LET THE CHICKENS RUN THE HENHOUSE? *DEMOCRATIZING PENSION FUNDS: CORPORATE GOVERNANCE AND ACCOUNTABILITY*, RONALD B. DAVIS (VANCOUVER: UBC PRESS, 2008).

The central thesis of this interesting, but clearly labour biased book, is that employees or plan beneficiaries ought to exercise greater decision-making control over the pension funds they participate in. In this way, Professor Ronald Davis argues, investee corporations can be influenced to behave with greater social, ethical, financial, and environmental responsibility. Notwithstanding its arguably optimistic if not naïve view of the potential benefits of democratizing pension fund governance, this book deals with many themes that highlight deficiencies in governance and accountability that many practitioners in the pension industry would likely admit should be addressed.

But will governance, investment returns, or responsible corporate behaviour be enhanced through the direct or representative forms of pension plan democracy urged by Professor Davis? Will the effort and expense of democracy promote the establishment or continuance of private pension plans in a voluntary environment? I don't think they will. But the answers to these questions are subject to debate, and this book, with its many threads, is an important contribution to that debate and to understanding governance issues associated with this form of compensation.

The starting point for Professor Davis' main argument is the assertion that "the corporation, even though it has been granted the status of a legal person under the law, is not accountable to anyone other than the shareholders."[1] According to Davis, a corporation is not a human being with social, environmental, ethical, or other concerns. It has a single-minded and one-dimensional objective, namely, short-term profit maximization. Davis' thesis hangs on a presumption that plan beneficiaries, on the other hand, have a more multi-dimensional view that should be allowed to blossom by removing institutional obstacles to plan member governance inherent in applicable trust, pension, and securities law doctrines. By introducing structural reform to enable plan members to effectively participate in pension fund investment decision-making, that is, by democratizing pension funds, the members will be able to ensure that there is more active investor participation and that non-financial criteria will be considered in pension fund investment policies and selections. This, Davis argues, will result in long-term increases in rates of return by ensuring corporations act more responsibly in the short-term, and it may also result in short-term collateral benefits for affected employees in their capacities as employees and as members of society.

This starting point requires a considerable leap of faith. Surely one must concede that plan participants must be just as interested in personal wealth maximization as corporations are in profit maximization. It is a point of debate as to whether corporations or plan participants have the broader view.

While corporations do have a legal obligation to maximize profit, they cannot realize this obligation without considering a broader range of interests than an individual plan

[1] Ronald B. Davis, *Democratizing Pension Funds: Corporate Governance and Accountability* (Vancouver: UBC Press, 2008) at 13.

participant. In my view, individual plan participants need only think of themselves, namely their retirement income security, their ongoing income security, and possibly income security for their dependents. Corporations on the other hand must, from a practical and a legal perspective, take into account the interests of many different stakeholders if the business is to flourish, including employees, retirees, customers, suppliers, lenders, underwriters, shareholders, and the public at large. Most corporations are absorbed with their public image, presumably because it is directly related to the effectiveness of selling their products or services, obtaining credit, and doing business with suppliers. They contribute substantially and visibly to charitable and cultural events. It is difficult to imagine a corporation successfully marketing its goods and services (and thereby generating revenues and profits) if it did not maintain a positive reputation amongst its customers, lenders, shareholders, and employees. Plan members on the other hand can be completely and anonymously selfish as long as they perform the work that enables them to accrue a pension. In short, Davis' thesis falls apart for me with its premise.

This premise seems to be fundamental to Davis' recommendations for reform. One might argue that if corporations and corporate plan administrators are already taking these matters into account, why bother making changes? And why bother making such changes when both the law and practice suggest that plan member participation is not a critical component of good governance. As Davis reluctantly acknowledges, but does not develop, research has demonstrated that expertise is more essential and a stronger contributor to long-term returns than self-interest.[2] This is not to say that there is no room for plan member participation as a disclosure and accountability tool, as appears to be the case in recent legislative reforms enacted in the United Kingdom.[3]

As mentioned above, the current system is not perfect and there is room for some of Davis' suggested reforms. One area is the problem of pension funds as passive investors that rarely, if ever, exercise their economic muscle. There are structural and doctrinal reasons for why this is so, as Davis clearly points out. But he seems to miss one obvious source for this in Canada. Most pension standards legislation restricts the number of voting shares a pension fund can hold in any one corporation to 30 percent. The rule derives from a conscious government policy to encourage passive investment by pension funds and prevent concentration of ownership of commercial businesses.[4] Many on the management side of the great labour-management divide have advocated abolition of this restriction in favour of greater reliance on the prudent person approach advocated by Davis.[5]

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2 See e.g. the articles in (2008) 1 Rotman International Journal of Pension Management: Effective Pension Governance: New Insights and Research Findings 1 at 1-71, online: Rotman International Centre for Pension Management <http://www.rotman.utoronto.ca/icpm/details. aspx?ContentID=223>.

3 Davis, *supra* note 1 at 157.

4 C.D. Howe Institute, *A Matter of Voice: The Case for Abolishing the 30 percent Rule for Pension Fund Investments* by Poonam Puri at 5, online: C.D. Howe Institute <http://www.cdhowe.org/pdf/ commentary_283.pdf>.

5 *Ibid.* at 1.

Davis does make reference to the so-called "10% rule," which is not an obstacle to the exercise of control for the reasons Davis gives.[6] The 30 percent rule is, however, a major problem.

But it should also be noted that the 30 percent rule does not prevent large pension funds from exceeding the 30 percent limit indirectly with the use of "blocker corporations" and other structures. This contributes to a two tier class of pension funds — the vast majority of small funds with insufficient assets or internal staff to directly manage investments, and large pension funds. It is only the relatively tiny basket of large Canadian pension funds that will have sufficient assets to support or justify internal staff to directly manage investments, let alone create the structures necessary to address regulatory restrictions like the 30 percent rule. It is only larger funds that can take a more activist role as investors.

According to Davis, the reliance on outside managers dilutes the likelihood that an employee's particular financial interests outside of long-term savings will be considered. Many would agree with this point. It also exacerbates the other advantages enjoyed by large funds over small ones.

One way to overcome this structural impediment would be to allow smaller funds to join with larger funds, as advocated in the report of the Ontario Expert Commission on Pensions[7] and recent Ontario budget proposals to permit larger funds to manage assets of smaller funds.[8] However, do larger pools not mean less democracy? The trend towards larger funds may mean that the hope of pension fund democratization is further diminished as the particular interests of employees of one employer are absorbed in a pool of many, with differing and probably competing interests and priorities.

Davis cites many useful authorities for the points he makes and the book is well-researched and generously footnoted; however, there are foundational statements that are not supported by authority and, without further explanation, may not be entirely accurate.

Davis says pension funds are usually trusteed. That depends. Most pension funds are small and are funded by means of insurance contracts.[9] They are not trusteed. Most pension fund *assets* on the other hand are in larger defined benefit plans, and most, but certainly not all of those, are held in trusts.[10]

Davis says the trusteed funds are run by boards of trustees appointed by employers that sponsor the pension plans[11] but acknowledges the heavy hand employers are granted under pension standards laws in plan and fund administration. The heavy hand exercised by employers is true, but they do not do this by appointing trustees to administer their plans or

6 The "10%" rule is the rule that restricts a pension fund from investing more than 10 percent of its assets in any single corporation's securities, which is rarely an issue since prudent diversification would not permit such concentration of plan assets: see Davis, *supra* note 1 at 18.

7 Ontario, Expert Commission on Pensions, *A Fine Balance: Safe Pensions, Affordable Plans, Fair Rules* (Toronto: Queen's Printer for Ontario, 2008) at 183-85.

8 Ontario, Ministry of Finance, *2009 Ontario Budget: Confronting the Challenge, Building our Economic Future* (Toronto: Queen's Printer for Ontario, 2009) at 131.

9 Ari N. Kaplan, *Pension Law* (Toronto: Irwin Law, 2006) at 5.

10 *Ibid.*

11 Davis, *supra* note 1 at 6.

funds. As Davis notes, pension standards laws in North America allow employers to be the administrators of the plans and underlying pension funds they provide or sponsor.[12] Most pension assets held under defined benefit plans provided by private sector employers are held in a custodial trust arrangement under which the trustee is a trust corporation (not a board of trustees) appointed by the employer pursuant to an agreement between the employer, qua administrator, and the trustee. The trustee has no investment discretion, but must take instructions from the employer (as administrator) or the nominees of the employer, which are generally one or more investment managers appointed by the employer. Under this structure, there are no independent trustees and no plan member oversight except through legislated disclosure rules that Davis finds inadequate. Employer-managers make all decisions, with little advance disclosure of investment decision-making, a fact that supports some aspects of change advocated by Davis.

As Davis notes, employer staff responsible for establishing investment policy and selecting investment advisors are not usually experts in investment management, but managers of the employer's business, typically employed in finance or human resources, or both. The board of directors of the employer will supervise this, however, this systemically results in passive investment and governance by persons who are not experts, per se, since most pension funds in my experience are not large enough to motivate employers to put in place internal investment management structures. Accordingly, they must rely on outside managers for that reason and for others cited by Davis. The result, passivity and higher investment fees.

But despite the challenges for smaller funds, all pension fund administrators in Canada must develop a statement of investment policies and procedures (SIP&P) in order to to set investment goals and policy, even if specific selections (and proxy voting powers) are left to professional managers. These are available for plan member inspection.

In the construction of the SIP&P, the links between environmental, ethical, social, and governance factors and financial performance are increasingly being recognized. As Davis points out, legal advice received by the United Nations Environment Programme Finance Initiative indicates that integration of environmental and social considerations into an investment policy so as to more reliably predict financial performance is not only clearly permissible,[13] but is arguably required under applicable prudential investment rules whether imposed under general trust or fiduciary doctrines or by minimum pension standards.[14] In my experience, most pension fund administrators take these matters into account without giving labour a formal seat on the governing body.

Professor Davis contends that workers should be active participants in the governance of pension funds and that "the representational weaknesses of pension plan participants as a

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12 *Ibid.* at 72.

13 United Nations Environment Programme Finance Initiative (UNEP FI) Asset Management Working Group, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* (London: Freshfields Bruckhaus Deringer, 2005), online: UNEP FI <http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf>. Also referred to in Davis, *supra* note 1 at 64.

14 For example, see the prescriptions in the *Pension Benefits Act*, R.S.O. 1990, c. P.8, s. 22.

decision-making body should be neither forgotten nor ignored."[15] Davis says the only justification for not allowing participants to participate is expertise and cites pension standards requirements as contributors to this.[16] He provides examples and argument to support non-expert boards.[17] He also says "the presence of trustees elected by the plan participants … does not seem to affect their investment returns."[18] But is that really true?

Relevant academic research seems to clearly refute the suggestion that employee representation would improve investment returns.[19] It might aid with disclosure, communication, or accountability to have some participant input, but clearly it is expertise from a practical as well as a legal perspective that enhances fund performance. The inaugural issue of the Rotman International Journal of Pension Management[20] featured several academic articles identifying the attributes of good pension fund governance. In general, the key features seem to be proper motivation and investment management expertise. While plan participants are generally motivated, they would rarely have the requisite expertise. This is not to diminish the role of appropriate disclosure and transparency and some of the recommendations Davis suggests on that front, but it would not appear to be a good argument for necessarily including participants in plan governance or investment decision-making.

Management side lawyers would no doubt take issue with other aspects of Davis' analysis. For example, Davis uses the deferred wage theory of pensions as an argument for labour governance or joint governance of defined benefit plans.[21] Management lawyers might argue that it is not the contributions or the fund that is the deferred wage in a defined benefit plan, but rather the defined benefit. In that context it is management's responsibility to provide and manage funding to be held by a third party as security for the promised benefit in accordance with minimum standards, and thus take the argument in a different direction. One might debate whether there is a presumptive rule that employees, retirees, and their beneficiaries are the exclusive beneficiaries of the pension trust, as Davis argues.[22] At the very least, employers are also beneficiaries, something that is explicitly recognized in some minimum standards statutes[23] but not addressed by Davis. This too affects the democratizing argument.

Defined benefit pension plans are already endangered, in part because of increasing regulation and loss of control of this aspect of the wage package by employers. Aside from adding further disincentives to voluntary establishment of defined benefit plans, greater employee control over plan governance and investment management will provide an additional incentive to move to defined contribution plans, or to joint governance models with "target" defined benefit plans, which are, in essence, defined contribution promises because target benefits can be scaled back to conform to available funding.

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15 Davis, *supra* note 1 at 7.
16 *Ibid.* at 72.
17 *Ibid.* at 155-57.
18 *Ibid.* at 72.
19 *Ibid.* at 155-57.
20 *Supra* note 2.
21 Davis, *supra* note 1 at 43-47.
22 *Ibid.* at 42-43.
23 See e.g. *Pension Benefits Standards Act, 1985*, R.S.C. 1985 (2d Supp.), c. 32, s. 8(3) (expressly requiring an administrator to administer the pension plan and the pension fund as a trustee for the employer and the plan beneficiaries).

Under pure defined contribution plans employees can usually make their own investment decisions, but again the choices are usually limited to mutual funds that are effectively governed by Davis' artificially constructed shareholders (that is, the fund managers). Maybe more labour participation is warranted here, as beneficiaries are directly affected. But there is also a lesson to be learned by reviewing empirical evidence of investment activity by plan participants in defined contribution plans. The biggest problem, in my experience, is participant apathy. Most "selections" tend to be in default funds and there is considerable lobbying by the employer side to create "safe-harbour" rules to reduce risk associated with the use of default options. The reason is because participants are too apathetic or too confused to make any investment decisions whatsoever.[24] Accordingly, even if all of the structural shifts Davis advocates were to come into existence, query whether there would be any change. In other words, you can lead a horse to water, but you cannot make it drink. And this is true whether you grant control through the direct or representative democratic structures Davis proposes.

Finally, plan beneficiaries are not immune from allowing conflicting interests to affect their judgment. The provincial offence proceeding against trustees of the Canadian Commercial Workers Industry Pension Plan provides some indication of that, although at this point the faults remain allegations as no decision has been rendered.[25]

This is a very interesting book. It cannot be properly debated within the context of a book review. This book will stir strong feelings for those in the pension industry. It should be read and debated. The bottom line, however, is that no one is going to argue that foxes should be in charge of henhouses. But henhouses should also not be run by the hens. They need to be run by expert and motivated producers.

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[24] Many studies have indicated that between 60 percent of participants in defined contribution plans are in default investment options: see e.g. Watson Wyatt Worldwide Thinking Ahead Group, "The Default Dilemma: When DC members can not or will not choose an investment option" *Watson Wyatt Perspective* (Winter 2009) 37.

[25] Financial Services Commission of Ontario, *Addendum to the Pension Examination Report of the Canadian Commercial Workers Industry Pension Plan* (Toronto: Financial Services Commission of Ontario, 2006), online: Scribd <http://www.scribd.com/doc/6718/Regulators-Report-on-UFCW-Pension-Plan-Part-2>.