Ontario's new law requiring pension funds to disclose their approach to ethical investing: Panel discussion

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Agenda

1. Overview of Legal Requirements
   - Randy Bauslaugh, McCarthy Tétrault LLP

2. Considering and Implementing ESG
   - Heather Lang, Sustainalytics

Ontario Investment Regulations:

SIPP and statements to members, deferred members and retirees to include information as to whether, and if so, how, ESG factors are incorporated

- SIPP: must be filed within 60 days of earlier of
  - (i) January 1, 2016 and
  - (ii) date of registration of plan
- First statements: with ESG reference:
  - Plan registered before 2015 – by July, 2017
  - Plan registered after 2014 – within 18 months of registration

Members, deferreds, and retirees can request SIPP and inspect copies filed with regulator

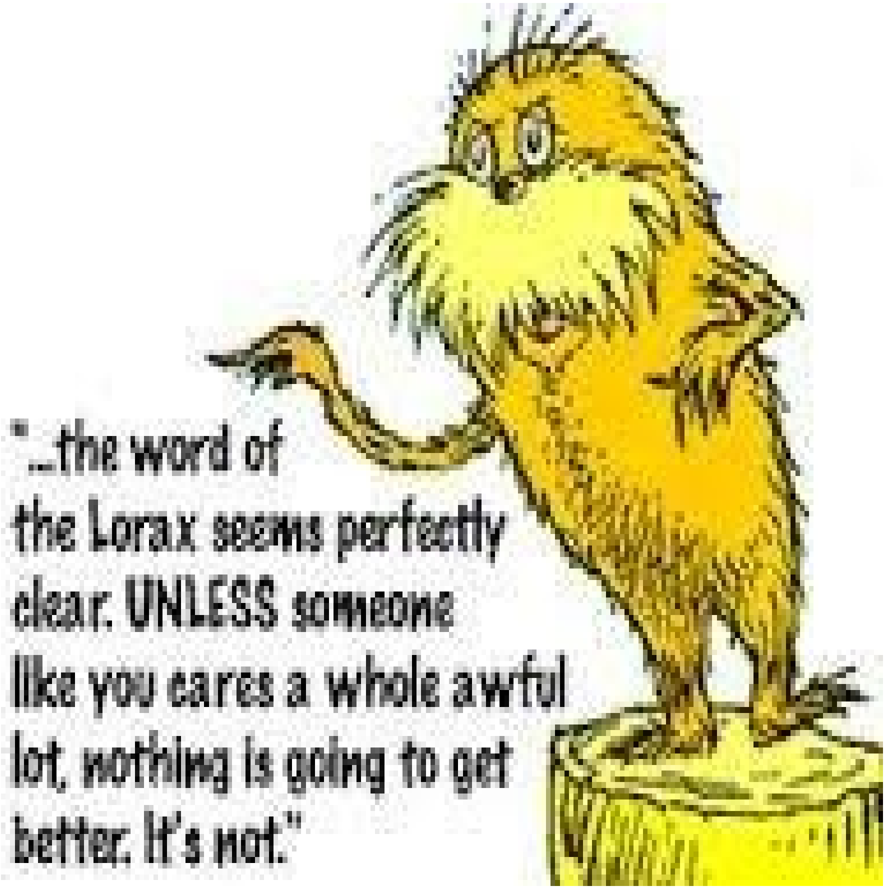
ESG factors – What are they?

Environmental

Social

Governance

… and **SRI/PRI ?**



ESG Factors: Define or Describe?

- Areas of public concern (e.g., genetically modified products, climate change, landmine production, consumer protection, animal welfare);
- Qualitative concerns not readily quantifiable in monetary terms (e.g. corporate governance, management structure, executive compensation);
- Externalities not well captured by market mechanisms (e.g., environmental pollution, waste disposal, sustainability, goodwill);
- Subject to regulatory interest, constraints or legislation (e.g., greenhouse gas emissions, nuclear energy, minimum standards compliance); and
- Supply chain issues, including downstream suppliers (e.g., violations of labour standards or human rights, poor or dangerous working conditions).

The Legal Dilemma: Can non-financial factors be taken into account ?

Three main concerns:

1. **ITA Regulations, section 8502 (a) primary purpose –**
   the primary purpose of the plan is to provide periodic payments to individuals after retirement and until death in respect of their service as employees.

2. **Common-law**
   Must act in best interests of plan beneficiaries
   "… *when the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests." -- Cowan v. Scargill (1984)*

The Legal Dilemma:

3. Prudence:

Common-law and pension standards:

"*care, diligence and skill that a person of ordinary prudence would exercise in dealing with the property of another person*."

Right process vs. right decision

Relevant considerations vs. irrelevant considerations

Are ESG factors relevant to the purpose of the trust, i.e., to provide lifetime financial benefits?

Member preferences?

The Law in a Nutshell

1. **Use as "tie-breaker"** -- allowed

2. **Use as a "lens"** -- allowed (maybe required)
   If relevant, <u>may/must</u> consider
   If not relevant, must not consider

3. **Use as a "screen"** -- depends
   Authorized by plan documents (yes)
   Authorized by SIPP only (doubtful)
   Beneficiary wishes/survey (doubtful)

Manitoba:

Section 28.1(2.2) of the *Pension Benefits Amendment Act* (Manitoba)

28.1(2) The administrator of a pension plan shall exercise the care, diligence and skill in the administration of the plan and the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person.

28.1(2.1) The administrator of a pension plan shall invest the assets of the pension fund, and manage those investments, in accordance with the regulations and in a manner that a reasonable and prudent person would apply in investing and managing a portfolio of investments of a pension fund.

28.1(2.2) Unless a pension plan otherwise provides, an administrator who uses a non-financial criterion to formulate an investment policy or to make an investment decision does not thereby commit a breach of trust or contravene this Act if, in formulating the policy or making the decision, he or she has complied with subsections (2) and (2.1).

Federal Investment Rules:

1. **Section 7.1(1)(f) of the *Pension Benefits Standards Regulations***
   - SIP&P to indicate retention or delegation of voting rights acquired through plan investments
2. **ESG disclosure should be consistent with proxy voting policy**
   - i.e., the "G" in ESG
3. **SIPP Exemptions for "Member Choice Plans"**
   - Application to Ontario?

The Legal Consequences

Failure to Disclose

= violation of Ontario PBA

= fines and penalties

Failure to <u>properly</u> disclose

FSCO is not likely to assess quality of statement

Improper disclosure is evidence of violation of the standard of care

What Administrators Should Do

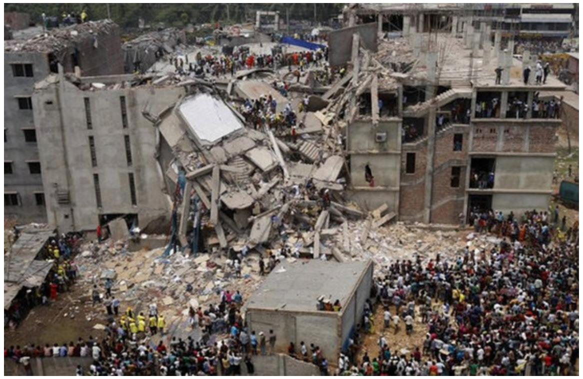
1. **Conduct research and obtain expert advice**

    - Employ proper methods
    - Exercise independent judgment
    - Study advantages and disadvantages
    - Due diligence
    - Retain qualified experts
    - Obtain complete, up-to-date information

What Administrators Should Do

2. Decide whether, and if so, how, ESG factors are to be incorporated

- Define or describe the factors
- Identify process to be followed (including roles and responsibilities)
- Whether existing investment funds incorporate ESG factors (especially DC)
- Whether additional investment options required (DC)
- Consider approaches to hiring and monitoring

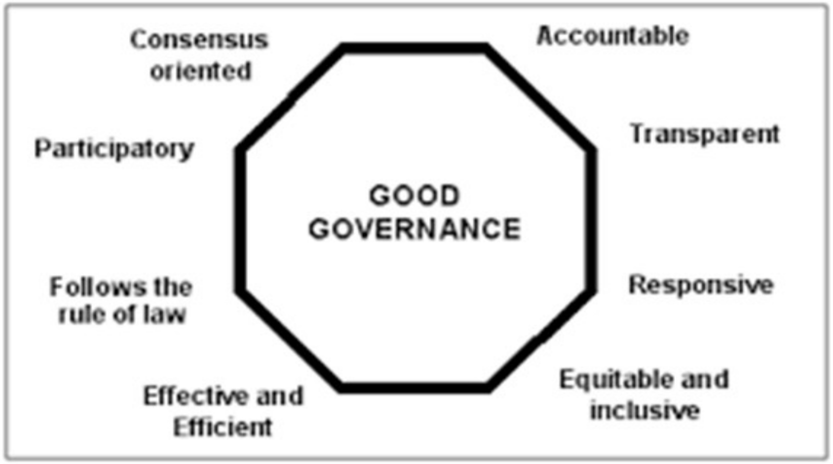


What Administrators Should Do

3. **Reflect decision in minutes and SIPP**

- Brief reasons
- Based on current information
- Provide discretion to
  - Withdraw
  - Change

- Consistency with proxy voting policy



ESG: Sample Minutes

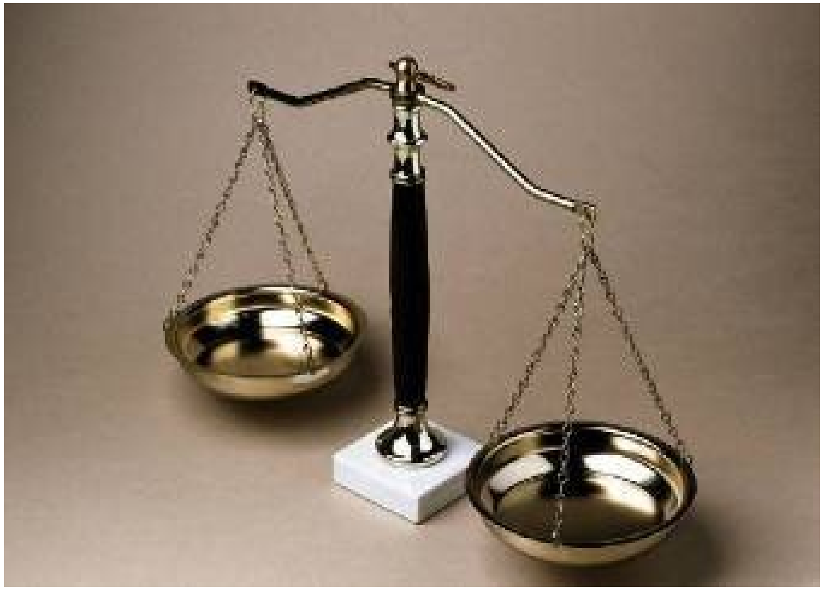
Regulations under the Ontario PBA require the SIPP to disclose whether, and if so, how, Environmental, Social and Governance (ESG) factors are incorporated into investment management of the pension fund. Research reviewed by the committee indicates a correlation between enterprises that take into account ESG considerations and those that are financially successful. The primary purpose of the pension fund must be to provide lifetime pensions, and while financial interests are paramount, ESG factors may be considered where relevant to the assessment of value, quality and mitigation of investment risk or when used as a tie-breaker between investments with similar financial metrics. After discussion, it was determined that the SIPP should be revised in the manner presented to ensure the availability of one or more investment funds that are managed to take into account ESG considerations.

ESG: <u>Sample</u> SIPP

In selecting investment options that consist of collective or aggregated funds such as pooled funds, mutual funds, ETFs, hedge funds, segregated funds or closed-end funds, the Administrator shall take into account the extent to which fund managers are able to consider environmental, social and governance (ESG) factors for investment purposes. One or more investment funds that expressly take into account ESG factors shall be provided. The Administrator shall otherwise monitor and evaluate such funds in accordance with the standards applicable to all other investment options.

What Administrators Should Do

4. Incorporate protective measures to reduce risk
   - Understand integration in existing offerings
   - Optimize diversification
   - Best of class
   - Communicate policy
5. Establish Benchmarks
6. Monitor Managers
7. DC Plans with Member Investment Choice



What Administrators Should Do Summary:

1. Conduct research and obtain expert advice
2. Decide whether, and if so, how, ESG factors are to be incorporated
   - Define or describe ESG factors
5. Reflect decision in minutes and SIPP
   - Ethical Screen may require changes to foundation documents
7. Incorporate protective measures to reduce risk
9. Establish benchmarks
10. Monitor managers
11. DC Plans??

Take -aways

1. Must disclose whether, and if so, how, ESG factors are incorporated in investment decision making
   - In SIP&P
   - In member statements
2. Disclosure is evidence. Must understand what ESG is in order to know whether to consider it or not, and how to take it into account.
3. A Legal conundrum:
   - Not considering relevant ESG factors is a potential fiduciary breach
   - Considering irrelevant ESG factors is a potential fiduciary breach
4. Ethical or negative "screens" may require changes to foundation documents
5. Appropriate ESG analytics is widely available (unavailability may not be an excuse)
   - And may be a good idea!

Questions and Comments

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