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Memo

Date:	November 8, 2017
To:	Ed Hankins, Region of York Marian Simulik, City of Ottawa Stephen VanOfwegen, Region of Peel Jeff Jackson, City of Mississauga Gerald Boychuk, City of Hamilton
From:	Marcus Turner and Paul Timmins
Copies:	Scott MacDonald
Subject:	**Municipal Governance**

Executive Summary

- Based on our view of governance structures, we believe that the proposal by the Ontario government to require an independent board for any municipality that wishes to adopt the prudent investment approach risks imposing a level of governance that is more complex than what is optimal for many municipalities given the smaller size of investable assets and the simpler portfolio that they are likely to consider and which will unnecessarily increase the governance budget needed to operate the investment program.

- We recommend that each municipality have the flexibility to create the governance structure that accurately reflects the characteristics of its current, and anticipated, investment portfolios as well as its internal resources.

- In the same sense that a lower governance framework introduces risk when managing a complex investment program, implementing a high governance structure for an investor with a smaller investable asset base and limited internal resources introduces additional operational and cost burdens which may detract from long-term performance.

Background

Recent amendments to Ontario Regulation 610/06 under the City of Toronto Act 2006 provide the framework for Toronto to invest its non-operating funds in a manner consistent with the prudent investor standard. The prudent investor standard has been in place in Ontario for pensions and endowments for many years, and provides guidance for managing investment portfolios. The standard is not prescriptive, but requires a fiduciary managing other people's money, to exercise the necessary skill, diligence and judgement of a reasonable person when assessing the risk and rewards of an investment strategy. The amendments also provide broad considerations for assessing an investment including the need for liquidity, income and preservation of capital.

The amended regulation affords the City of Toronto (the "City") much greater investing flexibility by extending its opportunity set beyond the restrictive list of low risk permissible investments that was previously the only option under the regulation.

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In concert with greater investment flexibility the amended regulation requires Toronto to establish an Investment Board and delegate to that board the power to make investment decisions. The regulation also requires that the board to be comprised of individuals who are not connected with the city by prohibiting the appointment of any officer or employee of the city (except the treasurer) and any member of the city's council. Board members will receive remuneration for their participation

The Ontario government has posted a proposal on the Regulatory Registry which proposes changes to Regulation 438/97 under the Municipal Act. That proposal indicates that other Ontario municipalities who wish to move away from the restricted list approach and adopt a prudent investor approach to manage their non-operating funds would be required to establish a governance structure similar to the one that the City of Toronto is developing – an investment board composed of independent members other than the treasurer. You have asked for our thoughts on different governance models for institutional investors and the appropriate circumstances for each.

Willis Towers Watson has extensive experience consulting on investment strategy and the related governance structures with multiple organizations that adhere to the prudent investor model and in this brief note we offer some high level thoughts on governance structures. We do not explore the unique nature of each municipality's investable assets since our objective is to provide an indication of practical governance frameworks that reflect the resources and materiality of the underlying investment portfolios.

Why Focus on Governance?

In institutional investment, governance describes the system of decision-making and oversight used to invest the assets of a fund. The responsibility for this role lies with fiduciaries who are faced with both high-level issues (where they will typically take responsibility) and more detailed implementation actions (where delegating to others is more likely to be used, and the fiduciaries' role becomes monitoring those actions).

We will use the term "Governance Budget" to describe the time and money that an institution is willing to commit to the management of its funds that is best matched to the complexity of their investment program, with likely shortfalls if mismatches exist. The institutional investor aims to create value by customizing their governance budget to accurately reflect the complexity of their portfolio as well as their investment beliefs, processes and internal organizational structure. Two common shortfalls are building too much governance in which case the investment strategy is likely under-used while the governance structure is more complex and costly than necessary and, more commonly, institutional investors try to undertake too much complexity with a limited governance budget.

Willis Towers Watson has evaluated and authored empirical studies on governance models, which are complemented by our practical observations with client experiences, and we believe the linkage between an optimal governance structure, and the improvement of a portfolio's long term return, is material and sustainable. Importantly, institutions generally benefit by developing a governance structure that reflects the intersection between their governance budget and the complexity of their investment program.

Improving governance is not a one-time exercise. A best-practice organisation will work at methodically adjusting its governance to reflect changes in the complexity of the assets and their uses. If properly executed, the ongoing costs to implement better governance are more than offset by the portfolio's net gains.

Categorizing Governance Structures

Based on our experience, we set out four broad categories of governance structures each of which can be successful if it corresponds with the appropriate level of Governance Budget. Of course, in practice there is a wide range of different governance structures, many of which will display characteristics of more than one category. Different governance models will incur different costs and time demands; there can be many combinations of internal and external resources.

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The following chart provides an overview of the four-factor governance framework; the different categories are described in greater detail below.

Governance Budget	Internal/External Resources	Expert Committee Oversight	Internal Asset Management	External Asset Management	External Advice
Advanced	Fully internal	Yes	Yes	No	No
Mid-Range (Hybrid)	Mostly internal and some external	Possibly	Yes	Possibly	Limited/not mandatory
Mid-Range	Limited internal and mostly external	Possibly	No	Yes	Yes
Limited	Mostly external	No	No	No	Yes

Advanced Governance Budget

This governance structure may be appropriate when there is a combination of experienced internal investment resources and an investable portfolio that is large enough to justify the compensation necessary to attract and retain these investment experts. In this model, the institution operates all aspects of their investment program including investment policy development, portfolio construction, investment management and ongoing oversight and reporting. An advanced governance model would be appropriate for a complex portfolio structure consisting of multiple actively managed asset classes.

Typically, an institution that has built out their own internal investment resources will have oversight from an expert board; these board members are often remunerated for their time. This model requires a significant investment in human capital and will employ a large number of specialized experts. Generally, an institution with an advanced Governance Budget will not retain external investment management or third-party advice and oversight.

Institutions in this category generally have very large, and often complex, investment portfolios.

For example, OMERS is responsible for investing and administering the plan assets for over 470,000 current and retired Ontario employees and their survivors, and manages assets in excess of CAD80bn. OMERS has an advanced Governance Budget and have developed internal expertise to manage their investments in asset classes which include natural resources, infrastructure, real estate and private equity.

Mid-Range (Hybrid) Governance Budget

In this model, the institution establishes some internal investment expertise for managing aspects of their portfolio and outsources other investment management functions where they do not have the required expertise. In many cases, such as insurance companies and large municipalities, institutions will retain internal expertise in the fixed income portfolio and retain third party management for other asset classes, including equities and alternatives, where the expertise is particularly expensive to acquire and retain. As with the advanced Governance model, the institution will generally retain ownership for developing the investment strategy and portfolio structure, although they may seek input from external advisors on a limited basis. A mid-range (hybrid) model is often appropriate for a portfolio structure consisting of multiple actively managed asset classes.

Generally this structure has less than ten fully dedicated internal resources and the assets, although significant, are often smaller than institutions that would employ the Advanced Governance Budget.

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Typically, institutions in this category will have oversight from an internal Investment Committee that reports to the Board of Directors or Council of the institution or municipality. The Committee is often comprised of individuals with some financial background (such as the CEO or Treasurer), who have a breadth of experiences but may not have the depth of experience typical in the Advanced Governance structure. As such, in addition to possibly retaining third party investment expertise, these institutions may retain third-party investment advisors to provide advice on portfolio strategy, and construction as well as on-going oversight of external managers.

Generally, these institutions have a large investment portfolio which can support the internal resourcing. In some cases the model is transitional; the institution's investment portfolio is growing and there may be a longer term objective to move additional investment functions in-house over time and ultimately shift to the Advanced Governance model.

Mid-Range Governance Budget

Institutions in this category have internal resources dedicated to hiring and retaining third party investment managers, as well as developing and overseeing the institutions' investment strategy and portfolio construction, but they will not directly manage the institutions' money. Similar to the preceding framework, the mid-range model is often appropriate for a portfolio structure consisting of multiple actively managed asset classes.

Generally this structure has a smaller internal infrastructure: often no more than five individuals. The governance structure is similar to the Hybrid model – there is some oversight from an internal investment committee that will typically include members with some financial expertise (such as the CEO or Treasurer). These institutions will have experience with investment strategy development, but often will rely more heavily on third-party advisors in developing a strategy that reflects their specific financial goals and objectives.

The assets under management can still be significant although the portfolio may not be as complex as some of the higher governance models. Nevertheless, institutions with smaller portfolios will often employ this model to improve their investment performance through an accentuated governance structure.

Limited Governance Budget

In this structure the institution will typically limit the internal resources devoted to managing the plan and look to an outsourced, or delegated model to optimize their governance budget. The institution will provide the company's financial framework, and specify their risk and financial tolerances and objectives, but they outsource all aspects of the investment program including investment policy, portfolio construction and investment management to a third party expert. A limited governance model may be suitably appropriate for a less complex portfolio structure consisting of a limited number of asset classes which may be invested passively.

Typically, there will be very limited, or no internal resources utilized in this structure; however, an internal investment committee (which generally includes the CEO) is typically established to monitor the progression of the third-party in achieving the institution's specified goals.

Historically, smaller institutional investors have explored this structure; however, there has been a trend for larger organizations to outsource this aspect of their business to access a governance model that employs dedicated investment professionals.

The table in Appendix A provides a summary of the functions described in the preceding section under the various governance models.

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Comments on Alternate Governance Structures

Above we outlined a range of potential governance structures starting from the highest governance, fully internal team and moving to the lowest governance structure where significant external advice is required.

The decision to employ full internal resources, or to outsource resources - and the extent of that outsourcing- will characterise the model employed. Empirical studies demonstrate the connection between improved performance and greater governance, but this does not suggest that the highest governance structure should be the default aspirational goal. In fact, depending on the circumstances, a lower governance model may be more appropriate for some organizations within the context of their size of the portfolio, the availability of internal resources and the complexity of the investment program.

Developing a high governance model may be appropriate if an institution has the capabilities to recruit and retain internal resources with the requisite investment management skills, if the investment program is significant in size. In addition to the complexity of building out an internal investment management organization, this can create HR issues around the level of remuneration as the institution will compete directly with investment consultants and managers for these individuals. Nevertheless, institutions with significant assets can justify the commitment of capital and resources, and the appropriate oversight, as this higher level of governance will typically improve risk and return over the long term.

In contrast, institutional funds that are smaller in size may benefit from a structure that outsources some, or all, of the investment management activities. This addresses some of the primary challenges with internal resourcing, and provides access to a greater breadth of specialist resources. This model does not require as exhaustive of a governance model.

So, in practice, there is a “size factor” at work. External delegation works for funds that cannot achieve the excellence and economy of scale to make an in-house Chief Investment Officer (CIO) the answer – that is the small-to-large funds, but not the very large.

Recommendations

These four models provide a useful framework for considering the most effective way to exploit different investment opportunities recognizing differing governance budgets. One common fault is for an institution to be overly ambitious in terms of the complexity of the investment structures in place relative to governance. As a short-term measure, an institution is best served by focusing on aligning its investment arrangements with existing governance. In the long term, however, the institution might well set its sights on improving governance, laying the foundation for the successful exploitation of more complex strategies if that is what it needs.

We recommend that each municipality have the flexibility to create the governance structure that accurately reflects the characteristics of its current, and anticipated, investment portfolios as well as its internal resources. The alignment of the investment arrangements with the governance structure should guide each municipality’s operating framework. In the same sense that a lower governance framework introduces risk when managing a complex investment program, implementing a high governance structure for an investor with a smaller investable asset base and limited internal resources introduces additional operational and cost burdens which may detract from long-term performance. In our experience, institutions will derive the greatest benefit from developing a customized governance framework that suits their needs. Done correctly, this accurately reflects the available resources and optimizes where the governance budget is spent without diminishing a suitable level oversight and risk management.

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An independent body is sometimes seen as a way to reduce the risk that conflicting interests may affect the decisions made. In the area of registered pension plans, the pension standards legislation in Ontario and many other Canadian jurisdictions permits an employer to act as both the sponsor of the pension plan (a non-fiduciary role) and as the administrator of the pension plan (a fiduciary role) The potential for conflicts is controlled through the imposition of the fiduciary obligations placed on the employer when acting as administrator and, by most accounts, that structure serves its purpose well.

Based on our view of governance structures, we believe that the proposal by the Ontario government to require an independent board for any municipality that wishes to adopt the prudent investment approach risks imposing a level of governance that is more complex than what is optimal for many municipalities given the smaller size of investable assets and the simpler portfolio that they are likely to consider and which will unnecessarily increase the governance budget needed to operate the investment program.

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 39,000 employees in more than 120 countries. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas — the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

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APPENDIX A – Alternate Governance Models

Governance Budget	Internal Expertise	Strategy Development	Portfolio Construction	Investment Manager Selection	Program Oversight
Advanced	▪ Professional investment specialists. ▪ External expert Board oversees all aspects of the program.	▪ Internal expertise exists to analyse investment strategy within context of institution's financial objectives and constraints and develop appropriate investment policy, ▪ Management and expert Board will approve the Investment Policy.	▪ Internal investment experts will develop portfolio structure to optimize the implementation of the investment strategy.	▪ In this model internal expert resources manage all aspect of the investment portfolios.	▪ The investment program is overseen by the external expert Board.

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Governance Budget	Internal Expertise	Strategy Development	Portfolio Construction	Investment Manager Selection	Program Oversight
Mid-Range (Hybrid)	▪ Professional investment specialists. ▪ Internal committee, with some financial expertise, oversees all aspects of the program.	▪ Internal expertise exists to analyse investment strategy within context of institution's financial objectives and constraints and develop appropriate investment policy, ▪ May seek external advice to complement analysis. ▪ Management/ Board/Council will approve the Investment Policy	▪ Internal investment experts will develop portfolio structure to optimize the implementation of the investment strategy. ▪ May seek external advice to complement analysis.	▪ Internal expert resources manage some aspects of the investment portfolios. Third parties are used where internal expertise does not exist. ▪ With advice from internal resources, the investment committee will approve hiring of all third-party investment managers. ▪ Internal specialists are responsible for changing external managers as required.	▪ The investment program is overseen by the Treasurer/ CFO and/or an investment committee. ▪ External advisor may be sought but not mandatory.

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Governance Budget	Internal Expertise	Strategy Development	Portfolio Construction	Investment Manager Selection	Program Oversight
Mid-Range	▪ Professional investment specialists. ▪ Internal committee, with some financial expertise, oversees all aspects of the program.	▪ Internal expertise exists to analyse investment strategy within context of institution's financial objectives and constraints and develop appropriate investment policy, ▪ May seek external advice to complement analysis. ▪ Investment committee will approve the Investment Policy.	▪ Internal investment experts will develop portfolio structure to optimize the implementation of the investment strategy. ▪ May seek external advice to complement analysis.	▪ Third party investment managers are used to implement all aspects of the program. ▪ With advice from internal resources, the investment committee will approve hiring of all third-party investment managers. ▪ Internal specialists are responsible for changing external managers as required.	▪ The investment program is often overseen by an external investment advisor who reports to the investment committee or Treasurer/ CFO.
Limited	▪ Few, or no, dedicated internal resource with limited investment experience. ▪ Internal committee, with some financial expertise, oversees all aspects of the program.	▪ Investment committee provides context of institution's financial objectives and constraints and third party expert develops appropriate investment policy.	▪ Third party will develop portfolio structure to optimize the implementation of the investment strategy.	▪ Delegated investment managers are used to implement all aspects of the pogrom. ▪ The delegated investment manager is responsible for all changes to underlying investment managers.	▪ The delegated investment manager reports on the progress of the program to the investment committee or Treasurer/ CFO.

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APPENDIX B - BIOGRAPHY

Marcus Turner, CFA, FRM

Director and Senior Investment Consultant, Willis Towers Watson

Marcus Turner is Director, Senior Investment Consultant in the Investment Consulting line of business of Willis Towers Watson. Among other responsibilities, Marcus helps large Pension Plans and Foundations explore Delegated Investment Service in the Canadian market.

Marcus has over 10 years of investment consulting experience and consults on a wide variety of issues including implemented OCIO solutions, asset allocation strategy, and investment structure optimization. He has worked with a variety of clients including Pension Plans, Foundations and Municipalities with assets ranging from $100 million to over $5 billion.

Prior to his investment consulting experience he had the opportunity to work in the investment management area of a large multinational insurance company where he was responsible for building and running the institution's proprietary trading desk.

Marcus graduated from the University of Toronto with a major in economics. He is a CFA Charterholder and a member of the Global Association of Risk Professionals. Marcus is currently the Programming Chair of the Toronto CFA Board and was formerly Chair of the CFA Portfolio Management Committee. He also chairs the Risk Management Subcommittee of PMAC.

Marcus specializes in alternative asset class research and has expertise in assessing currency, infrastructure and private equity managers as well as trends and developments in these asset opportunities. A frequent industry speaker, he has spoken on the role of infrastructure in pension portfolios and how to assess managers in this rapidly evolving space.

PAUL TIMMINS, B.A., LL.B.

Senior Consultant, Willis Towers Watson

Paul is a senior consultant in the Retirement Practice of Willis Towers Watson within the legal and governance group. He has 32 years of experience and has spent the last 28 years with the firm.

Paul works in the Retirement Practice, providing advice on plan design, governance, legislative compliance, plan documentation, and related issues. His specialties include plan design (particularly where that intersects with governance structures), tax effectiveness and alternate funding models.

Paul serves a variety of clients in manufacturing, natural resources, financial services, public sector, and media. His experience includes working with management, unions, joint boards/committees

Paul has spoken regularly at conferences and continuing education programs over the years. He has also served on the executive of the Pension Section of the Ontario Bar Association and as a member of the Pension Advisory Committee for the Registered Plans Division of the Canada Revenue Agency.

Paul is a member of the Law Society of Upper Canada and was called to the Bar in 1984 after earning a B.A. from the University of Toronto and an LL.B. from Queen's University. Prior to joining the firm Paul spent four years in the private practice of law specializing in labour and employment law.