Starting in 2016, Statements of Investment Polcies and Procedures must disclose how environmental, social, and governance (ESG) factors are considered when investing plan assets

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Because small and mid-size pension plans do not always have a pension lawyer on retainer, Actuarial Solutions Inc. has invited me to share my views on the emerging requirements in investment policy in respect of environmental, social, and governance factors.

Beginning January 1, 2016, the administrator of an Ontario registered pension plan must not only file the plan's Statement of Investment Policies and Procedures (SIPP) with the Superintendent of Financial Services of Ontario, but the SIPP must also contain information about whether environmental, social and governance (ESG) factors are incorporated into investment decisions and, if so, how. Since there may be legal consequences that flow from taking or not taking non-financial factors into account, this will require administrators to consider carefully how best to respond to this requirement.

To quote the 2008 Ontario Expert Commission Report, the legal problem is that "it remains somewhat uncertain precisely how, in practical and legal terms, the decisions of … administrators to pursue socially responsible investment can be reconciled with their duty to maximize the plan's investment returns for the benefit of its active and retired members." In other words, depending on the circumstances, an administrator may be found to be in breach of fiduciary duty for either taking ESG factors into account, or not taking ESG factors into account!

How should administrators deal with this disclosure requirement? The starting point is for administrators to have a better understanding of their legal duty and, a better understanding of what ESG means in the context of the investment of their specific pension funds. It's my experience that the issue of ESG as an investment consideration is not well understood. It doesn't help that ESG is mixed up with principles of responsible investment (PRI), socially responsible investment (SRI) and ethical investment.

The legal duty is driven by three main considerations.

First, income tax rules stipulate that the primary purpose of a registered pension plan must be to provide lifetime pension benefits. It is not supposed to be a fund to pursue other social goals.

Second, the general common-law rule is that where the purpose of a trust is to provide financial benefits for beneficiaries -- as is clearly the case in a plan to provide lifetime pension benefits -- the best interests of the beneficiaries are normally their best financial interests. This raises a concern about the appropriateness of taking into account non-financial criteria, such as ESG factors when evaluating investments. The relevant case law makes it fairly clear that ESG factors may be considered to break a tie between investments with the same financial metrics. It is not so clear on other uses.

Third, are considerations relating to the duty of prudence – the care, diligence and skill that a person of ordinary prudence would exercise in dealing with the property of another person. This prudence test turns the ESG issue into one of relevance. Where ESG factors relate to financial performance, financial risk mitigation and financial sustainability, not only will it be appropriate to take them into account, it may be necessary to do so. Since prudence is largely a process driven assessment – where the ‘right process’ is more important than getting the ‘right answer’ – it is possible that ESG factors could provide an additional lens or spotlight to enhance understanding or insight of financial metrics. If that is the case, then not only will such factors be permissible, but in some circumstances it may be argued that ESG must be taken into account. In other words, if an ESG factor can reasonably be expected to have a material impact on the financial performance of a particular investment, either in assessing value or risk mitigation, it will not only be a permissible consideration, but it may be a required consideration.

What is meant by ESG?

First of all, taking ESG considerations into account should not be considered a “tree-hugging exercise.” Nor should ESG be seen as a focus on ethical investing *per se*. That is something else entirely. Taking into account ESG factors does not mean avoiding investment in “sin” industries like pornography, gambling, alcohol, tobacco, or landmine production.

> If an administrator wishes to impose an “ethical screen” to avoid specific types of investment, it would be safer from a legal perspective to reflect that in its foundation documents, like the plan text or trust agreement. Setting it out in a SIPP may not be sufficient, even where it might be presumed that such a screen would be supported by the plan’s beneficiaries; for example, screening out investment in tobacco companies for a plan covering employees of the Cancer Society or Heart and Stroke Foundation. The SIPP is merely a policy – a record to guide and disclosure intended fiduciary conduct. It is not the document that creates the law that governs fiduciary conduct.

So what do we mean by ESG, if it’s not an ethical screen? This is something the administrator may have to define for itself because neither the legislation nor FSCO provide any guidance about what is meant by ESG factors. ESG factors are frequently regarded as having one or more of the following characteristics:

- Areas of public concern (e.g., genetically modified products, landmine production);
- Qualitative concerns not readily quantifiable in monetary terms (e.g., corporate governance);
- Externalities not well captured by market mechanisms (e.g., environmental pollution);
- Subject to regulatory interest, constraints or legislation (e.g., greenhouse gas emissions); and
- Issues arising within the supply chain (e.g., frequent violations of labour standards or human rights, and poor or dangerous working conditions, including issues with downstream suppliers).

So how are these factors relevant? As noted above, if an ESG factor can reasonably be expected to have a material impact on the financial performance of a particular investment, either in assessing value or risk mitigation, it will not only be a relevant consideration, but it may also be a required consideration. Accordingly, it is doubtful that many SIPPs will simply state that ESG factors will not be taken into account.

It is this potential requirement to take ESG into account that is so troublesome. How do pension fund administrators get access to that information? Lack of information and reliable ESG analytics may have been an excuse 10 years ago, but growing investor interest in ESG performance data has resulted in greater disclosure of such factors in regulatory filings made by public corporations. Demand for ESG analytics has also resulted in a number of reliable providers. For small and medium sized pension funds that do not make direct investments, their ESG disclosure may simply be to state that they will prefer managers that are able to consider ESG factors when selecting investment portfolios. In defined contribution plans that offer member investment selection, it may mean adding ESG or socially responsible funds to the menu of investment options, or it could simply mean disclosing how and to what extent ESG factors are taken into account under existing investment options.

The fact that there is mounting evidence that consideration of ESG factors is becoming more important to pension fund investors is also important. While administrators cannot always assume a herd mentality will protect them, the process driven assessment of fiduciary behaviour often depends on what are perceived to be best practices – i.e., what is the herd doing? There is increasing evidence that the herd is taking ESG factors into account. What the leaders do is also relevant. Many of Canada's largest pension funds appear to have embraced ESG for some time.

The governance aspect of ESG also brings into question the relevance of shareholder advocacy and corporate engagement strategies that could be exercised through the retention or delegation of voting rights acquired through plan investments. Accordingly, administrators should also ensure that their ESG disclosure is consistent with their proxy voting policy which must also be set out in the SIPP.

So in summary, what do plan administrators need to do?

1. Administrators need to be informed of what ESG considerations entail. They cannot make decisions about whether to take ESG factors into account if they don't know what that means. So it will require some learning that might include obtaining and reviewing evidence relating to the correlation of financial success and ESG considerations. It should also involve a discussion with consultants and legal counsel with a view to defining what the relevant ESG considerations are or should be and the extent to which their particular fund or investment managers can take such factors into account. Until they do this, administrators cannot properly consider whether or to what extent ESG factors can be referenced in the SIPP.

2. Administrators must then reach a considered decision on whether and to what extent ESG factors will be referenced in investment selection. The discussion and any decision ought to be properly reflected in the SIPP and in the minutes of the meeting at which the SIPP is adopted. This includes consistency with proxy voting statements in the SIPP.

3. Where administrators are in fact imposing ethical screens, they may wish to consider consulting legal counsel about what changes to their foundation documents may be necessary to ensure the screens are legally allowable.

4. Finally, administrators must take action or ensure appropriate action is taken and monitored. This may mean changes to reporting requirements of fund managers or other service providers. Where the plan is a defined contribution plan under which members are allowed to make investment selections, this may mean adding or providing

ESG investment alternatives, or disclosing how ESG is integrated into the existing options.

The disclosure requirement under the Ontario pension regulations arises out of a growing recognition that many plan administrators and plan beneficiaries want to be satisfied that their pension funds are not only profitably and securely invested, but that they are invested in companies that behave as good corporate citizens. There is also some evidence that good corporate citizenship results in better financial results and sustainability of financial results. But from a legal perspective, the very act of disclosure itself will be written evidence of appropriate fiduciary behaviour. Since it is not entirely certain that non-financial factors can be taken into account by fiduciaries providing financial benefits, administrators ought to consider the parameters of this issue carefully, and act accordingly.