Conducting a Governance Audit (Canada)

Author Contact Details: B. Bethune A. Whiston, Partner

Firm / Employer / Institution: Morneau Shepell Ltd.

Address: 895 Don Mills Road, Suite 700, Toronto, Ontario, CANADA, M3C 1W3

Phone Number: +1 (416) 383-6436

Email: bwhiston@morneaushepell.com

Author Contact Details: Tejash Modi, Principal

Firm / Employer / Institution: Morneau Shepell Ltd.

Address: 895 Don Mills Road, Suite 700, Toronto, Ontario, CANADA, M3C 1W3

Phone Number: +1 (416) 383-6471

Email: tmodi@morneaushepell.com

Pension plan governance refers to the formal framework that defines how the tasks and duties involved in the operation of a pension arrangement will be carried out. In order to properly assess the quality and effectiveness of an organization's pension governance, one needs to periodically engage in a review or audit. This paper highlights various aspects of a governance audit, including what a governance audit is, what its purpose may be, what it may cover, what can be done when problems are identified, and other considerations.

Introduction[1]

Pension plan governance refers to the formal framework that defines how the tasks and duties involved in the operation of a pension arrangement will be carried out. In other words, a pension plan governance structure focuses on describing what needs to be done, how it needs to be done and who needs to do it. It is this framework or structure, typically exemplified through a series of well documented policies and procedures, that assists an organization (and any committees or agents acting on behalf of the organization) to administer a pension plan in accordance with its terms as well as applicable law and any best practices guidelines that may exist.

In order to properly assess the quality and effectiveness of an organization's pension governance, one needs to periodically engage in a review or audit. This paper highlights various aspects of a governance audit, including what a governance audit is, what its purpose may be, what it may cover, who ordinarily would perform it, what can be done when problems are identified, and considerations regarding frequency and how the audit is paid for.

A pension governance audit is not rocket science, but there are a lot of interesting aspects to it and, as it relates to pension plans, when you delve into the detail it can get very complex. It is best to take a process oriented approach and have experts involved. The approach to doing a governance audit may be similar in many countries, but the specific legislative provisions, regulatory policies and best practice guidelines that an organization's governance is benchmarked against, would be expected to be very different from country to country. [2]

What is a Governance Audit?

As noted above, a governance audit is a review of a pension plan's:

- constating documents (i.e., the documents that create and support the plan);
- operating procedures and practices;
- delegation of the administrator's duties and responsibilities;
- investment management structure;
- service provider services; and/or
- documentation procedures[3]

What is the Purpose of a Governance Audit?

There is no one single perfect governance system. What is appropriate for one organization may not be appropriate for another. Although the exact nature of a governance audit may vary from plan to plan and from organization to organization, at their very core governance audits serve one or more of the following purposes:

---

[1] Certain portions of this paper are based on an article written by Peter Gorham, a former colleague of the authors', entitled "Performing A Governance Audit", Benefits and Pensions Monitor – April 2005, pp.33-35, and Chapter 27 of the Morneau Sobeco Handbook of Canadian Pension and Benefit Plans, 14th Edition, 2008, CCH Canadian Limited, entitled "Governance of Retirement Savings and Other Benefit Plans".

[2] Wherever appropriate, this paper makes reference to the requirements in Canada and in two of its largest provinces, namely Ontario, a common law jurisdiction, and Quebec, a civil law jurisdiction.

[3] Sommers, Jeffrey, "Commissioning a Governance Audit", Mondaq Business Briefing, March 21, 2007.

1. <u>Legal and Regulatory Compliance</u>

Although not a legal requirement, one of the main reasons to engage in a governance audit is to ensure that the terms of the pension plan as well as how the plan is administered are in compliance with applicable legislation and regulatory regimes and best practices guidelines.

Under the Ontario *Pension Benefits Act* (PBA), a pension plan administrator is first and foremost required to ensure that the plan and pension fund are administered in accordance with the statute and its regulations, as well as, to the extent there is no conflict with the legislative requirements, the terms of the plan documents themselves.[4] Moreover, plan administrators, and to varying degrees their employees and agents, are fiduciaries who owe fiduciary duties to the plan's beneficiaries. Pursuant to the PBA, the "administrator of a pension plan shall exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person".[5] Furthermore, the administrator "shall use in the administration of the pension plan and in the administration and investment of the pension fund all relevant knowledge and skill that the administrator possess or, by reasons of the administrator's profession, business or calling, ought to possess."[6] While the PBA expressly stipulates the administrator's duties, it offers little guidance on the means by which these duties are to be carried out.[7] A pension plan's governance framework serves to provide that guidance and, in turn, periodic governance audits serve to assist in ensuring that the framework enables, and continues to enable, the administrator to satisfy its statutory duties.

A governance audit can also assist in ensuring that plan documents and the way the plan is administered is in accordance with the minimum standards set out in pension legislation. The audit should include a review of administrative duties in this regard. Examples include: ensuring contributions are made within the time-frames set out in the plan and under applicable legislation; determining whether eligibility rules are adhered to; ensuring terminating or retiring members are provided appropriate portability options in a timely fashion; ensuring forms used by the administrator comply with minimum standards legislation; and confirming compensation used for benefit determination is accurate.[8]

Lastly, a governance audit can be useful in assessing whether the governance framework complies with directives and policies issued by applicable pension regulators and responds to any best practices guidelines issued by relevant associations and bodies. For instance, the Financial Services Commission of Ontario frequently issues policies on various plan administration topics such as record keeping/management and

[4] Subsection 19(1)
[5] Subsection 22(1)
[6] Subsection 22(2)
[7] The legislation in the province of Quebec, Canada's civil law jurisdiction, has provided more guidance on governance that the legislation of common law jurisdictions. Administrators of pension plans in Quebec are required to be committees with member representation, and these committees are required to adopt a set of by-laws which cover a number of governance related items.
[8] Sommers.

the duties of an administrator in responding to plan beneficiary complaints and inquiries; these policies elaborate on and clarify requirements under the PBA and its regulations and serve as a good indicator of what the regulator will require from a plan administrator in carrying out its duties.[9] Furthermore, best practices guidelines that ought to be considered as part of a governance audit include the various guidelines issued by the Canadian Association of Pension Supervisory Authorities (a national inter-jurisdictional association of pension regulators whose mission is to facilitate an efficient and effective pension regulatory system in Canada), such as the Guidelines for Capital Accumulation Plans, the Pension Plan Governance Guidelines and the Pension Plan Prudent Investment Practices Guideline, to name a few, as well as more globally, the CFA Institute's Global Code of Conduct for Pension Schemes and the Organization for Economic Co-operation and Development's Guidelines for Pension Fund Governance and Guidelines on Pension Fund Asset Management. While neither the pension regulator-issued policies nor the best practices guidelines have the force of law, these requirements and standards will inevitably be taken into account by courts in assessing a pension plan administrator's liability vis-à-vis its statutory and common law obligations.

2. Improving and Optimizing Pension Plan Administration

Regular governance audits of pension plans and their administration can also assist in improving and optimizing the administration process. A governance audit by an independent third party can identify legal compliance or administration problems so that appropriate remedies can be instituted before problems become difficult to manage and the ability of an administrator to carry out its fiduciary duties becomes compromised. In addition, a governance audit "forces the plan administrator to examine or re-examine plan administrator issues which are being raised during the course of the audit and which may otherwise not be brought to the attention of the administrator. For example the audit may determine that the individuals responsible for the day-to-day administration of the plan require a more thorough understanding of the plan's terms, which is something that the administrator may be unable to determine without the assistance of a review by an independent third party".[10] Lastly, the use of an independent third party will not only allow for an objective assessment of how the plan is being administered, but also enable comparisons to be made to industry benchmarks and best practices and facilitate the identification of measures that may improve and optimize the efficiency and efficacy of the administration.

3. Pre-emptive Identification, Assessment and Management of Risk

Regular governance audits of a pension plan will also allow for the pre-emptive identification, assessment and management of various plan specific risks such as investment irregularities or non-compliance issues, communication (or more precisely

[9] The Quebec regulator, la régie des rentes (the "Régie"), has also provided insight on governance issues in a number of publications. In particular, over the last decade, the Régie published a collection of four newsletters entitled, "Administering a pension plan well."
[10] *Ibid.*

miscommunication or misrepresentation) problems, funding deficiencies, etc. Ultimately, a failure to detect these and other issues early enough and thereby implement corrective measures may leave the fund, sponsor/administrator, officers and directors, or other persons involved in the administration of the plan susceptible to legal claims. Under the PBA, for example, every director, officer, official, agent or other person acting in a similar capacity may be found personally liable if the person causes, authorizes, permits, acquiesces or participates in the commission of an act that contravenes the PBA or its regulations, or fails to take all reasonable care in the circumstances to prevent the corporation or unincorporated association from committing such an offence.[11] A pre-emptive approach to risk may afford the plan sponsor/administrator the best defence to claims that it breached its fiduciary duties towards plan beneficiaries either under the governing pension legislation or common law.

What Should a Governance Audit Cover?

A governance audit can focus on various areas. It is important to identify the scope and the depth of an audit before starting. The more common types of audits include:

- High level overview – where the focus is on the policy-making, its implementation, and the structure of the governance system.
- Administration audit – where day-to-day administration is examined in detail for processes, accuracy, completeness, consistency, efficiency, compliance, and risks.
- Financial audit – where financial issues are reviewed and risks assesses. This looks at the investment process including manager selection and review as well as other financial issues such as contributions, corporate reporting, and the plan's financial position.
- Compliance audit – where the focus is on ensuring that the plan documentation and processes and procedures are compliant with and facilitate compliance with legislative and regulatory requirements.
- Benchmarking audit – where the focus is to compare aspects of the governance of the organization with an appropriate peer group.

Furthermore, special audits may be appropriate or even necessary in certain circumstances, such as:

- Pension plan conversions (from defined benefit to defined contribution or vice versa)
- Partial plan windups (becoming less of an issue now that various jurisdictions in Canada are removing partial wind-ups as an option for plan sponsors)
- Plan or organizational mergers
- Plan sponsor insolvency

Who Should Perform a Governance Audit?

Should a governance audit be conducted by an external third party such as a consultant, actuary or lawyer? This is not always necessary. Depending upon the purposes of the audit, the expertise of the personnel available to do the work and the budget available, certain audits,

[11] Section 110

more appropriately described as self-assessments, may be performed internally. Some situations where a knowledgeable internal person could effectively perform a self-assessment include:

- Documenting existing structures and the roles of the people and committees involved
- Checking calculations and communications for accuracy and completeness
- Where the people involved have experience with different processes and systems and can evaluate and make recommendations in an independent fashion
- Identifying plan risks, their potential impact, and control processes

An external third party with governance experience can be more effective for situations such as:

- Reviewing the current governance structure and preparing recommendations for improvements
- Reviewing processes and benchmarking them against best practices and/or industry averages
- Satisfying a board of directors or the senior pension committee that a thorough and independent review has been conducted
- Whenever there is any question as to the knowledge and ability of oneself or other internal personnel to impartially assess processes and practices
- In the event a special audit (described above) is necessary

Notwithstanding the fact that in certain circumstances self-assessments may be sufficient, there are some obvious advantages to having an independent experienced third party, such as an accountant, actuary, consultant or lawyer, conduct the governance audit. The third party will provide a fresh perspective on the plan documentation, administrative structures and operational procedures and processes, unaffected by internal culture or politics. While many internal people are knowledgeable about good governance, it can often be with limited experience of alternative structures and processes. As a result, the current system may get great marks for completeness, but it may be inefficient or ineffective for the organization.

In addition, having a governance audit supervised or managed by legal counsel, either in-house or external, should also be considered. Legal counsel, particularly counsel with pension law experience, can assist in identifying compliance issues as well as determining an appropriate strategy for dealing with these issues. Moreover, the participation of legal counsel, if not in the actual audit at least in the requesting of the audit and the receiving of the audit report, has the best likelihood of affording the organization the protection of solicitor-client privilege. Solicitor-client privilege will be particularly useful if there is a chance of a lawsuit.

What Can be done when Problems are Uncovered?

Some common types of problems uncovered by a governance audit include:

- Lack of understanding regarding the differing roles of plan administrator and plan sponsor
- Ineffective focus of the Board on detailed investment issues to the detriment of policy development

- Lack of documentation of the governance structure and processes
- Lack of appropriate delegation and oversight mechanisms
- Service provider contracting issues (i.e., lack of a contract, out-of-date contact, non-competitive terms)
- Benefit processing issues (e.g., inconsistent or incorrect interpretation of plan terms, records management and retention, etc.)
- Poor or improper documentation of plan administration practices and procedures
- Plan terms or administration being inconsistent with the terms of an applicable collective agreement
- Ineligible expenses being paid from the plan
- Issues with member communications (i.e., being out-of-date, inaccurate or missing deadlines)
- Other member-related issues (i.e., eligibility, monitoring investment behaviour, providing investment advice versus information)
- Funding issues (especially with multi-employer plans or when a plan sponsor is facing financial difficulties)
- Investment issues (e.g., the setting of benchmarks, performance measurement, manager selection and supervision, out-of-date investment policies, etc.)
- Conflict of interest issues

A written report is an essential product of an audit, even if it is often only issued in draft form. It serves to document the base from which the organization is starting, as well as the fact that the organization has recognized its obligation (whether fiduciary or not) to recognize and strive to achieve good governance. Once a report has been prepared, the next step should be a full understanding and evaluation of the recommendations in terms of importance and cost. They can be prioritized and an orderly process established for implementation. It is not always necessary to implement all recommendations. But where recommendations are not implemented, it is wise to document the consideration of the recommendation and the reason why the organization has decided not to respond to it (i.e., the recommendation may involve a high cost with minimal benefit).

Frequency of an Audit and Who Pays for it?

Many plan sponsors/administrators wait until a problem has occurred before commencing a governance audit. By then it may be too late. A governance audit could be very valuable if conducted on a regular (even if infrequent) basis or on a dynamic basis when there is suspicion that all is not as it should or could be. Probably this will be about every five to ten years. Another time to consider an audit is following a significant change in organizational structure or personnel. If the recommendations of an audit report have largely been implemented, the benefits should be evident long into the future.

Governance audits can be quite costly. The decision of who will bear the expense of the audit and report is not something that should be taken lightly. If the cost is paid from the pension fund, it may be argued that the report is the property of the pension plan and therefore should be disclosed to plan members. On the other hand, if the cost is paid directly by the plan sponsor, from general revenues for example, a strong argument may be made that the report is not the property of the pension plan and therefore not subject to plan membership disclosure. Minimizing disclosure may enable the sponsor/administrator to address problems and implement corrective measures without having to be bogged down by optics. Regardless of whether the report is disclosed to the plan membership or not, the administrator's role as fiduciary will require that it assess and act on the problems and recommendations raised in the report in a prudent, effective and timely manner.

Conclusion

As noted at the outset, a pension plan governance audit is not rocket science. However, its value in monitoring legal and regulatory compliance, improving and optimizing plan administration and facilitating the pre-emptive identification, assessment and management of risk cannot be overstated. At its heart, it is an opportunity to assess and improve on the quality and effectiveness of current practices and procedures that enable a plan administrator to satisfy their duties efficiently, prudently and transparently and thereby plan for future successes.