower in 2001 and 2002 when the stock market generally 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. It is, therefore, difficult to come to clear-cut conclusions about the quality of investment management by pension funds. From this data, it appears that active investments by pension funds (capital markets investments and other investments) do not lead to results which are significantly superior to more passive varieties of investments, such as indexed investments.²² It also appears that pension funds holdings are less volatile than a general market index, and less subject to short-term fluctuations, which is a positive feature in these funds and may be a trade-off with equity risks.

There is a significant amount of literature comparing pension fund performance with benchmarks. One set of studies indicates underperformance of DB plans as compared to

²² For the main Statistics Canada sources, assets are reported by book value and market value. The basis upon which funds report these values varies. Some funds may report assets based on the information they or custodians have available and these may reflect reporting on different bases (e.g., some gains or losses accrued to book value).

index benchmarks. Two studies looking at the period between 1973-1982 concluded that DB plans underperformed the S&P 500 by 1.10%²³ and by 0.44%²⁴ per year. Another study looking at the period between 1983-1989 concluded that DB plans underperformed the S&P 500 by 2.5% a year.²⁵

There is, however, also literature showing the opposite effect, indicating a “persistence effect”, or outperformance for pension funds over index benchmarks. One early study found that the average DB portfolio outperforms the S&P 500 by 1.44% per year.²⁶ This effect was later confirmed²⁷, and more recently reconfirmed by a study²⁸, which found that the average fund outperforms the market by 1.24% after expenses. For further studies on performance of DB funds, see footnote.²⁹

Thus, from the preceding literature, it can be observed that there are two major strands of thought on the issue with one showing no significant outperformance by pension funds over indexed investments, and the other showing some persistent outperformance.

Pension funds, as noted earlier, earned sizable profits from trading in securities. Buying and selling securities also makes a significant contribution to the revenues of pension funds. Pension funds also earned substantial investment income³⁰ during the period 1990-2004. Table 12 below provides data on the revenues of trustee pension funds for the period and the individual components of their revenue.

Table 12

²³ G. P. Brinson, R. Hood, and G. L. Beebower, "Determinants of portfolio performance" (1986) 44 *Financial Analysts Journal* 231.

²⁴ R.A. Ippolito, and J. A. Turner, 1987, Turnover, fees and pension plans performance, (1987) 43 *Financial Analysts Journal* 16.

²⁵ J. Lakonishok, A. Schleifer, and R W. Vishny, “The structure and performance of the money management industry” 1992 *Brookings Papers on Economic Activity: Macroeconomics* 339.

²⁶ G. L. Beebower, and G. L. Bergstrom, “A performance analysis of pension and profit-sharing portfolios: 1966-1975” (1977) 33 *Financial Analysts Journal*.

²⁷ J. A. Christopherson, W. E. Ferson, and D. A. Glassman, “Conditioning manager alphas on economic information: Another look at the persistence of performance” (1998) 11 *Review of Financial Studies* 111

²⁸ J. Busse, A. Goyal, and S. Wahal, July 2006, “Performance persistence in institutional investment management” available online: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890319, date accessed: September 15, 2007.

²⁹ K. Ambachtsheer, *Pension Revolution: A Solution to the Pension Crisis* (Toronto: John Wiley & Sons, 2007) at 236-238; W. Ferson, and K. Khang, “Conditional performance measurement using portfolio weights: evidence for pension funds” (2002) 65 *Journal of Financial Economics* 249; R. Wermers, “Mutual fund performance: An empirical decomposition into stock-picking talent, style, transactions costs, and expenses” (2000) 55 *Journal of Finance* 1655; A. Khorana, H. Srvaes and P. Tufano, “Mutual Fund Fees Around the World” (2007) *HBS Finance Working Paper* No. 901023 online: <http://ssrn.com/abstract=901023> date accessed: July 30, 2007.

³⁰ This is subject to the caveat that the “investment income” of pension funds would include income from real estate and short-term assets also. Therefore, the entire investment income cannot be attributed to dividend on stocks and interest on bonds traded in the capital market.

Revenues of Trusteed Pension Funds 1990-2004³¹
(\$Million)

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
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

Table 13, below, interprets the net profit on sale of securities and investment income as a percentage of the total revenues of pension funds.

³¹ Robert Anderson, note 19 above.

Table 13

Analysis of Investment Income and Profit on Sale of Securities 1990-2004³²
(\$Million)

Year	Investment Income	As a % of Total Revenue	Net Profit on Sale of Securities	As a % of Total Revenue	Total Revenue
1990	15,908	58.3	664	2.4	27,282
1991	15,683	52.2	2,360	7.9	30,050
1992	15,639	47.8	3,643	11.1	32,699
1993	16,124	39.8	9,559	23.6	40,519
1994	16,858	43.9	7,080	18.4	38,417
1995	18,009	42.4	9,790	23.1	42,445
1996	18,888	34.5	18,889	34.5	54,750
1997	19,185	30.1	29,847	46.9	63,641
1998	20,416	33.7	23,466	38.7	60,666
1999	21,778	34.9	25,439	40.8	62,316
2000	23,670	27.0	47,219	53.9	87,621
2001	21,901	34.3	8,309	13.0	63,858
2002	20,892	42.3	1,697	3.4	49,441
2003	24,361	38.7	10,499	16.7	62,984
2004	25,463	26.6	28,193	29.5	95,589

The trend with respect to investment income is clear. While it is increasing in dollar terms, due to the constant increases in investments, the importance of investment income as a component of the total revenues of pension funds has been on the decline. Investment income, which was over 58 percent of the total revenue in 1990, had fallen to just over twenty-five percent in 2006. The decline can be attributed, at least in part, to the combined effect of the fall in interest rates and reduced holdings of bonds by pension funds, mentioned in Part 2 above.³³

When we turn to the figures of net profit on sale of securities, their importance as a component of the revenues of pension funds has generally been on the rise, but there have been fluctuations. In 2000, at the height of a long bull market, the net profits from the sale of securities, at 53.9 percent, represented over half of the total revenues of pension funds. This source of revenue fell to a low of 13 percent in 2001 and less than 4 percent in 2002. By 2004, the net profit on sale of securities had recovered to almost 30 percent of the total revenue. Despite the instability and the swings, it appears that net profits from trading operations in securities now constitutes a significant part of the revenues of pension funds.

³² Based on data in Robert Anderson, note 19 above.

³³ See p. 12 above.

These findings indicate greater turnover in the investment portfolios of pension funds. This suggests that pension funds may be moving away from being sources of “patient capital” with a long term focus, and demonstrates a shift towards becoming more activist traders looking for short term movements in share prices. This may have implications for governance, whereby a shorter investment focus will not give pension funds as much of an incentive to become involved in governance.

(e) Conclusion

The data and the analysis in this part of the paper lead to the following conclusions:

- (i) Pension funds are important players in the capital markets. They invest substantial funds in the capital markets of Canada on a regular basis, with over \$160 billion invested between 1994 and 2006, net of sales of securities made during the period.
- (ii) Pension funds earn significant profits on the sale of securities and also derive considerable investment income by way of dividends and interest. Both sources of income have been on the rise during the years 1990-2004. However, profits on sale of securities have emerged as the more important source of revenue for pension funds. Investment income has shown a trend of consistent decline, and it fell from over 58 percent in 1990 to less than 27 percent in 2004. Net profits from the sale of securities, which represented less than 3 percent of the revenue of pension funds in 1990, rose to a high of almost 54 percent in 2000, and were about 30 percent in 2004. Although the trend with profits on sale of securities is quite variable during the period, their importance in the revenue structure of pension funds has been gaining in significance. This indicates that pension funds are likely to rely more on trading operations in securities than on income from holding securities.
- (iii) The revenue derived by pension funds from the sale of securities in the stock market is becoming the larger component of their revenues than the investment income derived from holding the securities. This indicates greater turnover in the investment portfolios of pension funds, and thus a shorter term focus on trading shares, which may have implications for the involvement of pension funds in governance.
- (iv) There is mixed evidence about the asset management performance of pension funds.
- (v) Pension funds’ presence in the capital markets lead to enhanced investor protection and public confidence in the markets.

Part 4 - Recent Trends in Pension Fund Investments: Private Equity and Venture Capital

(a) Introduction

This section examines investments by pension funds in venture capital and private equity, and draws the following conclusions:

- (i) Larger pension funds exhibit greater interest in new varieties of investments such as venture capital or private equity, which are a move away from the more traditional “stocks and bonds” model of pension fund investments. Thirty-two of the 100 largest pension funds have assets in venture capital and private equity, and these assets represent 8 percent of their total asset value. In comparison, only 2 percent of smaller funds have invested in private equity and venture capital, and their assets in this category, including real estate, are just 3 percent of their total.
- (ii) Investments in private equity and venture capital require greater scrutiny and involvement, both at the pre-investment stage as well as in the post-investment phase. This could be the explanation for the reluctance of smaller pension funds, with their limited resources and expertise, to venture into these areas.
- (iii) Empirical data indicate that private equity investments are often more profitable for pension funds. For example, Ontario Teachers’ Pension Plan (OTPP) earned a return of 31.4 percent on its investments in this category while its overall rate of return was 17.2 percent. Such higher returns are likely to be an incentive for the pension funds to invest more in this segment. There are also clear indications are that the trend for large pension funds to invest in private equity and venture capital will be greater in the future.

“Private equity” is the generic term for the private market reflecting all forms of equity or quasi-equity investment. Within this, there are generally three distinct market segments: buyout capital, mezzanine capital and venture capital. Buyout funds are a specialized form of private equity invested in established private or publicly listed firms that are undergoing a fundamental change in operations or strategy. Mezzanine capital is characterized chiefly by the use of subordinated debt, or preferred stock convertible into equity, and is meant for investment largely in the same variety of companies as buyout funds. “Venture capital,” on the other hand, is private equity meant mainly for high-risk investment in new or young companies following a growth path.³⁴

³⁴ Canadian Venture Capital and Private Equity Association. Glossary of Terms, available online: <http://www.cvca.ca/resources/glossary.aspx>, accessed November 19, 2007.

(b) Private Equity and Venture Capital: Literature Review

Gilles Chemla (2005) conducted an empirical study of 146 Canadian DB pension funds.³⁵ Only 39 of these funds had made venture capital and private equity investments, and the ones which made the investments were apparently the largest in terms of fund size, as evident from Table 15 below. The ones which invested in private equity (PE) had a median and a mean fund size that were more than twice larger than the average mean and median size of pension funds included in the study.

Table 15

Pension Funds – Comparative Size of Funds Investing in Private Equity and Venture Capital (\$Million (US))

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

Of the 39 funds which invested in venture capital (VC) and investments, Chemla (2005) reports that the average PE allocation was 2.4% of their total investments and the average VC allocation was 1.3% of the total. The data indicate the relatively minor size of this segment in the investment portfolio of the pension funds and are given in Table 16 below.

Table 16

Volume of Pension Funds' Investment in Venture Capital and Private Equity

Description	Venture Capital and Private Equity Investments as Percentage of Total Investments
Average private equity allocation	2.4%
Median private equity allocation	2.7%
Minimum private equity allocation	0.2%
Maximum private equity allocation	7.0%
Average venture capital allocation	1.3%
Median venture capital allocation	1.4%
Minimum venture capital allocation	0.2%
Maximum venture capital allocation	3.7%

³⁵ Gilles Chemla, "The Determinants of Investment in Private Equity and Venture Capital: Evidence from American and Canadian Pension Funds" (November 8, 2005). Available at SSRN: <http://ssrn.com/abstract=556421> or DOI: [10.2139/ssrn.556421](https://doi.org/10.2139/ssrn.556421)

The Chemla (2005) study was comparative and it found that Canadian pension funds invested a smaller part of their assets in venture capital and private equity than their American counterparts. The following explanations have been offered by the author for some of the differences in approach between Canada and the United States.

- i. The perception of Canadian pension fund managers that private equity, as an asset class, is complicated and difficult to evaluate, and requires extensive specific monitoring; and
- ii. A relatively less active market in Canada for initial public offerings, and the consequent difficulty making the investments liquid.

The survey conducted by MFC Global Investment Management (2007) includes private equity under “real estate and alternative investments” and the results of the survey confirm the trend identified by Gilles Chemla.³⁶ The MFC Global Investment Management survey also found that alternative investments were more popular among larger pension plans, defined as those with assets in excess of \$1 billion.

Among the larger pension plans, 8 percent had investments under the alternative category, and those assets represented 8 percent of their total asset value. For smaller pension plans with assets of less than \$1 billion, only 2 percent had made alternative investments, and the value of such investments was 3 percent of their total assets. The survey reports that “net increases are mainly expected for real estate and alternative investments using money shifting out of equities” and “[a]lmost no respondents expect a decrease in plan allocation” for these categories of assets.³⁷ Being late entrants, however, venture capital and private equity are still quite insignificant in terms of percentage of total asset values.

Private equity and venture capital investments, unlike investments in the securities of large public corporations, require more detailed analysis and closer involvement with the investee-businesses both at the time of making the investment and thereafter. This means that pension funds which opt for such investments must possess the requisite expertise for making investment decisions and also the time and resources required for monitoring after the investment has been made. The element of risk is also greater with such investments.

As noted earlier, the trend is for larger pension funds to be more active in private equity and venture capital investments. This can be explained by the volume of resources they command. The large asset and resource bases of these pension funds, and the expertise that is more easily accessible for them, apparently permit and encourage the funds to make more investments in these relatively new areas, and these funds are not deterred by the negatives – namely, the need for closer involvement and greater oversight, and higher risk.

³⁶ MFC survey, note 17 above.

³⁷ *Ibid.* at p. 2.

Recent reports about the acquisition of Bell Canada by a consortium of investors led by Ontario Teachers Pension Plan (OTPP) through the private equity route has renewed the interest in private equity as an avenue for pension fund investments. David Mather (2006) has found that 32 out of the top 100 pension funds in Canada have made allocations for private equity, and OTPP is the most active among these 32 funds.³⁸

According to the Mather's estimates, the return from private equity has been significantly higher for three major pension funds – OTPP, Ontario Municipal Employees Retirement System (OMERS) and Caisse de depot et placement du Quebec – than the returns earned by them from the other segments of their portfolios. The comparative returns estimated by Mather are presented in the table below.

Table 17

Comparative Returns from Private Equity and Other Asset Classes³⁹

	Overall Return on Investment %	Return on Private Equity %
OTPP	17.2	31.4
OMERS	16.0	23.2
Caisse de depot et placement du Quebec	14.7	29.8

Investments by way of venture capital and private equity will likely mean that pension funds will move beyond focusing on corporate governance changes to investee-companies, which are structural and can cut across all the companies in which they invest, to being involved in particular businesses and business decisions. Direct involvement of pension funds in matters like selection of CEOs and nominating directors on the boards is a departure from their traditional role in corporate governance when we consider the general sense of hesitation and reluctance that marked the approach of pension funds in dealing with issues of corporate governance of investee-companies in the 1990s. These issues are discussed in greater detail Part 6 below.

(c) Conclusion

From the discussion and the data presented above, it would be reasonable to conclude that:

- (i) Larger pension plans are more active in new varieties of investments such as venture capital and private equity, and smaller plans are less inclined towards them. Thirty-two of the 100 largest pension funds in Canada have invested in

³⁸ David Mather, "The Inner Workings of Private Equity" *Benefits Canada*, August 2006. Available online: http://www.benefitscanada.com/investments/alternative/article.jsp?content=20060831_152120_5084, accessed November 16, 2007.

³⁹ Ibid.

private equity and venture capital, and these assets represent 8 percent of the total. A survey of a sample of smaller pension funds found that only 2 percent of them made investments in private equity and venture capital, and this category together with real estate was just 3 percent of their total asset base.

- (ii) Investments in private equity and venture capital require greater scrutiny and involvement, and this could be the explanation for the reluctance of smaller pension funds to venture into these areas.

Empirical data indicate that private equity investments are often more profitable for pension funds than their overall portfolio.

Part 5 - Pension Funds and Corporate Governance

(a) Introduction

This part of the report examines the involvement of pension funds in the governance of the corporations in which they hold shares, and it draws the following conclusions.

- (i) The Canadian Coalition for Good Governance (CCGG) was launched mainly by larger pension funds to enhance their involvement with the issue of good governance of corporations in which the funds hold shares. CCGG regularly examines current issues and prepares policy guidelines for its members. In addition, Pension Investment Association of Canada (PIAC) also provides guidance to its members on playing an effective role in their capacity as shareholders in corporations. These organizations show the systemic efforts undertaken by the pension funds sector to promote good governance in corporations.
- (ii) The literature on the subject finds that the involvement of institutional investors, including pension funds, in corporate governance has myriad implications, both positive and negative. The positive ones are mainly the size of the holdings of pension funds and their ability to influence corporations, their ability to hold corporations to account through litigation and effective use of the threat of exit. Important among the negative aspects of pension fund involvement in corporate governance include free-riding by other shareholders, conflicts of interest situations for pension fund managers who are dependent on the support of corporate managers and absence of proprietary interest on the part of pension fund managers.
- (iii) In general, pension funds in Canada place reliance on informal discussions with corporate managers for resolving corporate governance issues, and prefer to avoid more confrontational methods, such as negative voting, litigation or proxy campaigns. This trend has continued substantially in the recent years, but litigation by pension funds against corporations appears to be on the increase as well as other more active forms of intervention in governance.

- (iv) Pension funds have generally not been keen on seeking representation on the boards of directors of corporations. But this trend is likely to see some changes with increasing private equity investments.
- (v) Data on shareholder proposals is insufficient to arrive at clear conclusions on the use of this instrument by pension funds to intervene in corporate governance.
- (vi) A minority of pension funds (about 30 percent) surveyed in 2006 delegated the task of voting to their investment managers. Of these, about 70 percent gave freedom to the investment managers to decide on how to vote. This may indicate the constraints of lack of resources and expertise on the part of smaller pension funds to effectively exercise their voting rights as shareholders of corporations.

(b) Pension Fund Initiatives to Promote Good Corporate Governance

This section reviews the initiatives taken by pension funds and their associations to encourage good governance principles among corporations. The last few years have seen increased awareness on the part of pension funds to engage in efforts to promote the good governance of corporations in which they hold shares.

The Canadian Coalition for Good Governance (CCGG) was launched in 2002, directly as a product of this realization. According to CCGG, its mission is to “represent Canadian institutional shareholders in the promotion of corporate governance practices that best align the interests of boards and management with those of the shareholder.”⁴⁰ Currently, CCGG has guidelines on corporate governance practices, executive compensation and majority voting.⁴¹ In addition, CCGG has also prepared a discussion paper on “break fees” or “termination fees” payable to bidders by target companies whose directors have agreed to support a takeover bid.

In November 2006, David Beatty, the Managing Director of CCGG, stated that the efforts of CCGG to promote good corporate governance have been successful, and that governance “risk ratings” for corporations declined from over 35 percent in 2002 to 26 percent in 2005.⁴² CCGG has gained significantly in stature since its launch in 2002, and continues to play an active role in promoting institutional investor involvement in the governance of corporations.

Pension Investment Association of Canada (PIAC), which was established in 1977, is another association of pension funds with 130 members representing assets of \$890

⁴⁰ Canadian Coalition for Good Governance. Mission and Mandate, available online: <http://www.ccg.ca/about-the-ccgg/mission-and-mandate/>, accessed November 26, 2007.

⁴¹ *Ibid.* Guidelines and positions papers, available online: <http://www.ccg.ca/guidelines/>, accessed November 26, 2007.

⁴² *Ibid.* available online: <http://www.ccg.ca/media/files/speeches/David%20Beatty%20%2D%20Luncheon%20Address.pdf>, accessed November 26, 2007.

billion. PIAC also encourages the engagement of its members in corporate governance, and has formulated Corporate Governance Principles and Guidelines (2007) for the guidance of its members.⁴³

The initiatives described above are major systemic efforts undertaken by pension fund associations in the recent years to encourage their members to engage with the corporations in which they hold shares and to promote good governance of the corporations. Some of the larger pension funds, such as the Ontario Teachers Pension Plan have also been significant players in corporate governance interventions in the last few years. There is evidence of increasing pension fund activism in corporate governance in Canada.

(c) Literature Review

This section reviews the scholarly literature on the subject of the role of institutional investors in corporate governance. The debate on “institutional investors” – pension funds being preeminent among them – and their impact on corporate governance can be traced to the 1970s when judicial decisions such as *Blankenship v. Boyle* (1971)⁴⁴ (US), and the works of scholars, such as Peter Drucker’s *The Unseen Revolution: How Pension Fund Socialism Came to America* (1974)⁴⁵ and Rifkin and Barber’s *The North Will Rise Again: Pension, Politics and Power in the 1980s* (1978)⁴⁶ made their appearance. The interest in institutional investors continued through the 1980s with scholars like John Langbein and Richard Posner (1981)⁴⁷ and Kathleen Paisley (1985)⁴⁸ writing on the subject.

In the 1990s, a series of research papers was written on the subject of institutional investors and their role in corporate governance. Scholars like Bernard Black (1990⁴⁹ and 1992⁵⁰), John C. Coffee, Jr. (1991)⁵¹ and Gilson and Kraakman (1991)⁵² expressed general optimism that institutional investors would make a significant contribution to the governance of the corporations in which they held shares. They would do this through enhanced monitoring of corporate managers, which would lead to better value for the

⁴³ PIAC Corporate Governance Principles and Guidelines, available online:

<http://www.piacweb.org/files/PIAC%20Corporate%20Governance%20Principles%20and%20Guidelines%20may%209%202007.pdf>, accessed November 26, 2007.

⁴⁴ 329 F. Supp. 1089 (D.D.C.) (1971).

⁴⁵ (New York: Harper & Row, Publishers, 1976).

⁴⁶ (Boston: Beacon Press, 1978).

⁴⁷ 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, and the article is evidence of the growing interest in the subject of institutional investors and their practices during the period.

⁴⁸ “Public Pension Funds: The Need for Federal Regulation of Trustee Investment Decisions” (1985) 4 *Yale L. & Pol’y Rev.* 188.

⁴⁹ Shareholder Passivity Re-examined” (1990) 89 *Mich. L. Rev.* 520.

⁵⁰ “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.

⁵¹ “Liquidity v. Control: The Institutional Investor as Corporate Monitor” (1991) 91 *Colum. L. Rev.* 1277.

⁵² “Re-inventing the Outside Director: An Agenda for Institutional Investors” (1991) 43 *Stan. L. Rev.* 863.

corporations in terms of business profits and share prices in the stock market. These scholars mostly viewed the matter from the perspective of the capital markets, and their writings were aligned with the ideas of the law and economics movement which was particularly influential during the 1980s and 1990s.

There were, however, other voices which were less sanguine about the pension funds playing a meaningful role in corporate governance. In an empirical study on nine large pension funds, William O'Barr and John M. Conley (1992)⁵³ found that pension fund managers were quite conservative, and they generally preferred to avoid personal responsibility for decisions. They were eager to adopt investment strategies, such as indexing, which undermined individual choice. Roberta Romano (1993)⁵⁴ was another scholar who expressed reservations about the ability of institutional investors to play an effective role.

Sunil Wahal (1996) conducted an empirical study of American corporations which were targeted by nine large pension funds for activism between 1987 and 1993, and concluded that pension fund activism was not effective in improving corporate performance.⁵⁵ Subsequently in 1998, Bernard Black, who had earlier been optimistic about activism on the part of institutional investors, concluded from empirical data that their effect on firm performance is not significant.⁵⁶ This conclusion naturally leads one to the question – what is the value of pension fund intervention on the corporate governance front if it does not necessarily increase firm performance or value in purely quantifiable terms? Perhaps the value of governance is more related to accountability and transparency, than directly to financial results.

Jeffrey MacIntosh (1993) examined the role of institutional investors in the Canadian capital markets,⁵⁷ and he shared the optimism of scholars like Bernard Black (1990) and John Coffee (1992) that institutional investors would play a positive role. MacIntosh anticipated that the “rise of the institutional investor is likely to improve monitoring of corporate managers.”⁵⁸ To facilitate institutional investors to play an activist role, Jeffrey MacIntosh recommended a number of regulatory initiatives, which included measures to protect fund managers against pressure from corporate managements and regulatory amendments to encourage communications among the shareholders without triggering complex proxy procedures.

Kathryn Montgomery (1992) conducted a survey of over 100 institutional investors in Canada in 1992, and found that there was increasing awareness of corporate governance

⁵³ *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.

⁵⁴ “Public Pension Fund Activism in Corporate Governance Reconsidered” (1993) 93 *Colum. L. Rev.* 795.

⁵⁵ Sunil Wahal, “Pension fund activism and firm performance” (1996) 31 *J. Fin. & Quantitative Analysis* 1.

⁵⁶ Bernard S. Black, “Shareholder Activism and Corporate Governance in the United States”. As published in *The New Palgrave Dictionary of Economics and the Law*, vol. 3, pp. 459-465, 1998 Available at SSRN: <http://ssrn.com/abstract=45100> or DOI: [10.2139/ssrn.45100](https://doi.org/10.2139/ssrn.45100)

⁵⁷ “The Role of Institutional and Retail Investors in Canadian Capital Markets” (1993) 31 *Osgoode. Hall L. J.* 371.

⁵⁸ *Ibid.* at p. 471.

among them. The survey found that large, public sector pension funds were more inclined to be activist in their capacity as shareholders than smaller, private sector ones.⁵⁹

Jeffrey MacIntosh (1996) dealt specifically with the question of the role of institutional investors in corporate governance.⁶⁰ MacIntosh drew up lists of some positive factors that favoured institutional investor activism and many negative factors which discouraged activism, and concluded that by and large experience affirmed the optimism that he had earlier expressed about the potential of institutional investors to make a positive difference.⁶¹ The positive and negative factors identified by MacIntosh are summarized below.

i. Positive Factors in Shareholder Activism by Institutional Investors

- a. Large institutional shareholders, acting in unity, would be a check against controlling shareholders. Even if the institutional shareholders are unable to technically pass or defeat ordinary resolutions, which require a simple majority of fifty percent plus one vote, they would be effective in dealing with special resolutions which require two-thirds majority.
- b. Institutional investors have significant powers of moral suasion and are well-fitted to play the role of diplomats and critics.
- c. Institutions, with their resources, are more likely to sue erring managements than private or retail investors.
- d. Through the exercise of dissent rights and the exit option, institutional investors can send strong signals to management, and this would be an effective check on management.
- e. Institutional investors can be a significant force in spurring legislative change.

ii. Negative Factors in Shareholder Activism by Institutional Investors

- a. Activism by institutional investors is dogged by the problem of free-riding by other investors, retail and/or other institutions. This discourages pension funds that wish to initiate activism.
- b. Institutions are themselves managed by agents who are under fiduciary duties, and this undermines their efficacy in overseeing corporations which are also managed by a set of fiduciaries. The absence of proprietary interest on the part of fund managers makes their role as monitors less effective.
- c. Fund managers are usually dependent on corporate managers for their business, and, if they are overactive in their role as monitors, they run the risk of losing the business.

⁵⁹ 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 and Larsen, eds., *Corporate Governance and Securities Regulation in the 21st Century* (Butterworths, Toronto, 2004).

⁶⁰ Jeffrey MacIntosh, "Institutional Shareholders and Corporate Governance in Canada" (1996) 26 *Can. Bus. L.J.* 145.

⁶¹ The studies referred to above were conducted in the context of "institutional investors" in general, rather than pension funds in particular. However, pension funds have always been the major component of institutional investors, and the findings are mostly from the perspective of pension funds, rather than the more recent entrant – mutual funds.

- d. There could be conflicts of interests for the persons in charge of the institutional investors, as they often act in dual capacities – namely, corporate managers or directors who are looking for investments *and* fund managers who have funds which must be invested. There could be temptations for them to invest the funds in their own companies.
- e. Institutional investors holding nonvoting shares would be ineffective as monitors, because they lack voting rights.
- f. There could be political pressure on institutional investors not to take certain actions – for example on the ground that they would weaken the economy – although the institutions might consider them appropriate in the interests of the investee-corporation and the beneficiaries of the fund.
- g. There are systemic limitations on the monitoring capacity of institutional investors, in terms of human and financial resources.
- h. The need for liquidity places institutional investors – in particular, mutual funds – under conflicting pressures. However, this would not be very relevant for pension funds which necessarily have a medium and long-term perspective on their investments.
- i. Legal restraints on institutional activism, such as the rule on proxies (which has since been amended), discouraged communication among the shareholders and weakened their efficacy.
- j. The dominant culture among institutional investors is one of passivity, which it would be difficult for them to overcome.
- k. A fear of political backlash in the form of greater regulation of institutional investors could deter activism.
- l. By sending out negative information about particular corporations, institutional investors could provide the lead for a “race for exit” among the shareholders.
- m. Systemic difficulties such as the lack of contact details for all the shareholders might make it difficult for the institutional investors to communicate with other shareholders.
- n. Institutional managers are as vulnerable to short-termism as their counterparts in the investee-corporations.

From the above discussion, it can be concluded that views on the ability of institutional investors to engage in shareholder activism and the efficacy of activism on their part have been mixed. More research in this area would be beneficial to compare these results with recent trends in shareholder activism by institutional investors.

(d) Institutional Investor Activism in Canada

This section examines activism by pension funds against corporations. While examining the question of institutional shareholder activism in Canada, it is important to bear in mind the structural differences between the corporate sector in Canada and that in the United States. Widely-held public corporations in which no single shareholder or an

identifiable group of shareholders have controlling power are the norm in the United States, but the situation is somewhat different in Canada.⁶²

In a study conducted in 1998, the latest year for which data are available, almost 50 percent of the top 100 listed Canadian corporations were under the control of a family or an identifiable group of shareholders. Another quarter was foreign-controlled, and only the remaining one quarter fell under the category of widely-held corporations with no controlling shareholders.⁶³

This difference in corporate control pattern is important in examining American literature on the subject of activism by institutional shareholders. When there is a controlling group of shareholders, as is often the case in Canada, activism by other shareholders, including institutional investors, may be less effective than it would be when a corporation has no controlling shareholders. If the controlling shareholders are so determined, it would be legally possible for them to override the wishes of the institutional investors. However, on the other hand, the Canadian regulatory framework protects minority shareholder rights in ways not present in the United States, such as through the oppression remedy, so this comparison is difficult to make.

In addition, there are also cultural factors like the preference in Canada for a less confrontational approach. Jeffrey MacIntosh (1993) observed:

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.⁶⁴

More recent evidence of the preference for dialogue and persuasion, prior to public confrontation, among Canadian institutional investors and pension funds is found in the Annual Report of the Canadian Coalition of Good Governance (CCGG) for 2004.⁶⁵ The Coalition did not advocate overt activism. Its report stated:

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

⁶² 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*. Available online: [http://www.tfmsl.ca/docs/V4\(3A\)%20Nicholls.pdf](http://www.tfmsl.ca/docs/V4(3A)%20Nicholls.pdf), accessed November 26, 2007.

⁶³ Randall Morck and 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*. Available online: [http://www.tfmsl.ca/docs/V4\(5\)%20Morck.pdf](http://www.tfmsl.ca/docs/V4(5)%20Morck.pdf), November 2007.

⁶⁴ Jeffrey MacIntosh, *supra* note 60 at 381.

⁶⁵ Canadian Coalition for Good Governance (CCGG). Corporate Governance Principles and Guidelines, May 2007. Available online: <http://www.ccg.ca/media/files/annual-reports/CCGGAnnualReport2005.pdf>, October, 2007.

progress at any particular company, may choose to speak publicly or vote their shares accordingly.⁶⁶

There are, however, instances of confrontational conduct on the part of pension funds. Jeffrey MacIntosh (1996) cited the role of institutional investors in defeating dual class recapitalizations proposed by Crownx, Seagrams and Canadian Tire, and the poison pill provision in Labatt.⁶⁷ More recently, there have been lawsuits, such as those filed by OTPP and OPT against Nortel and OMERS against Ford Canada.⁶⁸

Pension fund managers' practice of holding discussions with corporations appears to be continuing, and it serves as an informal mechanism for their intervention in matters of governance.⁶⁹ There are reports that Claude Lamoureux of OTPP commanded significant respect among corporations when he raised issues of governance with them, and was usually able to prevail upon the corporations.⁷⁰ Canada Pension Plan is in the regular practice of seeking information from corporations on environmental issues and risks.⁷¹

(e) Shareholder Activism by Pension Funds: Its Different Dimensions

This section examines the various instruments adopted by pension funds for shareholder activism. Representation on the boards of directors of investee-corporations, litigation against erring corporate managements, initiating and/or supporting shareholder proposals and proxy voting can be identified as some of the instruments for institutional shareholders to play a role in the business and affairs of the corporations in which they hold shares. These different varieties of shareholder activism on the part of pension funds are discussed below. The conclusion drawn in this section is that pension fund activism is on the rise in the recent years, and it is likely that this trend will continue.

i. Representation on the Board of Directors

This section examines whether pension funds are in the practice of seeking representation on the boards of directors. Seeking representation on the board of directors of the investee-corporations is one of the most direct forms of activism on the part of institutional shareholders. Kathryn Montgomery's survey of institutional investors conducted in 1992, referred to earlier, found that "most institutions shy away from board representation, citing the conflict-of-interest that could arise from 'wearing two hats.'"⁷²

The reluctance of pension funds to seek board representation is confirmed by events like those in Memotec in the early 1990s. Caisse de depot et placement du Quebec and

⁶⁶ *Ibid.* at p. 3.

⁶⁷ Jeffrey MacIntosh, note 60 above, at p. 173.

⁶⁸ (2006), 79 O.R. (3d) 81 (C.A.).

⁶⁹ Elizabeth Church, "Cleaning up corporate governance, one company at a time" *The Globe and Mail*, 27 June 2005, at p. B5.

⁷⁰ See e.g. Derek Decloet, "Why teachers won't be preachers" *The Globe and Mail*, September 6, 2007, at p. B2.

⁷¹ Shawn McCarthy, "Assess climate risks, firms urged" *The Globe and Mail*, 31 October 2007, at p. B3.

⁷² Kathryn E. Montgomery, "Market Shift – The Role of Institutional Investors in Corporate Governance" (1996) 26 *Can. Bus. L. J.* 189 at p. 195.

Ontario Municipal Employees Retirement Board (OMERS), both public sector funds identified as more activist, supported another institutional shareholder, Gordon Capital Corp., to place independent directors on the board of Memotec corporation as a part of the solution for ending a dispute with its management.⁷³ It is significant that the pension funds did not play a direct role.

ii. Litigation by Pension Funds

This section examines litigation as an instrument applied by pension funds to voice their grievances against corporations and its efficacy. It concludes that there is a recent trend for litigation in Canada. Reports of litigation against corporations by pension funds are rather limited. The Allen Committee on Corporate Disclosure (1995), established by Toronto Stock Exchange, described the attitude of institutional investors towards litigation:

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.⁷⁴

There have been approximately 12 significant cases filed in Canada by institutional investors against corporations and decided by the courts since 1996.⁷⁵ Of these, one was filed by OMERS against Ford Motor Co. OMERS invoked the oppression remedy against Ford Motor Co., assailing its transfer pricing system by which most of the profits of the Canadian Ford Motor Co. were transferred to the American Ford Motor Co. While the court upheld the fact of oppression, OMERS was denied relief because the oppressive practices had occurred mostly before it bought the shares of the company.⁷⁶

More recently in January 2007, Ironworkers Ontario Pension Fund filed a suit against Research in Motion (RIM) with respect to the stock options granted by it. The suit was filed in Ontario, and it was settled in October 2007, in a matter of months.⁷⁷

There have been lawsuits filed by Canadian pension funds against Canadian corporations in courts in the U.S. They were able to approach the American courts because the securities were listed on American stock exchanges, and OTPP appears to be particularly in favour of commencing action in the United States. OTPP is on the record as stating

⁷³ See Jeffrey MacIntosh, note 60 above, at 378.

⁷⁴ 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 p. 333.

⁷⁵ *Ibid.* at p. 335-338.

⁷⁶ Note 68 above.

⁷⁷ Catherine McLean, “RIM suit settled; stock surges 11%” *The Globe and Mail*, 6 October 2006, at p. B9.

that it trades securities on the NYSE as opposed to the TSE so that it can pursue litigation in the U.S. if necessary. Some leading examples of this trend of OTTP pursuing litigation in the U.S. are provided below.

- OTTP lawsuits against Nortel, settled by the corporation which made a payment of nearly \$2.5 billion to the investors, among whom was OTTP.⁷⁸
- OTTP suit against Biovail, which was settled in December 2007 for \$138 million.⁷⁹

The tendency to approach courts in the U.S. can be potentially explained by the perception that Canadian courts are not up to the task of effectively dealing with capital markets misconduct, and investors are reluctant to file actions in Canada.⁸⁰ John Chapman (2007) expects that various factors, such as the increased presence of American institutional investors in Canada, entrepreneurial lawyers and success fee engagements, and the increasing popularity of the oppression remedy in Canadian corporate law, would contribute significantly to changes in the Canadian capital markets and litigation in Canada by the investors. There appears to also be a lack of confidence on the part of certain stakeholders, including pension funds, on the ability of regulators to engage in effective public enforcement.⁸¹

The choice of litigation by institutional investors and its efficacy have been studied in the United States, and these studies provide divergent reports about the instrument of litigation. Keith Johnson (1997) has argued that institutional investors are best suited for the task of deterring corporate fraud through securities litigation.⁸² Large holdings and the consequent incentive for the institutional investors to sue and their sophistication and expertise are cited by Johnson as the grounds for his view that institutional investors would be effective in deterring corporate fraud through litigation.

On the contrary, James Cox and Randall Thomas (2002) concluded that many institutional investors failed to file claims in securities class actions initiated by others.⁸³ A more recent study, published in 2006, has concluded that securities class actions initiated by pension funds were more effective in procuring settlements than those

⁷⁸ Catherine McLean, "Nortel pays big to settle lawsuits" *The Globe and Mail*, 9 Feb. 2006, at p. B1.

⁷⁹ Ontario Teachers' Pension Plan, "Teachers' announces \$138 million Biovail settlement," news release dated December 11, 2007. Available online: http://www.otpp.com/web/website.nsf/web/biovail_settlement, January 2008.

⁸⁰ See e.g. Madelaine Drohan, "Canada's corporate crime capers" *The Globe and Mail*, 23 June 2005, at p. A23.

⁸¹ Poonam Puri, "Enforcement Effectiveness in the Canadian Capital Markets" (June 2005) Capital Markets Institute, Joseph Rotman School of Business, University of Toronto.

⁸² Keith L. Johnson, "Deterrence of corporate fraud through securities litigation: the role of institutional investors" (1997) 60 *Law. & Contemp. Probs.* 155.

⁸³ 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.

initiated by other classes of plaintiffs.⁸⁴ This suggests that the choice of plaintiff, or lead plaintiff, has an impact on substantive outcomes.

iii. Shareholder Proposals

This section examines shareholder proposals as an instrument for pension funds to exercise their rights in corporations. Shareholder proposals are an instrument for shareholders to influence corporate management. They enable shareholders to put the issues which they consider important on the agenda of shareholder meetings and to have them voted on. Empirical data on shareholder proposals initiated by pension funds is not specifically available. Shareholder Association for Research and Education (SHARE) maintains a database of shareholder resolutions from 2004, and it contains details of the resolutions proposed by Carpenters Local 27 Pension Trust. Table 18, below, provides a summary of the number of proposals initiated by Carpenters for the annual meetings held from 2004 to 2006.⁸⁵

Table 18

**Number of Shareholder Proposals Initiated by Carpenters Local 27 Pension Trust
2004-2006**

Year	Number of proposals	Outcome
2004	16	Six proposals were withdrawn. Out of the remaining, 8 had 10 percent support, and the remaining 2 had between 10 and 20 percent support.
2005	21	14 of the proposals were withdrawn, and another 2 are reported to have been "omitted." There is no information on 3 resolutions, and the remaining 2 had 10.8 percent and 13.5 percent support respectively.
2006	11	1 proposal was withdrawn, and 8 were "not on ballot." The remaining 2 proposals had 4 percent and 10.4 percent support respectively.

The data indicate that Carpenters Local 27 Pension Trust has been activist, and initiated a number of shareholder proposals in the recent years, but the outcomes are not

⁸⁴ 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 Available at SSRN: <http://ssrn.com/abstract=938722>

⁸⁵ Shareholder Association for Research and Education (SHARE). Shareholder resolution database. Available online: <http://www.share.ca/en/shareholderdb>, accessed November 21, 2007.

encouraging and they raise questions about the efficacy of the proposals initiated by this fund. More empirical data are necessary to draw any clear conclusions on the issue. Gil Yaron (2005) is of the view that pension funds are not generally active in initiating shareholder proposals.⁸⁶ According to Yaron (2005), most pension funds do not explicitly state their policy on engagement with the corporations in which they hold shares.⁸⁷ A possible explanation for this trend could be the traditional reliance of pension fund managers on resolving issues, as they arise, through informal negotiations with corporate managers.

A 1999 study of shareholder proposals initiated by pension funds in the United States found that the impact was negative. There was decline in the market prices of shares targeted by pension funds. The study found transitory decline in prices for corporations which were targeted once during the sample period, but the decline was permanent for corporations which were subject to repeated shareholder proposals.⁸⁸ This suggests that shareholder proposals by pension funds could certainly have an impact. This view is supported by the findings of Aaron Dhir, who examined shareholder proposals from the perspective of their potential to advance human rights and social policy within corporate governance debate. 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-CBCA 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.⁸⁹

iv. Proxy Voting

This section examines proxy voting by pension funds, and concludes that the trend is for increasing direct participation by pension funds in the shareholder voting process. Voting rights are a key attribute of shares issued by business corporations. The guidelines on corporate governance drawn up CCGG and PIAC do not provide any direct suggestions on how pension funds must use proxy votes. The question of how pension funds have exercised their voting rights in the recent years has been studied by Shareholders Association for Research and Education (SHARE). The graph below, which is extracted from the 2006 Key Proxy Vote Survey Report compiled by SHARE indicates the manner in which pension funds which responded to the survey exercised their voting rights.⁹⁰

⁸⁶ Gil Yaron, note 10 above.

⁸⁷ *Ibid.*

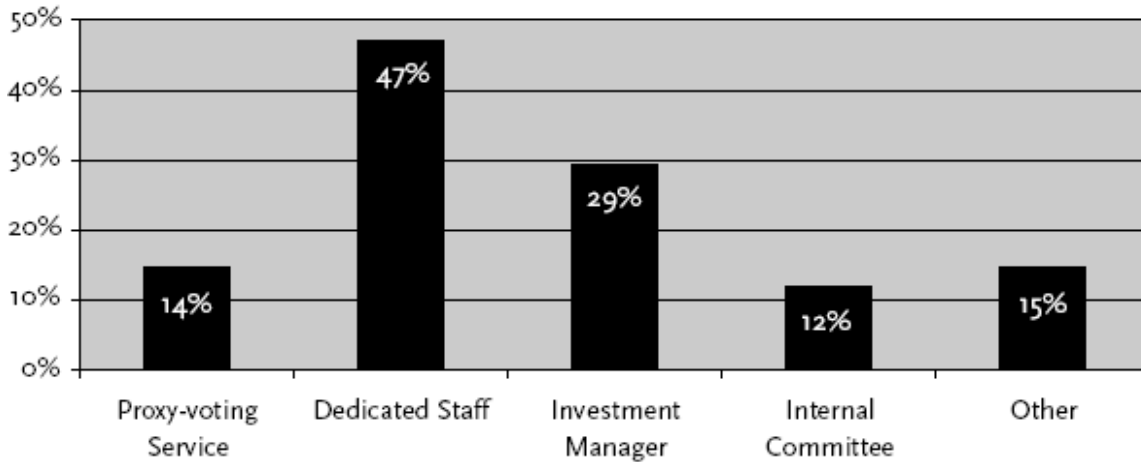
⁸⁸ Andrew K. Prevost and Ramesh P. Rao, "Of What Value are Shareholder Proposals Sponsored by Public Pension Funds?". Available at SSRN: <http://ssrn.com/abstract=177268> or DOI: [10.2139/ssrn.177268](https://doi.org/10.2139/ssrn.177268)

⁸⁹ 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, at p. 412.

⁹⁰ Shareholders Association for Research and Education (SHARE). 2006 Key Proxy Vote Survey, p. 34. Available online: http://www.share.ca/files/Proxy_Survey_2006_FINAL.pdf, October 2007.

Chart 2

Proxy Voting Methods and Responsibility for Proxy Voting



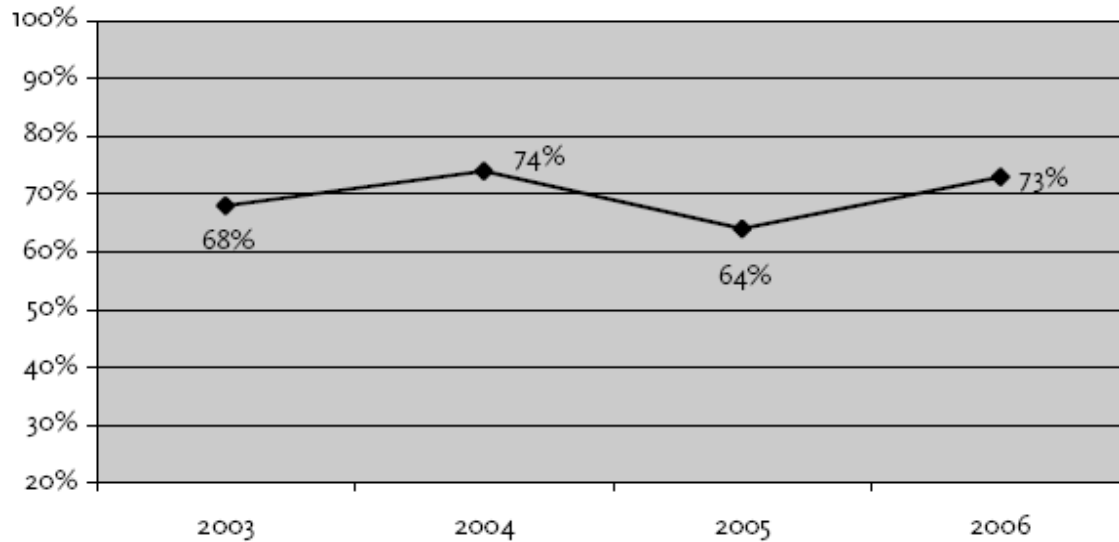
About half of the surveyed funds exercised their voting rights directly through dedicated staff, and another 12 percent did so through internal committees. A minority of 29 percent of the funds left the task to the fund managers. The fact that this minority of pension funds did not directly exercise their voting rights in corporations in which they hold shares and left the task to their investment managers is significant. There is no data on the size of the pension funds which chose not to vote directly, but given the activism of the larger funds, it would be reasonable to conclude that smaller pension funds fell into this category of delegating the task to the fund managers or investing in pooled funds with no voting rights. In that case, lack of resources and expertise on the part of the smaller funds can be offered as the explanation for their preference to leave the task to the fund managers.

Yet another question with respect to funds which did not directly exercise their votes but left the task to fund managers is whether the fund managers were under any instructions from the pension fund trustees to exercise the voting rights, or they had freedom to vote as they decided. The following graph, also taken from the SHARE report, answers this question.⁹¹

⁹¹ *Ibid.* p. 35

Chart 3

**Percentage of Investment Managers Who Exercised Discretion
Over 85% or More of Pension Plan Client Proxies**



SHARE commented as follows on the figures in the chart:

... a majority of pension funds continue to delegate the decisions on how their proxies should be voted to their investment managers or proxy-voting firms, instead of instructing their voting fiduciaries. As we noted in the introduction, this practice raises questions about how pension plan trustees can fulfill their duty to oversee proxy voting if they delegate the voting decisions fully, without any direction, to someone else.⁹²

About 70 percent of the fund managers who exercised the voting rights on behalf of their pension fund-clients were also free to decide on how to vote. This again points to the issue of lack of resources and expertise on the part of the smaller funds and this is the probable explanation for the trend. Gil Yaron (2005) has identified a number of legal and other barriers to the effective exercise of voting rights by pension fund trustees. These include lack of confidential proxy voting, selling of voting rights, free-rider problems and rational apathy. To overcome these problems, Yaron (2005) has advocated a five-step fiduciary process for the oversight of proxy voting.⁹³

(f) Conclusion

The involvement of pension funds in the corporations in which they are shareholders, as discussed above, suggests the following:

⁹² *Ibid.*

⁹³ Gil Yaron, note 10 above.

- (i) Canadian Coalition for Good Governance (CCGG), which was launched mainly by pension funds to enhance their involvement with the issue of good governance of corporations, undertakes systemic efforts in this direction. It regularly examines current issues and prepares policy guidelines for its members. Pension Investment Association of Canada (PIAC) is another agency that provides guidance to its members on playing an effective role in their capacity as shareholders in corporations. These are the systemic efforts in the pension funds sector to promote good governance in corporations.
- (ii) It has been found that the involvement of institutional investors, including pension funds, in corporate governance have myriad implications, both positive and negative. The positive ones are mainly the size of the holdings of pension funds and their ability to influence corporations, their ability to hold corporations to account through litigation and effective use of the threat of exit. Important among the negative aspects of pension fund involvement in corporate governance include free-riding by other shareholders, conflicts of interest situations for pension fund managers who are dependent on the support of corporate managers and absence of proprietary interest on the part of pension fund managers.
- (iii) Pension funds in Canada tend to place reliance on informal discussions with corporate managers for resolving corporate governance issues, and prefer to avoid more confrontational methods, such as negative voting, litigation or proxy campaigns. Although this trend has continued substantially in the recent years, litigation by pension funds against corporations appears to be on the increase as well as other more active forms of intervention in governance.
- (iv) Pension funds have generally not been seeking representation on the boards of directors of corporations. This trend might see some changes with increasing private equity investments by the funds.
- (v) Data on shareholder proposals is insufficient to arrive at clear conclusions on the use of this instrument by pension funds to intervene in corporate governance.
- (vi) A minority of pension funds (about 30 percent) surveyed in 2006 delegated the task of voting to their investment managers. Of these, a large portion (about 70 percent) gave freedom to the investment managers to decide on how to vote. This may be due to the limitations faced by smaller pension funds in terms of resources and expertise.

Part 6 - Pension Funds' Role in Policy Making and Regulatory Changes

(a) Introduction

This part of the paper examines the role played by pension funds in policy making and in influencing regulatory changes. The major conclusions from this part of the paper are as follows:

- (i) Pension funds play an active role and appear to be quite effective in campaigning for regulatory changes in which they are interested as investors in the capital markets. The amendments made to the *Canada Business*

Corporations Act in 2001 with respect to proxies and shareholder communications, as well as the removal of the Foreign Property Rule from the *Income Tax Act* in 2005 are prominent examples of the efficacy of pension fund activism in bringing about policy and regulatory changes.

- (ii) Campaigning for policy and regulatory changes is done both at the collective level – through organizations such as the Canadian Coalition for Good Governance (CCGG) and Pension Investment Association of Canada (PIAC), and by larger pension funds such as Canada Pension Plan Investment Board (CPPIB) and Ontario Teachers Pension Plan (OTPP).

The trend for initiatives by pension funds in the shaping of policy and regulatory change is likely to continue. The ongoing campaign for the removal of the investment rules applicable under the federal *Pension Benefits Standards Regulations, 1985*⁹⁴ is one example of such lobbying efforts. The push toward more effective public enforcement and the general mood among large pension funds for greater activism also point in this direction.

(b) Pension Fund Activism in Shaping Policy – A Review

In recent years, pension funds have been quite active in campaigning with government authorities and influencing public policy on a number of issues. Between November 1997 and October 2007, Pension Investment Association of Canada (PIAC) submitted a total of 44 representations to various governmental bodies and agencies on issues of interest to pension funds.⁹⁵ The governmental agencies to which submissions have been made include the Bank of Canada, the Federal Department of Finance, the Canadian Securities Administrators and the U.S. Securities and Exchange Commission.

In terms of substantive content, the representations submitted by PIAC are quite broad and cover a range of subjects in the capital markets. The issues that they have addressed include:

- 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); and
- Executive compensation, continuous disclosure and corporate governance practices (June 2007).

The Canadian Coalition for Good Governance (CCGG) has also been active in filing representations with public bodies and agencies on a number of regulatory issues. From

⁹⁴ SOR/87-19, s.6.

⁹⁵ Pension Investment Association of Canada. Complete list of submissions made by Pension Investment Association of Canada from November 1997 till October 2007 available online: <http://www.piacweb.org/submissions.html>, accessed November 23, 2007.

2003 onward, it has filed 18 submissions with governmental agencies such as Industry Canada, the Canadian Securities Administrators and the Toronto Stock Exchange.⁹⁶

In addition to collective submissions made by organizations such as PIAC and CCGG, the larger pension funds such as Canada Pension Plan Investment Board (CPPIB) and Ontario Teachers Pension Plan (OTPP) have also submitted individual responses to governmental bodies such as the Ontario Securities Commission (OSC) on the regulatory proposals published by the Commission calling for public comments. From 2005 and till November 2007, CPPIB and OTPP have made five submissions to OSC on subjects such as statement of executive compensation and registration requirements.

The above data are evidence of pension fund activism in the formulation of policy on issues which affect them as investors in the capital markets. Two recent examples of success in achieving regulatory change – proxy amendments to the *Canada Business Corporations Act* in 2001 and the deletion of the Foreign Property Rule in 2005 – are discussed below.

i. Proxy Rules

The proxy rules in the *Canada Business Corporations Act*⁹⁷ (CBCA) before 2001 discouraged communication among shareholders, as it was not clear whether such communications would trigger the complex proxy procedures provided in the statute. These required the shareholders who wished to discuss corporate issues to send out, at their expense, proxy circulars to all other shareholders, and hampered pension funds from coordinating among themselves in the matter of exercising voting rights in the corporations in which they held shares. When Industry Canada proposed amendments to the CBCA, *inter alia*, to relax the proxy rules and encourage communications among shareholders, PIAC supported the amendments.⁹⁸

The proxy rules in the CBCA were amended in 2001.⁹⁹ The amendments to the CBCA increase the rights of shareholders to communicate among themselves, and facilitated the framing of appropriate regulations. The regulations that have been framed set out the conditions under which persons other than management can communicate with shareholders without having to produce a dissident proxy circular. The regulations also set out the circumstances under which a person may solicit proxies by public broadcast without sending a dissident's proxy circular.¹⁰⁰

The new rules facilitate communication by pension funds and other shareholders and allow them to work in unison and achieve coordination in exercising their voting rights.

⁹⁶ Complete submissions of Canadian Coalition for Good Governance available online: <http://www.cgg.ca/submissions/>, accessed November 23, 2007.

⁹⁷ R.S.C. 1985, c. C-44.

⁹⁸ Industry Canada. *Regulatory Impact Statement – Canada Business Corporations Act (CBCA)*, Bill S-11 (September 2005), available online: <http://www.ic.gc.ca/epic/site/cd-dgc.nsf/en/cs01381e.html#consultations>, accessed November 26, 2007.

⁹⁹ CBCA, Sections 147 to 153.

¹⁰⁰ *Canada Business Corporations Regulations*, SOR/2001-512, Sections 54 to 69.

Even before the amendments were made to the *CBCA* in 2001, OTPP had adopted the practice of announcing how it planned to cast its votes.¹⁰¹ While such practices would certainly enhance their effectiveness as shareholders, OTPP was advised against doing so, and discontinued the practice.¹⁰² OTPP no longer announces its voting plans.

ii. Foreign Property Rule

As noted earlier, PIAC had been campaigning for the deletion of the Foreign Property Rule from 1999.¹⁰³ It engaged scholars from the University of Western Ontario to provide a cost-benefit analysis of the rule, and published their study in November 2002.¹⁰⁴ The study showed that there was hardly any net benefit from the Foreign Property Rule. The sustained efforts made by pension funds bore fruit in 2005, when the Foreign Property Rule was finally removed. Before this, the limit on foreign assets was increased from 10 percent to 20 percent in 1990, and then to 30 percent in 2001.¹⁰⁵

It is quite clear from the above that pension funds pay attention to the policy issues that affect their functioning and devote energy and resources for making efforts to bring about regulatory changes. It is also evident from current developments, outlined below in Section (c), that this trend of pension fund activism is likely to continue and gain in strength.

c. Current Activism – Investment Rules

The federal *Pension Benefits Standards Regulations, 1985* lay down quantitative limits for individual investments by pension funds. Among these, the ceiling of 30 percent with respect to the voting stock of corporations is important, as it defines the position of pension funds as passive investors who cannot have a decisive say in the business and affairs of corporations.¹⁰⁶

Increasingly, the quantitative limits on shareholding by pension funds are finding disfavour among the funds, and there are calls for the removal of limits. There was a recent news report that “several of Canada's biggest pension funds are 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.”¹⁰⁷ Significantly, the report added:

¹⁰¹ See Elizabeth Church, note 69 above.

¹⁰² *Ibid.*

¹⁰³ See p. 16 above.

¹⁰⁴ Note 7 above.

¹⁰⁵ *Ibid.*

¹⁰⁶ This was the defining theme of the policy recommendations dated July 4, 1986 published by the Pension Commission of Ontario for the regulation of pension fund investments. These led to 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.

¹⁰⁷ Nicole Mordant, “Pension funds want ‘bizarre’ rule retired” *The Globe and Mail*, 17 July 2007, at p. B4.

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. "It means we have to put resources against managing around [the rule] rather than using the resources to increase our investment value," said Deborah Allan, a spokeswoman for Teachers.

As noted in Section 4 above, larger pension funds are actively taking up venture capital and private equity investments, and quite often they acquire controlling interest in businesses. The report noted that the calls for removal of the investment rules "come 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."¹⁰⁸ In this climate, it is not surprising that the ceilings on investments are proving to be suffocating.

More recently, OMERS has called for the removal of the ceilings rule and for its suspension while the issue is under consideration by the government.¹⁰⁹ OMERS has argued that the rule has resulted in loss of investment opportunities for Canadian pension funds, and that the opportunities have instead gone to foreign investors.

(d) Conclusion

In conclusion, it can be stated that pension funds are activist in seeking regulatory changes with respect to the policy issues which affect them, and their activism is on the increase.

- (i) Pension funds are active and appear to be quite effective in campaigning for regulatory changes in which they are interested as investors in the capital markets; the amendments to the *Canada Business Corporations Act* in 2001 with respect to proxies and shareholder communications, and the deletion of the Foreign Property Rule from the *Income Tax Act* in 2005 can be cited as examples of pension fund activism and success in achieving policy and regulatory changes.
- (ii) Campaigns for policy changes are done both at the collective level, through organization such as CCGG and PIAC, and by large pension funds such as CPPIB and OTPP, individually.

¹⁰⁸ Ibid.

¹⁰⁹ Janet McFarland, "OMERS wants restrictions lifted" *The Globe and Mail*, 20 October 2007, at p. B9.

Part 8 - Conclusion

This paper has examined the impact of pension funds on the capital markets and corporate governance. It has identified a number of conclusions based on available literature and data, and raised a number of areas that are ripe for future research. The general finding is that pension funds are becoming more activist, both with respect to the variety of investments which they make and in the matter of governance of the corporations in which they have investments. Pension funds are an importance force in the capital markets, and participate increasingly in the process of regulatory changes and policy making. In general, larger pension funds which have significant resources and expertise available to them tend to be more dynamic in their investment decisions as well as corporate governance interventions. Policy initiatives which can support smaller pension funds also to play a more meaningful role are an area for future research.

The paper did not explore the impact of pension funds on the economy more generally. To the extent possible, further research or analysis on the impact that pension funds have on employment generally, as well as on the employment and training of a class of highly skilled knowledge workers and other elite professionals should be explored. Another area which could not be explored in any detail in this paper is the impact that pension funds in Ontario have on the financial services innovation. This would be a fruitful area for further inquiry. An analysis of why (or why not) pension funds are incubators of innovation is relevant in terms of the economic incentives that drive them as well as the impacts that they have on the economy.

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