Recent Corporate Scandals - Should Benefit Plans Care?

By

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RECENT CORPORATE SCANDALS – SHOULD BENEFIT PLANS CARE?

Governance is a hot topic once again. It became a major focus for public corporations in the early to mid 1990s. "Pension plan governance" then became a topic of significant discussion. Like a lot of good but not particularly exciting concepts, governance got less attention as time went by, particularly in the heady days of the stock market boom. When the bubble burst, it was immediately apparent that some very high flying corporations had simply never developed a culture of governance and accountability. The resulting corporate debacles have ranked with anything previously seen. The ultimate toll of the carnage is still hard to predict, since the legislative initiatives spawned in response to these corporate scandals are still being developed and implemented. The complete destruction of Arthur Andersen, formerly a distinguished pillar of the accounting profession, bears testimony to the virulence of the disease.

What has all this got to do with benefit plans? There are (at least) two major respects in which trustees of benefit plans should look to what we can learn from these experiences. First, and most importantly for the purposes of today's presentation, trustees of pension and other plans should look to the governance of their own plans to determine to what extent their own procedures, and the accountability within their organizations, need to be improved to minimize the risk to the funds they manage, and to preserve their ultimate ability to provide the anticipated benefits.

Secondly, while less important for present purposes, institutional investors need to be concerned about the reliability of the corporations and other entities in which they invest. Lack of sound governance jeopardizes the integrity and viability of capital markets. There is in my view an unavoidable role for pension and benefit plans large and small, as well as other institutional investors, to insist on adequate standards of corporate governance and accountability. It is unfortunately safe to say that the time has passed when it was acceptable for institutional investors simply to assume that corporate boards are doing the right thing, or that someone else will provide the necessary policing to ensure accountability.

I will address these two broad topics in turn.

I. GOVERNANCE GUIDELINES FOR PLAN TRUSTEES

A. ANALOGY TO CORPORATE GOVERNANCE

In the wake of the collapse of Royal Trust in the early 1990s, a report entitled "Where Were the Directors?" was issued by the Toronto Stock Exchange Committee on Corporate Governance in Canada. The current corporate governance guidelines at the Toronto Stock Exchange are derived form the report.

The approach set out in the policies of the Toronto Stock Exchange is that reporting companies must provide in their annual report or information circular a "statement of corporate governance practices". In that report, they must comment on the extent to which they follow, or do not follow, fourteen numbered guidelines suggested by the TSX. Reporting companies are not required to follow the guidelines. They are only required to report the extent to which they do or do not follow the guidelines. This approach to governance allows issuers to determine for themselves what is the most appropriate approach to governance for them.

A number of the guidelines suggested by the TSX for corporate issuers could not be applied to pension and benefit plans. (Indeed, a number of them are not readily applicable to non-corporate public issuers, such as income trusts. There is currently a debate over the extent to which the corporate governance guidelines should be applied to such public non-corporate entities.) However some of the corporate governance guidelines merit consideration by benefit plan trustees.

1. The board of directors of every corporation should explicitly assume responsibility for the stewardship of the corporation and, as part of the overall stewardship responsibility, should assume responsibility for the following matters:

    (a) adoption of a strategic planning process;

    (b) the identification of the principal risks of the corporation's business and ensuring the implementation of appropriate systems to manage these risks;

    (c) succession planning, including appointing, training and monitoring senior management;

(d) a communications policy for the corporation; and

(e) the integrity of the corporation's internal control and management information systems.

2. Every board of directors should implement a process to be carried out by the nominating committee or other appropriate committee for assessing the effectiveness of the board as a whole, the committees of the board and the contribution of individual directors.

3. Every corporation, as an integral element of the process for appointing new directors, should provide an orientation and education program for new recruits to the board.

4. Every board of directors should expressly assume responsibility for, or assign to a committee of directors the general responsibility for, developing the corporation's approach to governance issues. This committee would, amongst other things, be responsible for the corporation's response to these governance guidelines.

5. The board of directors, together with the CEO, should develop position descriptions for the board and for the CEO, involving the definition of the limits to management's responsibilities. In addition, the board should approve or develop the corporate objectives which the CEO is responsible for meeting.

6. The board of directors should implement a system which enables an individual director to engage an outside adviser at the expense of the corporation in appropriate circumstances. The engagement of the outside adviser should be subject to the approval of an appropriate committee of the board.

B. PENSION GOVERNANCE GUIDELINES

In May 2001, the Canadian Association of Pension Supervisory Authorities (CAPSA) released for comment a draft of a "Pension Plan Governance Guideline and Implementation Tool". This document has two parts. The first articulates thirteen principles representing a "governance guideline". The second part contains the suggested implementation mechanism for a governance structure. In May 2002, CAPSA released a letter commenting on the response to its 2001 draft. The letter indicated that the implementation tool had been found not very helpful, and indicated that

further work would be done to develop a revised tool for implementation of a revised pension plan governance guideline. The principles set out in the 2001 draft of the governance guideline are set out below.

1. The pension plan should have clearly stated objectives which are documented and made available to plan members and beneficiaries.

2. There should be clear delineation and documentation of roles, responsibilities and accountabilities of all participants in the governance structure.

3. The governing body must fulfil its fiduciary responsibilities to plan members and beneficiaries.

4. The governing body should have the right mix of skills and experience and the members of the governing body should collectively demonstrate the skills, capability and dedication required to fulfil their governing responsibilities.

5. Members of the governing body should be provided with appropriate training and undertake ongoing education.

6. There should be a procedure for the selection and succession planning of members of the governing body and senior management.

7. The governing body should receive appropriate, timely and accurate information.

8. A communication policy should be established for plan members and beneficiaries to ensure transparency and accountability.

9. A code of conduct and control mechanism for conflicts should be established.

10. Every pension plan should have an internal control framework to ensure that potential risks are addressed and appropriate controls are in place.

11. The governing body should have appropriate mechanisms in place to oversee the administration of the pension plan and ensure compliance with legislative requirements.

12. Objective performance measures should be established for all key decision makers including the governing body, senior management, staff, custodians, investment managers, third-party benefit administrators and professional service providers/professional advisers. Performance should be regularly evaluated against the performance measures and results should be reported to appropriate stakeholders. Performance measures should be reviewed regularly.

13. The governing body should periodically review governance procedures to ensure the objectives of the pension plan are effectively pursued. Best practice for self-assessment reporting would require the governing body to periodically report to pension plan members, beneficiaries, employer(s) and bargaining agent(s).

The breadth of these principles demonstrates a huge difficulty in attempting to articulate common guidelines applicable to all pension plans. There are great differences among pension plans which we can illustrate by reference to four kinds of plans (within a much greater numerical range of plans):

(a) a company sponsored non-contributory defined benefit plan;

(b) a contributory defined contribution plan;

(c) a jointly-trusteed industry-wide or single employer pension plan; and

(d) a pension plan for unionized employees all the trustees of which are appointed by the union.

Whether the plan is for public sector or private sector employees, or for union or non-union employees, adds to the variety. As a group, pension plans are more heterogeneous than corporations. Yet the guidelines suggested by CAPSA appear to be more directive and less facilitative than those that apply to corporations (which at least exhibit the common characteristic of aiming to be profitable enterprises to return value to their shareholders). One would have thought that a less directive approach would be adopted with a heterogeneous group. Looked at another way, the kind of pitfalls which the trustees of a multi-employer jointly-trusteed plan would need to avoid, and the governance practices that they designed to achieve their goals, could be very different

from the potential pitfalls faced by an employer (or an employer-appointed retirement committee) administering a non-contributory defined pension plan, which is different again from the pitfalls likely to be encountered in respect of a contributory defined contribution plan.

C. "RULES" VERSUS "PRINCIPLES"

A frequent question concerning the CAPSA initiative is whether the pension regulators intend to impose the "principles" as mandatory rules, or whether they would be adopted as principles and guidelines. This echoes the fairly vigorous debate we have seen in Canada over the last year about the response to corporate scandals, and whether Canada should follow the heavy-handed approach taken by the U.S. Congress in enacting the Sarbanes-Oxley legislation, and by the SEC acting under the direction of the Congress pursuant to that legislation. In Canada the head of the Ontario Securities Commission, backed up by elements of the popular media, has insisted that tough new rules are required. Interestingly, other securities regulators, notably the Chair of the B.C. Securities Commission and the President of the Toronto Stock Exchange, have come out in a very determined and articulate fashion to argue the cause of principle-based regulation. They have been supported by a report of the Canadian Council of Chief Executives. The CCCE Report takes as its touchstone the proposition that:

> "Corporate governance is in the end an expression of values rather than a set of rules."

Rather than outright regulation, the CCCE Report favours a three tier approach. First, issuers should be required to disclose their approach to governance. The theory is that requiring someone to tell you what he or she is doing will cause the person to "do the right thing". Secondly, "softer" regulation should come through the rules of the Toronto Stock Exchange, applicable accounting standards adopted by the CICA, and other requirements. Thirdly, legislation to enforce compliance with mandatory rules should be used only as a last resort. In the context of benefit plans, the equivalence would be reporting to stakeholders on governance practices, insistence by actuaries and auditors on minimum standards with respect to such matters as valuation assumptions and internal controls, and mandatory requirements only as a last resort.

I come down firmly on the side of a principle-based approach rather than a rules-oriented approach. There are two principal reasons for this applicable to the governance of all kinds of entities. First, one size does not fit all. It is essential that differently sized entities that are differently situated be able to determine what governance practices work best for them, within some fairly basic principles that can apply to all. Secondly, while it may be flattering to those of us who make laws and work with them for our daily living to have people think that "stronger" laws produce "better" results, our collective experience tells us otherwise. Particularly in regulatory contexts such as securities or pension regulatory matters, the drive towards more and more detailed rules tends to promote a culture of literal compliance, coupled with the search for "loopholes". It often ends with professionals trying to explain to mystified directors or trustees that doing things one way produces an onerous regulatory burden, while doing them another way (which may seem substantially the same) produces a quite different result.

In the context of benefit plans, there are additional reasons to avoid an excessive rule based approach. First, we have already seen over the last ten to fifteen years how an increase in regulatory burden has led employers to abandon defined benefit pension vehicles that in the long run may be far better for employees than a defined contribution plan or the (comparatively unregulated) group RRSP. Secondly, imposing a huge regulatory burden on pension plans will (reasonably enough) encourage trustees of other benefit plans to feel grateful that they do not face such a burden, and incline them to ignore what are seen as unreasonable requirements. If a principle-based approach is taken to the more heavily regulated area of pension plans, there will be more prospect that the same principles could gain some recognition and acceptance from trustees of other benefit plans, which plans are, for those who need to rely upon them, just as important, even though not subject to the same regulatory regime.

D. COMMENTARY ON APPROACHES

One could write a great deal on the enumerated guidelines set out under Parts A and B above. Elements that are found in both approaches include the following (here I am generally following the sequence of the extracts from the TSX governance guidelines set out under A above):

1. appropriate succession planning;

2. adoption of a communications policy;

3. a focus on the integrity of internal controls;

4. assessing the effectiveness of the board of directors or trustees;

5. appropriate training for new members; and

6. reporting on the board's approach to governance matters.

The TSX guidelines specifically recommend that the directors explicitly assume responsibility for the stewardship of the corporation, and assume responsibility for identifying the principal risks of the corporation's business and ensuring the implementation of appropriate systems to manage these risks. These two elements, assumption of responsibility and risk management, do not show up as clearly in the CAPSA guidelines, yet it seems to me that very often there is confusion about proper accountability within benefit plans precisely because the trustees are not sure that it is they who have the responsibility for the stewardship of the plan assets and the proper governance of the plan.

While it is obvious, as we have discussed many times in the context of delegation and necessary reliance on professionals, that trustees cannot undertake all of the functions related to the pension plan themselves, there needs to be a recognition that the buck stops with the trustees. Unless that fundamental recognition is made, there is little likelihood that appropriate governance will follow. The second highlighted aspect, risk management, goes hand in hand with this. Unless trustees genuinely feel that they are ultimately responsible, they are not as likely to feel that it is their job to identify the risks to the plan and its assets or to feel that they are responsible for putting in place mechanisms to manage those risks.

It is not hard to identify the principal risks faced by benefit plans. Standard mechanisms can be put in place to minimize outright misappropriation and other dishonest activities due to promotion of fraudulent claims. The greater risks are more difficult to contain. They include: obtaining a reliable and clearheaded assessment of the liabilities of the plan; managing the investment of the plan's assets to match those liabilities; ensuring the accuracy of data on which valuations are based and benefits paid; and avoiding errors in the computation of benefits and the communication of benefit advice. For most of this, trustees are dependent upon professionals such as actuaries, investment

managers, internal administrative staff or third party service providers. Being armed with a sense of what can go wrong will allow trustees to assess whether they are getting the right kind of information, whether that information on its face seems reliable, and whether it is supported by appropriate backup.

Trustees need to steer a middle ground between wishful thinking and assuming the worst. Their approach towards funding and benefit levels in the current investment climate provides a vivid example. In view of continuing low interest rates and poor investment returns, it may be assumed that some plans will start to have solvency valuation problems. If the trustees blithely assume that improving investment returns will make everything right, they may continue payments of benefits at an unsustainable level for too long, with the result that, when they do have to make some adjustment, the pain will be worse than if the adjustment had been made earlier. On the other hand, if trustees overreact to the first sign of danger and cut benefits when that is not necessary, those with pensions in payment will suffer needlessly. Faced with such difficult questions, it is not surprising if trustees respond by feeling that the whole issue is beyond their control, and yet that is precisely what they must avoid. The ultimate decision rests with them, and if they feel they do not have an adequate basis upon which to deal with the issue, then they are not getting adequate advice from appropriate persons.

E. SUMMARY

Managing a benefit plan in current circumstances is not easy. With an aging population more focused on retirement and other benefits, more sophistication on the part of members, greater awareness of individual entitlements, continuing distrust of those put into positions of responsibility, greater calls for accountability, and a tough investment climate, it is easy to feel overwhelmed. Proper governance structures go a long way to providing an answer. If the important risks and issues receive frequent periodic attention, and all issues are approached within a structured process based on adequate information and sound advice, it is not only certain that better decisions will result, but also that trustees will feel a lot more comfortable with the decisions they make. The CCCE Report urged that corporate governance is an expression of values. At a more basic level, it is the process of identifying what needs to be done, who must do it, and how those who must oversee the "doers" will know that the job is in fact being done. Any group of trustees with adequate support should be able to devise a system to make sure that these objectives are met.

II. "SHAREHOLDER" ACCOUNTABILITY

As noted in passing above, the grotesque failings by corporate management in the United States which have been exposed over the last eighteen months have led to a heavy-handed rule based response by the U.S. Congress. Some ideas such as CEO and CFO certification of financial statements are worthwhile, but the Act also directs the enactment by the SEC and others of complex rules on numerous different areas, from audit committee composition and procedure to whistle-blowing by professional advisors. The rules when completed will be so detailed and voluminous that they are quite likely to produce a "technical compliance" approach. It is a reasonable prediction that the effort will ultimately be self-defeating.

The best way to enforce appropriate standards of corporate governance is for investors to avoid enterprises that do not exhibit adequate governance standards, and support those that do. I would go a step further. If it is indeed the case that a crisis of confidence in corporate management and boards of directors has impaired the ability of capital markets to operate as the engine of economic growth, then it is essential that those who have the biggest stake in the capital markets take some action to remedy the situation. There are after all only so many government bonds to go around, and the more investors flee to them the lower the yields will go. Pension and benefit plans' solvency and funding unavoidably depend upon adequate returns being available in the market. If indifference to proper corporate governance is destroying the markets, then institutional investors will have to do something about it. It is not enough to leave it to the enactments of securities regulators and policing by their enforcement arms (however great the prurient interest in the occasional "perp walk").

In the context of discussions about the desirability of socially responsible investing, we have all come to recognize that many of the values promoted by socially responsible investors dovetail readily with the objectives of more mercenary investors. It is possible that a fast buck can be made from the stock of a company that is indifferent to its environmental obligations, but long-term value cannot be built in that way. Cutting corners will catch up with the business, in all likelihood sooner rather than later. It is beyond the scope of this presentation to address the proper limits on the application of socially responsible values in determining the investments of pension and benefit plan assets. An overall caveat we have stated is that if the objective of the "investment" becomes to promote a "crusade" rather than to ensure an adequate and sustainable financial rate of return, then

there is a severe danger that the trustees may commit a breach of trust or that the assets of the plan will not be adequately safeguarded.

One might therefore question my assertion that institutional investors must take steps to promote the integrity of corporate management and the enterprises in which they invest. That is in one sense a crusade. However, even articulated in its narrowest way, the duty of trustees in relation to investment is to attempt to get the best financial return on the assets under their stewardship, commensurate with avoiding undue risk. Recent events have demonstrated that the integrity of capital markets is essential to the ability to earn adequate returns. The integrity of the market depends upon the integrity of corporate management and the culture of corporate governance. It also depends upon all the participants in the financial industry demonstrating integrity and proper ethical values.

It is not just the CEOs, other senior executives and directors of the failed enterprises who have contributed to the current malaise. Fundamental questions have arisen about the reliability of analysts' reports, insider trading and preferential participation in public offerings by those who can channel more business to investment dealers, which have contributed to the public's mistrust of the financial system. Institutional investors are such a large part of the capital markets that they can enforce adequate codes of practice if they make it clear that they will not deal with intermediaries who do not comply with them. I submit that they must do so, because if they do not, no one else can or will do so.

The key concept is accountability. Corporations that function well have promoted the need for accountability by executives, including the accountability of the CEO to the board of directors. The question that remains is, to whom is the board of directors accountable? In theory it is to the shareholders. In practice the board renominates itself on an annual basis and investors have no practical choice as to who is elected as a director, and it is unlikely to be a wise use of time and resources to engage in a proxy battle to put in a different slate of directors. I conjecture that a lot can be done short of that.

We are now accustomed to quarterly, if not more frequent, conference calls with senior executives, in which any broker or analyst can hear firsthand what is going on in the current quarter and (for those who prefer to take what passes for a long view in today's market) what may happen in the next

quarter. Yet, how often do institutional investors sit down with the chair of a corporate board and perhaps a couple of senior directors and talk candidly about their corporation's approach to governance issues? Would that not be at least as worthwhile as learning on a quarterly basis about monthly sales levels in a particular division? I believe that simple steps of that kind could produce some marked improvements in the extent to which corporate boards are accountable, and are perceived as being accountable, for their corporation's governance practices. Without such steps, corporate boards are ultimately accountable only to themselves. For some boards that is enough, but they are fortunate and comparatively few. All of us benefit by accountability, not just those to whom the accountability is owed, but those who are held accountable.

III. INVESTMENT MANAGEMENT

These thoughts lead back to some final thoughts about the role of the investment managers for pension and benefit funds, and the proper relationship between those managers and the trustees and administrative staff of plans. With the exception of a few very large funds (of which Ontario Teachers is one example), pension and benefit funds have not themselves taken a lead in challenging resolutions put before annual meetings of shareholders by their boards of directors. Certain investment managers (one example is Jarislowsky, Fraser) have taken initiative in this regard. Many investment managers now report on a quarterly basis on their proxy voting during the quarter, usually by reference to those situations in which they have opposed a proposed resolution. The resolutions opposed have typically been those to approve shareholder rights plans that lack certain features, and repricing of stock options. It is fair to say that on the whole institutional investors and investment managers did not oppose the widespread use of stock options in the late 90's that contributed to a number of the corporate scandals that have materialized. The institutions and investment managers were prepared to buy the proposition that it made sense to "align" the interests of management with shareholders.

Trustees of pension and benefit plans are unavoidably dependent upon their investment managers. This is true even in the case of very large funds that have brought a substantial part of the investment management role in-house. As a general matter, the duty of the trustees is to prudently choose and prudently monitor the investment managers. That can in practice degenerate into a proforma exercise of checking the returns realized over historical periods against an index or other benchmark. A good case can be made that that is not an adequate approach. The solvency and

stability of plans depends upon being able to achieve assumed rates of return over an assumed time frame. That obviously does not mean every year, because in a severe down market no one is going to be able to produce positive investment returns. However it is a reasonable proposition that investment strategies adopted for pension and benefit plans should aim to avoid the worst of the decreases in value in down markets, at the cost of missing out on the greatest increases in rising markets.

One test the trustees might currently perform is to look back over the quarter-by-quarter and year-by-year investment returns over the last four to five years and see whether the investment strategy has served the plan well. I acknowledge that this is a particularly difficult area of management for trustees, but achieving adequate returns over the long term is absolutely central to the success of the plan. Trustees will often feel ill equipped to judge how good a job the investment manager is doing. That cannot justify the trustees in proceeding on faith alone. Their staff and/or consultants should be able to assist them with an appropriate evaluation of the performance of the investment managers, and regular direct contact with the investment managers to discuss their approach to investment and the achieved results is essential.

In addition to dealing with the investment manager on that level, which is crucial to the governance of the plan itself, it would be appropriate under current circumstances for trustees to ask their investment managers for their views on the governance of corporations generally, and particularly of those corporations which make up a substantial portion of the fund's portfolio. The statements made earlier about the "investment" by institutions in good corporate governance hold equally true for investment managers.

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