Pension plans and their investment rules: investing in alternative investment funds in full compliance

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Numerous pension plans today are among the largest investors of capital in private equity, venture capital and hedge funds.[1]

In many cases, such pension plans hold assets valued in the tens or hundreds of millions of dollars (or even more) consisting of various categories and sub-categories of investments. It is therefore not surprising that with the recent lower rates of return of the traditional forms of investments, pension plans are increasingly opting to invest a portion of their assets in alternative investment funds.

Pension plans are however subject to many particular legislative and regulatory provisions, including rules governing their investments that they must take into account when making such investments.

For example, regarding defined benefit pension plans, Quebec's *Supplemental Pension Plans Act* (hereinafter the "**SPPA**") stipulates that only the pension committee[2] (or a person to whom it has delegated this power) may "decide how the assets of the plan are to be invested."[3]

In addition, the pension committee must adopt a written investment policy. This policy must, in particular, take into account the characteristics of the pension plan, its financial obligations and the other requirements prescribed by law.[4] The SPPA also provides that the investments must be made in conformity with this investment policy, as well as the rules and limits provided by law.[5]

The federal statute governing pension plans, i.e. the *Pension Benefits Standards Act, 1985* (hereinafter the "**PBSA**"), as well as the main regulation thereunder, the *Pension Benefits Standards Regulations, 1985* (hereinafter the "**PBSR**"), also impose various obligations on pension plan administrators pertaining to investments.[6] Thus, in the case of a defined benefit pension plan that is subject to the PBSA, the plan administrator is required to establish a written statement of investment policies and procedures (i.e. an investment policy)[7] and to invest the assets of the pension fund in accordance with the regulations[58] and in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund (i.e. the prudent method of portfolio management).[9]

This article will not describe all the investment obligations of pension plan administrators, but will highlight several significant principles that administrators of defined benefit pension plans must keep in mind before investing in an investment fund.

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1. Does the pension plan's investment policy permit the proposed investment in the investment fund?

The SPPA not only requires the pension committee to adopt a written investment policy, it also provides that this written policy must set out specific conditions, such as the permitted categories and sub-categories of investments.[10] Similarly, under the PBSR, a pension plan's written investment policy must, among other things, set out the categories of investments.[11]

The pension plan administrator must therefore verify whether the language of the investment policy permits investments in the investment fund in which it plans to invest.

For example, does the pension plan's investment policy permit a portion of the pension fund's assets to be invested in units of a limited partnership whose purpose is to hold equity interests in real estate or infrastructure projects? Another example was considered in the case of *Syndicat général des professeurs et professeures de l'Université de Montréal* c. *Gourdeau et al.*[12] in which the plaintiff, the University of Montreal's union of professors, alleged in its court proceedings that the members of the investment committee of the University of Montreal's pension plan had made investments in a hedge fund, notwithstanding that the applicable investment policy did not specifically allow investments in this category of funds.[13]

We note also that some investment policies only provide that the plan administrator may assign a portion of the portfolio to a portfolio manager, without any reference to the notion of investment funds. However, because of the characteristics of the funds they administer, many managers of alternative investment funds are not registered managers. Private equity and venture capital funds that invest for the purpose of exercising a certain degree of control in, or to participate actively in the management of, the projects or businesses they invest in, typically do not qualify as "investment funds" within the meaning of the law, and their managers are not normally registered, whether as portfolio managers or investment fund managers.[14]

The language of the investment policy should therefore be considered carefully, and special attention should be paid to the terminology used and its legal meaning.

If a conclusion cannot be made that the proposed investment clearly qualifies as one of the permitted categories or sub-categories of investments under the pension plan investment policy, it would be prudent for the policy to be amended before the proposed investment is approved. The amendment in question could refer specifically to that investment or provide for the addition of a new category or subcategory of investments that clearly includes the proposed investment.

The pension plan administrator should also ensure that the amendment to the investment policy is appropriate in the circumstances, particularly in light of the characteristics of the pension plan, its financial obligations and the other provisions of the investment policy.

In addition to the foregoing, we believe it would be prudent for the plan administrator to verify whether the categories of investments described in the targeted investment fund's investment policy are included in the permitted categories or sub-categories of investments under the pension plan's investment policy.

It should be remembered that, in accordance with the standard structure of alternative investment funds, once the plan administrator has committed capital in the targeted investment fund by signing a subscription agreement, the fund manager generally has the right to make calls for payment at its discretion during the fund's investment period, by requiring investors (including the plan administrator) through drawdowns to pay a part or all of the amount they committed to the fund. The fund manager may then invest the said amounts in any portfolio investment of its choosing that

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complies with the investment policy of the fund. Furthermore, unlike hedge funds, the majority of private equity and venture capital funds do not usually allow investors to request the redemption of their interests in the fund. Therefore, the pension plan becomes “captive” and will not be able to recover its investment until liquidation of the fund, unless it finds a purchaser in the secondary market.

In addition, the plan administrator cannot assume that the fund manager will follow or comply with the terms and conditions of the pension plan’s investment policy, even if it has been disclosed to it. Indeed, the investment fund manager is not acting as agent for the pension plan administrator investing in its fund. Since the amount invested by the pension plan administrator is pooled with the funds of other investors, the investment fund manager (unlike a portfolio manager) cannot undertake to comply with the investment policy of a specific investor.

The manager’s investment decisions are collective (for the entire fund) and are therefore only subject to the restrictions imposed on it by the investment fund’s organizational documents, i.e. primarily the restrictions set out in the fund’s investment policy. However, there are ways to circumscribe this power of the manager, as we shall see in greater detail in the sections below.

Finally, we note that the plan administrator should also satisfy itself that the other pension plan documents contain no provisions that could prohibit, restrict or otherwise limit the proposed investment.

2. Does the proposed investment comply with the other limits or requirements set out in the investment policy?

The permitted categories and sub-categories of investments are not the only conditions that must be set out in the pension plan’s written investment policy. Indeed, the SPPA stipulates that the investment policy must, for instance, also set out the proportion of the assets that can be invested in debt securities and equity securities, as well as measures for ensuring the diversification of the portfolio.[15]

As for the PBSR, it provides that the investment policy provisions must also deal with the asset allocation and the diversification of the portfolio.[16]

Investment policies usually contain one or more provisions that set out the maximum percentage of the assets in the pension fund that can be allocated to various permitted categories or sub-categories of investments. When the proposed investment is made, it must therefore comply with any applicable limit in this regard. In addition, the investment policy generally contains other specific requirements relating to certain categories or sub-categories of investments

Such requirements may, for example, deal with the quality of the securities that can be held in respect of a category or sub-category of investments (e.g.: a minimum rating of “A” by a recognized credit rating agency) or the minimum market capitalization of a security at the time of purchase. They may also prohibit the purchase of certain securities. Any specific condition, limit or prohibition that may apply in the case of the proposed investment must be respected. Furthermore, one should also review all the types of investments permitted by the investment policy of the targeted investment fund, since, as we noted above, the pension plan administrator will not be entitled to review or approve the investments made by the fund manager in accordance with that policy.

If some of the investments that can be made by the investment fund manager may potentially contravene any requirement of the pension plan’s investment policy, the plan administrator should then negotiate a bilateral collateral agreement (commonly known as a “side letter”) with the fund manager to require that it take certain protective measures to prevent any possible contravention of

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the pension plan's investment policy.

Such measures can, for instance, include the right to be excused from participating in certain investments. In such a case, the side letter may provide that the manager will be required to set up an alternative investment vehicle or parallel fund structured in parallel to the investment fund, to be used for the investments that have been excluded by the plan administrator, and in which the pension plan holds no interests (but in which the other investors have mirror interests to the interests they hold in the investment fund). The organizational documents of private equity and venture capital funds often permit this type of structure to be implemented. If this is not the case, it may be important to provide for it in a side letter, depending on the circumstances.

Moreover, even where the investment fund's organizational documents provide for this type of mechanism, it is standard practice for an investor, such as a pension plan administrator, to require prior notification by the manager of any intention to make any investment identified in the side letter as potentially problematic for the investor.

We note that the side letter should be concluded with the fund manager at the time the plan administrator commits to the capital of the fund upon the signature of the subscription agreement, since, once it has been signed, the manager will no longer have any incentive to make any additional undertakings to the plan administrator.

3. Does the proposed investment comply with the rules and limits in the applicable legislation and regulations?

The SPPA contains certain rules and limits governing investments. For example:

> the pension committee must endeavor to constitute a diversified portfolio in order to minimize the risk of major losses;[17]
> the pension plan's assets cannot be invested, directly or indirectly, in shares carrying more than 30% of the voting rights attached to the shares of a legal person.[18]

Under the SPPA, any person who makes an investment that is not in compliance with the law is, by that sole fact and without further proof of wrongdoing, liable for any resulting loss.[19] In addition, the members of a pension committee who approved such an investment are, by that sole fact and without further proof of wrongdoing, solidarily liable for any resulting loss.[20] However, such persons incur no liability if they acted in good faith on the basis of an expert's opinion.[21] According to Retraite Québec, an "expert" is any person who is able to provide a specialist's opinion on a given subject.

In addition to this liability, any person who contravenes any of the rules applicable to investments commits a penal offence and is liable to a fine of $500 to $25,000.[22]

The PBSA and the PBSR also contain various rules and limits pertaining to investments. Thus, section 8(4.1) of the PBSA states that the plan administrator must comply with the regulations and invest in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund.

We note that the administrator will not be found liable under this section if a contravention of the section occurred because the administrator relied in good faith either on the report of a person whose profession lends credibility to the report (including an accountant, lawyer or actuary), or on financial statements prepared by an accountant or a written report prepared by an auditor that have been represented to the administrator as fairly reflecting the financial condition of the plan.[23]

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As for the PBSR, it primarily provides that the investment of the plan assets must be done in accordance with Schedule III of the regulations, entitled “Permitted Investments”.[24]

That Schedule sets out various rules and limits, including the rule that a plan administrator may not, directly or indirectly, invest moneys of the plan in any one person if 10% or more of the total market value of the plan’s assets has already been invested in the person, or if 10% or more of the total market value of the plan’s assets would be invested in the person as a result of the investment.[25]

According to the definitions set out in that Schedule, the word “person” includes a corporation, trust, partnership or fund or an unincorporated association or organization.

Another rule contained in Schedule III provides that the plan administrator may not, directly or indirectly, invest the moneys of the plan in the securities of a corporation to which are attached more than 30% of the votes required to elect the directors of the corporation.[26]

We note that, like the SPPA, the PBSA provides for certain penal offences. Thus, any person who contravenes a provision of the PBSA or its regulations commits an offence and is liable, on summary conviction, to a maximum fine of $100,000 or a maximum term of imprisonment of one year (or both), in the case of an individual.[27] In the case of a corporation or other body, the penalty is a maximum fine of $500,000.

In the case of *R.* v. *Christophe et al.*,[28] the Ontario Court of Justice held that certain investments approved by the members of an investment committee contravened one of the applicable rules under the *Pension Benefits Act* of Ontario and its general regulations, and convicted the members in question of a penal offence. The Court then sentenced each of the individuals to a fine of more than $22,000.

Given that there can be significant consequences where investments are made in breach of the law (or regulations, as applicable), pension plan administrators therefore have every interest in ensuring the investments are compliant.

In this regard, it is customary to provide a confirmation in a side letter from the investment fund manager that it will ensure that the pension plan administrator is not in breach of certain rules and restrictions as a result of any of the investments made by the fund. Such clauses are common, but, as previously noted, must be negotiated at the time the plan administrator commits capital to the fund.

4. Was a due diligence review done of the proposed investment and are the results of the review satisfactory to the plan administrator?

Under the SPPA, the pension committee must notably exercise the prudence, diligence and skill that a reasonable person would exercise in similar circumstances.[29]

Similarly, under the PBSA, the plan administrator must exercise the degree of care in its administration of the pension plan that a person of ordinary prudence would exercise in dealing with the property of another person.[30] With respect to investments, the administrator must invest the assets of the pension fund in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund.[31]

Accordingly, where the pension plan administrator is considering making a particular investment, including an investment in an investment fund, it should conduct a due diligence review whose

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scope will vary according to the proposed investment. Indeed, where certain investments are being considered, a prior due diligence review will be simpler and easier. In the case of investments in large investment funds or complex and/or innovative financial instruments, extended and detailed reviews will usually be necessary.

Some investments involve the analysis of highly technical and voluminous documentation (such as an investment in a complex master-feeder fund structure). For such investments, it is important to obtain the information and/or particulars necessary to properly identify and understand the potential benefits and risks of the proposed investment before making a decision. In this regard, it will be essential to review the offering memorandum or private placement memorandum of the fund. If the fund is not proposing to issue an offering memorandum, it may be appropriate to require that it do so to ensure that one properly understands the parameters of the investment.

Indeed, at the time the plan administrator is making its commitment to the fund, the investment fund may hold very few or no assets (except for open-ended funds such as hedge funds). In such a case, the offering memorandum or private placement memorandum will be almost the only tool that can provide a proper understanding of the portfolio investments that will be made by the fund and the investment strategy that will be used by the manager. Obviously, the fund's organizational documents must also be reviewed, since they constitute the main contract between the investors and the manager. The plan administrator will also wish to satisfy itself, in particular, that these organizational documents contain protective measures in the event the manager is caught in a conflict of interest, and also contain sufficient information disclosure requirements on the part of the fund manager.

As part of its review, the plan administrator should also be able to examine the side letters concluded with all the other investors. If there is no "most favoured nation" type of provision in the fund's organizational documents, the administrator should negotiate a side letter with the manager that includes such a clause.

If the plan administrator does not have all the necessary skills to properly assess the fund's documentation and make an informed decision on the proposed investment, it should request the assistance of qualified professionals in the field.

In the report that these professionals submit to the plan administrator on the results of their analysis, they will, for instance, be able to inform the plan administrator whether the said documentation raises specific questions or problems in relation to the pension plan, or whether some provisions of the documentation differ substantially from the standard documentation generally used in the market for this type of investment.

Finally, in all cases where the plan administrator decides to make an investment, it is important for it to properly document both the process followed and its final decision (including the reasons for it).[32] Any analysis or report provided by professionals, as well as all the other relevant documents and correspondence leading up to the decision, should be conserved in the plan administrator's records.

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1. According to the data collected by Preqin, 23% of the capital invested worldwide in investment funds in 2012 stemmed from public or private pension funds (source: Benoît Leleux, Hans Van Swaay and Esmeralda Megally, *Private Equity 4.0 – Reinventing Value Creation*, John Wiley & Sons Ltd., 2015, at p. 38).
2. Section 168 of the SPPA.
3. Sections 169 and 170 of the SPPA.
4. Section 168 of the SPPA.
5. The plan administrator administers the pension plan and pension fund as a trustee (section 8(3) of the PBSA).
6. Sections 7.1(1) and (2) of the PBSR.
7. Section 8(4.1) of the PBSA and sections 6(1) and 7 of the PBSR.
8. Section 8(4.1) of the PBSA.
9. Section 170 of the SPPA.
10. Section 7.1(1) of the PBSR.
11. Superior Court of Montreal, file number 500-06-000294-054.

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12. This case was settled out of court and the settlement was approved on May 26, 2015 by the Superior Court of Québec (2015 QCCS 2496).
13. Section 5 of the *Securities Act* (Quebec).
14. Section 170 of the SPPA.
15. Section 7.1(1) of the PBSR.
16. Unless it is reasonable in the circumstances to act otherwise (section 171.1 of the SPPA).
17. Section 175 of the SPPA. This limit does not however apply in the cases referred to in the second paragraph of that section.
18. Section 180 of the SPPA.
19. Section 180 of the SPPA.
20. Section 180 of the SPPA.
21. Section 257 of the SPPA. Where such an offence is committed by a legal person, the fine is tripled (section 259 of the SPPA).
22. Section 8(5.1) of the PBSA.
23. Section 6(1)a) of the PBSR.
24. Section 9(1) of Schedule III. However, the 10% limit does not apply to the investments listed in section 9(3) of Schedule III, which, among others, include investments in an investment fund that meet the requirements applicable to pension plans set out in Schedule III, investments in a fund that replicates the composition of a widely recognized index of a broad class of securities traded at a marketplace (index funds) and investments in securities issued or fully guaranteed by the Government of Canada, the government of a province, or an agency thereof.
25. Section 11 of Schedule III. The expression “security”, defined in Schedule III, includes, in particular, the shares of any class of shares of a corporation and any ownership interest in the case of any other entity. The 30% limit does not apply to investments made in securities of real estate corporations, resource corporations or investment corporations, as defined in Schedule III.
26. Sections 38(1) and (1.1) of the PBSA.
27. 2009 ONCJ 586.
28. Section 151 of the SPPA. It must also act with honesty and loyalty in the best interest of the plan members and avoid conflicts of interest.
29. Section 8(4) of the PBSA.
30. Section 8(4.1) of the PBSA.
31. The Canadian Association of Pension Supervisory Authorities (CAPSA) stresses the importance of this practice in its Guideline no. 6 (Pension Plan Prudent Investment Practices Guideline) published in November 2011. CAPSA is a national interjurisdictional association of pension regulators whose mission is to facilitate an efficient and effective pension regulatory system in Canada. CAPSA’s Guideline no. 6 is intended to help plan administrators demonstrate the application of prudence to the investment of pension plan assets. Regarding the documenting of the plan administrator’s decisions, this guideline states the following, in particular: “Any time a key decision is made, it should be well documented, and include the reasons and circumstances that were considered.”

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