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The Association of Canadian Pension Management
L'Association canadienne des administrateurs de régimes de retraite

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Fiduciary Considerations Relating to Environmental, Social & Governance Issues for Canadian Retirement Arrangements

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FOREWORD

ACPM is the leading advocacy organization for a balanced, effective and sustainable retirement income system in Canada and our membership manages retirement plans for millions of plan members.

ACPM believes in the following principles as the basis for its policy development in support of an effective and sustainable Canadian retirement income system:

Diversification through Voluntary / Mandatory and Public / Private Options
Canada's retirement income system should be comprised of mandatory public programs ("First and Second Pillar") and an appropriate mix of voluntary workplace and individual savings arrangements ("Third Pillar").

Empowering Choice in Coverage
Third Pillar arrangements should be encouraged and play a meaningful, ongoing role in Canada's retirement income system.

Harmonization
Canada's pension legislation should always strive for better harmonization across jurisdictions.

Adequacy, Security and Affordability
The components of Canada's retirement income system should ensure a healthy balance between these three objectives to enable Canadians to receive adequate and secure retirement incomes at a reasonable cost and in an efficient way for individuals and organizations.

Innovation in Plan Design
Canada's retirement income system should encourage and facilitate innovation in plan design in all three Pillars.

Adaptability
Canada's retirement income system should be able to adapt to changing circumstances without the need for comprehensive legislative changes.

Clarity and Transparency
Legislation, regulations and retirement income arrangements should be clearly defined and pension plan beneficiaries should be appropriately informed of risks, costs and benefits.

Good Governance
Excellence in governance and administration in the retirement income system.

1. INTRODUCTION

The administrators of Canadian pension plans are fiduciaries with significant duties that include investing pension fund assets so that pensions are secure and provide the promised benefits. Low interest rates, pandemics, longevity, inflation, currency and a wide variety of other risks make that task more difficult. Sustainable investing, including ESG, is an area where some investment risks that have been acknowledged for decades are now becoming more acute (e.g., climate risk). How pension plans, can and should, account for ESG risks in light of the fiduciary duties applicable to pension fund investing is an issue that pension plan administrators globally are struggling to manage. This paper attempts to assist Canadian pension plan administrators understand their fiduciary duties relating to investments and ESG and how to implement an appropriate ESG strategy as fiduciaries.

For clarity, there are three main ESG investment strategies that are often discussed:

(1) **ESG Integration**: Embedding ESG data with traditional financial analysis of a company. This is the most common sustainable investing approach in Canada. ESG Integration is focused on Value (i.e., considered in process to manage risks and/or identify investment opportunities)[1].

(2) **Divestment**: Exclude specific companies, industries or sectors based on Values, ethical considerations, or negative ESG characteristics. Examples include: Socially Responsible Investment (SRI) or Fossil Fuel Free funds. This strategy can only be employed by pension plan fiduciaries where the Values also satisfy the Value test.

(3) **Sustainability Focused**: Funds focus in specific areas, such as renewable energy, waste and water management, sustainable forestry and agriculture. This category of investments is relatively new in Canada. Again, this strategy must also satisfy the Value test.

2. GLOBAL UPDATE ON ESG REQUIREMENTS RELATING TO RETIREMENT ARRANGEMENTS

The issues relating to ESG that fiduciaries are facing worldwide are similar and therefore it is instructive to see the varied international regulatory guidance relating to ESG investing to date.

United Kingdom

The United Kingdom permits pension funds to consider ESG factors in investment decisions and requires pension funds to describe how they consider ESG factors in their statements of investment-policy principles.

More specifically, in 2018 the UK investment regulations were amended by The Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018. Subsection 4(2) of this amendment expressly requires that statements of

[1] RIA Report 2020 p. 18 "ESG integration is the most prominent RI strategy in Canada, with $3.0 trillium AUM. This represents approximately 95% of all reported RI AUM."

investment principles include the trustees' policies in relation to "financially material considerations over the appropriate time horizon" and "non-financial matters", both of which include ESG considerations.[2]

Furthermore, paragraph 5(5)(c) of the amendment provides that affected schemes must publish a statement reporting on how the statement of investment principles has been followed, reviewed, and/or changed during the year.[3]

Regulations under The Pension Schemes Act 2021 are expected. The current proposals require occupational defined benefit (DB) and defined contribution (DC) pension schemes with assets of over £5 billion, all master trusts and all authorised schemes offering collective money purchase benefits to establish specific governance arrangements to manage climate-related risks and to produce Task Force on Climate-related Financial Disclosures (TCFD) reports. TCFD reports will have to be made publicly available. These proposals came into force in October 2021 for schemes with assets over £5 billion, and in October 2022 the same rules will apply to schemes with assets over £1 billion.[4]

United States

Currently, the United States does not permit pension funds to consider ESG factors in investment decisions. Specifically, in late 2020, the United States Department of Labor published final rules on "Financial Factors in Selecting Plan Investments," 85 Fed. Reg. 72846, and "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights," 85 Fed. Reg. 81658. Each of these regulations requires pension plan fiduciaries to select investments based solely on the consideration of "pecuniary factors", which excludes ESG considerations that look to non-financial objectives.[5]

Both regulations were made under the Employee Retirement Income Security Act of 1974 ("ERISA"). Subparagraph 404(a)(1)(A) of ERISA expressly requires that plan fiduciaries act "for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan". The Department was concerned that the growing emphasis on ESG investing may prompt ERISA plan fiduciaries to make investment decisions for purposes distinct from providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan. It therefore took the position that the fundamental purpose of ERISA was to provide secure and valuable retirement benefits, and that this was the paramount, and eminently worthy, "social" goal of ERISA plans. As such, only pecuniary factors should be considered by fiduciaries.

In March 2021, however, the Department of Labor issued a statement noting that the rules above led to investor confusion and had a chilling effect on the appropriate integration of ESG factors in investment decisions. As such, the Department of Labor stated that it intends to revisit the rules. In the meantime, it

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[2] The Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018 (S.I. 2018/ 988) – Amendments to the Occupational Pension Schemes (Investment) Regulations 2005, s.4(2).

[3] The Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018 (S.I. 2018/ 988) – Amendments to Disclosure Regulations, s.5(5)(c).

[4] https://www.accountingforsustainability.org/en/activities/projects/pensions-toolkit/pensions-guidance/uk-pension-schemes-act-2021.html; https://gowlingwlg.com/en/insights-resources/articles/2021/the-pension-schemes-act-2021-points-for-trustees/; https://www.icas.com/professional-resources/pensions/implementation-of-the-new-pension-schemes-act-2021#:~:text=A%20new%20Pension%20Schemes%20Act,placed%20on%20the%20largest%20schemes

[5] Financial Factors in Selecting Plan Investments, A Rule by the Employee Benefits Security Administration on 11/13/2020.

will not enforce the rules or otherwise pursue enforcement actions against any plan fiduciary based on a failure to comply with them.[6]

More recently, in late May 2021, Democratic senators introduced a bill titled "The Financial Factors in Selecting Retirement Plan Investment Act" that seeks to provide more legal certainty by amending ERISA. The legislation was referred to the Committee on Health, Education, Labor and Pensions. If passed, the legislation would amend ERISA to make clear that plans may consider ESG factors in their investment decisions when they are expected to have an impact on investment outcomes, provided plans consider them in a prudent manner consistent with their fiduciary obligations. It would also codify a longstanding principle that plans may consider ESG factors as tiebreakers when deciding between otherwise comparable options. It would also formally repeal the Department of Labor's rule on Financial Factors in Selecting Plan Investments from 2020 and seek to limit future regulatory actions that impose unfair regulatory burdens in an effort to discourage ESG investing by ERISA plans.[7] Finally, on October 13, 2021 the Department of Labor announced a proposed rule, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, that would remove barriers to plan fiduciaries' ability to consider ESG factors when they select investments.[8] The consultation period closed on December 13, 2021 and the Department of Labor is currently reviewing the responses it received. Finally, on February 11, 2022, the Department of Labor issued a "Request for Information on Possible Agency Actions to Protect Life Savings and Pensions from Threats of Climate-Related Financial Risk", in which it is seeking information about ways that climate change may impact the retirement industry and whether it should take additional, broader action to protect ERISA plans from climate change risks. The time window to provide comments on this request closed on May 16, 2022.

European Union

The European Union permits pension funds to consider ESG factors in investment decisions and requires pension funds to describe how they consider ESG factors in their statements of investment-policy principles.[9]

Specifically, subsection 1(b) of Article 19 in EU Directive 2016/2341 (the "Directive") requires member states to allow institutions for occupational retirement provision ("IORPs") to take into account the impact of ESG factors.[10] Likewise, section 1 of Article 21 of the Directive requires IORPs to have in place an effective system of governance which must include consideration of ESG factors related to investment assets in investment decisions.[11] Finally, Article 30 of the Directive requires member states to ensure that IORPs prepare and, at least every three years, review a written statement of investment-policy principles, including how the investment policy takes ESG factors into account.[12]

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[6] https://www.dol.gov/sites/dolgov/files/ebsa/laws-and-regulations/laws/erisa/statement-on-enforcement-of-final-rules-on-esg-investments-and-proxy-voting.pdf

[7] The Financial Factors in Selecting Retirement Plan Investment Act, TAM21761, 117th Congress, 1st Session.

[8] US Department of Labor proposes rule to remove barriers to considering environmental, social, governance factors in plan management | U.S. Department of Labor (https://www.dol.gov/newsroom/releases/ebsa/ebsa20211013)

[9] EU Directive 2016/2341, Article 30 – Statement of Investment Policy Principles.

[10] EU Directive 2016/2341, Article 19 – Investment Rules, s. 1(b).

[11] EU Directive 2016/2341, Article 21 – General Governance Requirements, s. 1.

[12] EU Directive 2016/2341, Article 30 – Statement of Investment Policy Principles.

According to the International Actuarial Association, while each EU member state is subject to the Directive, each determines how the Directive is implemented in their country.[13] EU Member states may exempt certain funds which operate pension schemes with fewer than 15 or 100 members from certain conditions of the legislation.[14] If a pension fund wishes to provide its services in other EU Member States, however, it has to apply all the rules laid down in the Directive.[15]

EU Regulation 2019/2088 (the "Regulation on sustainability-related disclosures in the financial services sector") also came into effect in March 2021. It is a broad regulation designed to increase transparency regarding sustainability in financial markets. Article 4 of this Regulation imposes new ESG disclosure requirements on pension funds, including how funds consider the "principal adverse impacts" on sustainability.[16] Where sustainability is not considered, pension funds are required to explain why.[17] Article 10 requires affected schemes to disclose this information on their websites in a "clear, succinct and understandable" way that is easily accessible.[18]

Australia

Australia permits pension funds to consider ESG factors in investment decisions, so long as it is in the best financial interests of its beneficiaries. It also requires superannuation funds to describe how they consider ESG and labour factors.

In June 2021, the "Your Future, Your Super" bill (the "Bill") came into effect. Part 1 of Schedule 3 of the Bill requires trustees to act in the best financial interests of the fund's members.[19] Provisions enabling the government to ban certain types of investments not considered to be in the members' best interests were ultimately removed from the Bill.[20] However, the Assistant Minister for Superannuation, Financial Services and Financial Technology made clear her government's stance on ESG consideration: "The mission of a super fund is not to change the earth's temperature; it is to create a return on investments for those individual members."[21]

The Bill also requires underperforming funds to inform members about their underperformance and bans funds from accepting new members if they underperform for two years in a row. Many believe that these performance tests will negatively impact ESG investing. Not all ESG-integrated funds are likely to outperform the market, and pressure on trustees to keep from underperforming may hinder efforts to expand ESG integration.[22] Finally, Part 1 of Schedule 1 of The Financial Services Reform Act 2001 requires

[13] International Actuarial Association, « Pension Fund Environmental, Social and Governance Risk Disclosures: Developing Global Practice » at page 9.
[14] EU Directive 2016/2341, Article 5 – Small IORPs and Statutory Schemes.
[15] EU Directive 2016/2341, Article 5 – Small IORPs and Statutory Schemes.
[16] EU Regulation 2019/2088, Article 4 – Transparency of adverse sustainability impacts at entity level.
[17] EU Regulation 2019/2088, Article 4 – Transparency of adverse sustainability impacts at entity level.
[18] EU Regulation 2019/2088, Article 10 – Transparency of the promotion of environmental or social characteristics and of sustainable investments on Websites, s.1.
[19] Your Future, Your Super Bill 2021, Schedule 3– Best Financial Interests Duty, Part 1—Main amendments
[20] https://www.theguardian.com/australia-news/2021/jun/03/superannuation-bill-passes-lower-house-after-coalition-dumps-controversial-kill-switch
[21] https://www.ft.com/content/f7a0c0a7-9921-4ce1-8513-7a4f17333204
[22] https://www.asianinvestor.net/article/how-australias-new-rules-could-jeopardise-esg-efforts/469260

superannuation funds to disclose to what extent labour standards and/or ESG considerations are taken into account in the selection, retention and realisation of investments.[23]

In contrast to the "Your Future, Your Super" bill, in April 2021 the Australian Prudential Regulation Authority ("APRA") released its draft guidance for financial actors (including superannuation trustees) regarding the management of financial risks related to climate change.[24]

The draft, titled "Prudential Practice Guide CPG 229 Climate Change Financial Risks (CPG 229)", does not expressly direct entities to consider environmental factors, but the Chair of APRA suggests the guidelines are "aimed at ensuring decisions are well-informed and appropriately consider both the risks and opportunities that the transition to a low carbon economy creates."[25] The guidelines advise trustees to do many things. For example, subsection 16(c) advises trustees to periodically assess and re-evaluate the risks, opportunities and accountabilities arising from climate change,[26] while section 45 advises trustees to disclose decision-useful, forward-looking climate risk information.[27]

Finally, the potentially ground-breaking Federal Court of Australia case of McVeigh v. Retail Employees Superannuation Trust settled in late 2020. In 2018, Mark McVeigh sued REST, his superannuation fund, after it failed to provide him with information on how it was managing the risks of climate change. McVeigh alleged REST had breached the Superannuation Industry Act (the "SIA") and the Corporations Act by failing to manage those risks. The SIA requires trustees to act with care, skill and diligence, and to act in the best interest of members. This includes managing material risks to its investment portfolio. The parties reached a settlement, and REST agreed its trustees have a duty to manage the financial risks of climate change. It agreed to implement a goal for the fund of a net-zero carbon footprint by 2050, to measure, monitor and report climate progress in line with the Task Force on Climate-related Disclosures, to ensure investee climate disclosure, and to publicly disclose portfolio holdings, among other commitments. The settlement falls short of establishing a legally binding precedent that superannuation trustees should take additional steps to consider and report on the risk of climate change. However, it may be an indication of the changing face of the duties a superannuation trustee in Australia owes to its members.

New Zealand

New Zealand permits pension funds to consider ESG factors in investment decisions. Only recently did New Zealand begin to require pension schemes to disclose how they consider ESG issues in their investment processes. In 2021, New Zealand's Ministry for the Environment introduced the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Bill, which mandates climate-related disclosure for funds with assets above $1 billion by way of amendments to the Financial Markets Conduct

[23] Financial Services Reform Act 2001, Schedule 1—Financial Services and Markets, Part 1—Main amendments, 1013D Product Disclosure Statement Content—Main Requirements, s.1(l).
[24] Prudential Practice Guide CPG 229 Climate Change Financial Risks (CPG 229)
[25] https://www.apra.gov.au/news-and-publications/apra-releases-guidance-on-managing-financial-risks-of-climate-change
[26] Prudential Practice Guide CPG 229 Climate Change Financial Risks, Governance, s.16(c)
[27] Prudential Practice Guide CPG 229 Climate Change Financial Risks, Disclosure, s.45.

(FMC) Act 2013.[28] This will affect a number of different entities, including crown financial institutions such as the NZ Super Fund (which held $31 billion in assets as of late 2020).[29]

Disclosures will be required for financial years commencing in 2022. Reporting will be based on the TCFD framework, which is widely acknowledged as international best practice. Under the proposed legislation, elements of the disclosures relating to greenhouse gas emissions would be required to have independent assurance. The Financial Markets Authority would be responsible for the independent monitoring and enforcement of the relevant reporting entities' compliance with the new reporting standards.

Japan

Japan does not require pension funds to consider ESG factors in investment decisions, or to disclose how they consider ESG issues in their investment processes. Japan does not have specific legislation regarding the consideration of ESG factors.[30] However, pension funds have voluntarily signed initiatives aimed at ESG investing. For example, Japan's Financial Services Agency developed the Principles for Responsible Institutional Investors ("the Stewardship Code"), which numerous funds (including some pension funds) have voluntarily signed onto. The Stewardship Code contains guidelines to establish a fiduciary duty of institutional investors on behalf of their clients and emphasizes the importance of considering ESG factors in investment decisions.[31]

There are also no disclosure requirements related to ESG consideration in pension funds. Pension schemes regulated by the Ministry of Health, Labour and Welfare have received little guidance regarding the consideration of ESG factors.[32] This has led to calls from the Principles for Responsible Investment, the United Nations Environment Programme Finance Initiative, and The Generation Foundation for the Japanese government to implement ESG disclosure rules in pension schemes' statements of investment principles. Despite a lack of legislation around ESG considerations, Japan is the fastest growing market for responsible investing.[33]

South Korea

South Korea does not require pension funds to consider ESG factors in investment decisions, or to disclose how they consider ESG issues in their investment processes. Article 63 of Chapter IV of the National Finance Act (which governs state pension funds) expressly requires funds to consider "stability, liquidity, profitability and public benefits" and does not discuss ESG issues.[34] Similarly, all private sector funds are governed by the Financial Investment Services and Capital Markets Act, which states under Article 79 that entities have a fiduciary duty of due care and good faith in protecting investors' interests[35] but does not

[28] See the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Bill.
[29] https://www.pionline.com/sovereign-wealth-funds/nz-super-climate-risk-report-says-progress-has-boosted-returns
[30] International Actuarial Association, « Pension Fund Environmental, Social and Governance Risk Disclosures: Developing Global Practice » at page 11.
[31] Principles for Responsible Institutional Investors, Second Revision of the Stewardship Code.
[32] Fiduciary Duty in the 21st Century - Japan Roadmap, page 13.
[33] https://www.unpri.org/news-and-press/pri-publishes-japan-roadmap-new-report-makes-recommendations-on-esg-considerations-for-the-japanese-market/382.article
[34] National Finance Act, Chapter IV Article 63.
[35] Financial Investment Services and Capital Markets Act, Article 79.

provide for ESG guidance.[36] However, consideration of ESG factors by the National Pension Service (South Korea's largest public pension fund covering 90% of total pension assets in South Korea and the third largest fund in the world[37]) is expressly permitted by Article 102(4) of Chapter VI of the National Pension Service Act.[38]

The Korea Corporate Governance Service also introduced South Korea's Stewardship Code in December 2016, which strengthened the fiduciary responsibilities of institutional investors who adopt the code and encourages the consideration of ESG factors. Four pension funds have voluntarily adopted the Code thus far.[39] In January of 2021, the Korean Financial Services commission announced that it will review the Stewardship Code to consider introducing revisions that will further strengthen fiduciary duties related to ESG.

KEY TAKE-AWAYS

(1) Different approaches exist globally with respect to regulatory guidance on ESG.

(2) The financial best interests of the members continue to be a dominant requirement.

(3) Disclosure regarding ESG considerations in investing is required in multiple jurisdictions, including on statements and also on websites.

(4) Mandating governance arrangements to manage at least some ESG risks, e.g., climate, are evolving.

3. CANADIAN LEGAL SUMMARY ON ESG: COMMON LAW AND CIVIL LAW

It is important to outline the legal framework for pension plans in Canada as it relates to ESG. Legislation plus common law and civil law rules must be understood, notwithstanding that there is a lack of legislation and much of the relevant case law is not recent and often comes from other jurisdictions.

The following must be considered:

(1) The relevant documentation governing a pension plan at inception may expressly prohibit or directly restrict the plan sponsor in any decision respecting the divestment of any investments that currently exist within the investment portfolio based on ESG factors or set parameters for the investment of the portfolio. However, that is not typically done in Canadian pension plans.

(2) None of the applicable minimum pension standards legislation in Canada, nor the trustee acts, specifically restricts or authorizes ESG considerations in investment decisions.

(3) There is no definition of ESG factors or considerations in Canadian pension legislation.

[36] See the Financial Investment Services and Capital Markets Act.
[37] Investor Obligations and Duties in 6 Asian Markets, page 45.
[38] National Pension Act, Chapter VI Article 102(4).
[39] http://sc.cgs.or.kr/eng/participation/investors.jsp

(4) Pension standards legislation in Canada requires pension plan administrators to ensure pension plans and pension funds are administered in accordance with applicable legislation and the plan terms.

(5) Canadian pension standards legislation[40] include a prudent person rule that applies to the investment of pension assets. The prudent person rule is typically captured in the care, skill and diligence required of a pension plan administrator, for example in section 22 of the Ontario Pension Benefits Act (the "PBA"):

> **Care, diligence and skill**
> **22** (1) 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.
>
> **Special knowledge and skill**
> (2) The administrator of a pension plan 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 possesses or, by reason of the administrator's profession, business or calling, ought to possess.
>
> **Member of pension committee, etc.**
> (3) Subsection (2) applies with necessary modifications to a member of a pension committee or board of trustees that is the administrator of a pension plan and to a member of a board, agency or commission made responsible by an Act of the Legislature for the administration of a pension plan.
>
> **Conflict of interest**
> (4) An administrator or, if the administrator is a pension committee or a board of trustees, a member of the committee or board that is the administrator of a pension plan shall not knowingly permit the administrator's interest to conflict with the administrator's duties and powers in respect of the pension fund.
>
> **Employment of agent**
> (5) Where it is reasonable and prudent in the circumstances so to do, the administrator of a pension plan may employ one or more agents to carry out any act required to be done in the administration of the pension plan and in the administration and investment of the pension fund.
>
> **Trustee of pension fund**
> (6) No person other than a prescribed person shall be a trustee of a pension fund.

[40] In Quebec, pension plans are governed by the Quebec Supplemental Pension Plans Act (SPPA) and by the Civil Code of Québec (CCQ). All pension plans must be administered by a pension committee which must act in the capacity of a trustee. In accordance with both the SPPA and the CCQ, the members of the pension committee must exercise the prudence, diligence and skill that a reasonable person would exercise in similar circumstances, must act with honesty and loyalty in the best interest of plan members and beneficiaries, and cannot place themselves in a conflict of interest. In addition, pension committee members who act in good faith and rely on the opinion of an expert, including investment advice, are deemed to have acted with prudence.

Responsibility for agent

(7) An administrator of a pension plan who employs an agent shall personally select the agent and be satisfied of the agent's suitability to perform the act for which the agent is employed, and the administrator shall carry out such supervision of the agent as is prudent and reasonable.

Employee or agent

(8) An employee or agent of an administrator is also subject to the standards that apply to the administrator under subsections (1), (2) and (4).

Benefits of administrator

(9) The administrator of a pension plan is not entitled to any benefit from the pension plan other than pension benefits, ancillary benefits and a refund of contributions.

Benefits of members of pension committee, etc.

(10) Subsection (9) applies, with necessary modifications, to a member of a pension committee or board of trustees that is the administrator of a pension plan and to a member of a board, agency or commission made responsible by an Act for the administration of a pension plan.

(6) All Canadian pension jurisdictions require a plan to have a written statement of investment policies and procedures ("SIPP") that contain prescribed information.

(7) Some Canadian pension jurisdictions require ESG disclosure to be included in annual and biennial statements.

(8) Most provinces have adopted, by reference, the investment requirements under the Pension Benefits Standards Regulations, 1985 (Canada) (the "PBSR") which are set out in Schedule III of those regulations. Those that have not, have generally legislated rules that are in all material respects the same. The main constraints in Schedule III are as follows:

1) 10% rule limits investment in one entity to no more than 10% of the plan assets, but the rule does not apply to certain investments.

2) 30% voting rule prohibits an administrator from investing, directly or indirectly, the moneys of the plan in securities to which are attached more than 30% of the votes that may be cast to elect the directors of the corporation. There are permitted exceptions to this rule and many plans have structured investments to own a much larger percentage of the economic value while complying with the 30% rule relating to the voting securities.

3) Related party restrictions also exist.

(9) The Income Tax Act (Canada) (the "ITA") requires that the primary purpose of a pension plan must be to provide retirement income (Regulation 8502(a)).

(10) There is limited case law relating to the ability of fiduciaries to consider ESG factors in investment decisions, but based on the few decided cases available the following principles emerge[41]:

1) ESG factors may be considered in investment decisions where the relevant documents governing the trust[42] authorize or direct such consideration.

2) ESG factors may be considered under the common law if all of the trust beneficiaries consent; this is typically not a realistic expectation.

3) Where an ESG factor is directly relevant to the financial performance (risk and return) of an investment, it is a relevant and proper investment consideration.

4) Any conclusion as to whether an investment or divestment is in the best financial interest of the beneficiaries[43] should be rationally based on evidence after appropriate due diligence.

5) In the case of trusts expected to continue for an extended period (as is the case with the most pension funds) the best financial interest of the beneficiaries should be assessed over the long term. The short-term return of competing possible investments is not determinative. Where an ESG factor leads to a well-founded conclusion that a class of investments is or is not in the best long term financial interest of the beneficiaries, it may properly be included or excluded.

6) Except where the trustees reach a well-founded good faith conclusion that a particular class of investment is or is not in the long term best financial interest of the beneficiaries, any preference in favour of, or absolute refusal to consider, such investments based on values is potentially a breach of trust or violation of the plan administrator's fiduciary duties.

7) When weighing alternative investments (as opposed to setting an investment policy with absolute bars), ESG factors can probably be safely relied upon as a "tie breaker" when deciding between otherwise equally financially prudent investments. Despite some American authority that ESG factors can be relied upon where the negative financial impact is only de minimis, that principle is not supported by UK law and should not be assumed to be applicable in Canada.

8) Only two Canadian jurisdictions, Ontario and Manitoba, have specific rules relating to the use of ESG factors. A consultation by the federal government included questions relating to how federally regulated pension plans ought to consider ESG. A subsequent consultation by the federal

[41] In Quebec, essentially the same principles emerge from the provisions of the SPPA, the CCQ and the limited decided cases.

[42] In Quebec, a pension plan is not a trust, but a contract between the employer and the plan participants that is governed by both the SPPA and by the CCQ (including provisions regarding contracts, trusts and the administration of the property of others). Pursuant to the SPPA, the CCQ and relevant case law, the plan's assets are held in a pension fund, which is referred to as « trust patrimony » and which consists of the property transferred in trust, and constitutes a « patrimony by appropriation » that is autonomous and distinct from that of the settlor, trustee or beneficiary and in which none of them has any real right.

[43] In Quebec, legislative provisions require plan administrators to act in the « best interest » of plan members and beneficiaries, and do not specify that they must act in their « best financial interest ». Nonetheless, in light of the various CCQ provisions governing the administration of the property of others, including the requirement to make the fund increase in value, as well as the basic purpose of a pension plan which is to provide retirement income, it is safe to say that Quebec law requires plan administrators to act in the best financial interest of plan members and beneficiaries.

government questioned how federally regulated pension plans ought to consider and accommodate climate risk.[44]

Subsection 28.1(2.2) of the Manitoba Pension Benefits Act reads as follows:

> "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)."
>
> Subsection 78(3) of Regulation 909 to the Ontario PBA reads as follows: "The statement of investment policies and procedures shall include information as to whether environmental, social and governance factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated."

(11) Both pension regulators and securities regulators in some jurisdictions in Canada have published guidance notes regarding ESG.

(12) Many Canadian pension plan administrators have made commitments to adhere to local, national and transnational covenants or principles, such as the Principles for Responsible Investment developed by the United Nations.

KEY TAKE-AWAYS:

(1) Pension standards legislation in Canada require pension plan administrators to ensure pension plans and pension funds are administered in accordance with applicable legislation and the plan terms, as well as with the care, skill and diligence of a prudent administrator.

(2) Pension plan administrators may consider ESG factors in investment decisions provided that any such investment is in the best financial interest of the beneficiaries and that their decision is rationally based on evidence after appropriate due diligence. Such investments based on ESG factors would not be a breach of trust or a violation of the plan administrator's fiduciary duties.

4.ESG REPORTING

There is a wide range of methods for ESG reporting across Canadian pension plans from minimum legislated requirements to voluntary dedicated reports on responsible investing and climate change. Legislators are starting to explore possible reporting standards, so it is an important time to determine what reporting supports the long-term sustainability of the Canadian pension system.

As noted above, section 78(3) of Regulation 909 under the Ontario PBA, which came into force on January 1, 2016, requires plan administrators to include in the SIPP "information as to whether environmental,

[44] The summary of the OSFI consultation can be found at http://www.osfi-bsif.gc.ca/Eng/fi-if/in-ai/Pages/clmt-rsk-let-1021.aspx

social and governance factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated."

Note that Section 40 of Regulation 909 prescribes statements to be included in annual or biennial statements to plan members, including information about whether ESG factors are incorporated into the SIPP and, if so, how those factors are incorporated.

In January 2021 the Office of the Superintendent of Financial Institutions (OSFI) released a discussion paper entitled "Navigating Uncertainty in Climate Change: Promoting Preparedness and Resilience to Climate-Related Risks" to elicit feedback from stakeholders on climate-related risks.

Developing Reporting Standards

i) Reporting by Companies

There has been significant progress in sustainability-related financial reporting as seen by the growing prominence of the Sustainability Accounting Standards Board (SASB), which sets standards internationally to guide the disclosure of financially material sustainability information by companies and investors. SASB Standards identify the subset of ESG issues most relevant to financial performance in specific industries and SASB provides education and other resources that advance the use and understanding of its Standards. As of January 2022, over 250 institutional investors—representing US $76 trillion assets under management and 23 countries—support SASB and/or use SASB Standards to inform their investment decision-making.

A significant number of large institutional investors, including large pension plans, are part of the Investment Advisory Group (IAG) of the SASB Alliance, which recognizes the SASB Standards as being globally applicable as part of a core set of company ESG disclosures and ask issuers to use SASB Standards in disclosures to investors.

At COP26 in November 2021, the IFRS Foundation announced the formation of a new International Sustainability Standards Board (ISSB) that is integrating all the major disclosure frameworks. The IFRS Foundation will complete consolidation of the Climate Disclosure Standards Board (CDSB—an initiative of CDP) and the Value Reporting Foundation (VRF—which houses the Integrated Reporting Framework and the SASB Standards) by June 2022. The ISSB has now been officially established.

Moreover, organizations with global assets under management of US $121 trillion as of December 31, 2020, are signatories of the Principles for Responsible Investment (PRI), which are a voluntary and aspirational set of investment principles that offer possible actions for incorporating ESG issues into investment practice. One of the principles is focused on reporting on ESG activities and progress towards implementing the principles.

ii) Reporting by Investment Managers and Institutional Investors

As the number of companies reporting on ESG factors continues to grow, investors are incorporating ESG data into the investment process to improve their understanding of the risks and opportunities of possible investments. In addition, investment managers are marketing products with ESG-related features.

In July 2021, the CFA Institute released an exposure draft with a focus on developing voluntary, global industry standards to establish disclosure requirements for investment products with ESG-related features. The draft procedures are intended to be used by independent verifiers to test the disclosures that an investment manager makes for a particular investment product.

The Canadian Securities Administrators have released new guidance that seek to clarify and explain how current securities regulatory requirements apply to ESG-related investment fund disclosure.[45]

In Europe, two regulations have recently come into force: the EU Taxonomy Regulation in July 2020 and the Sustainable Finance Disclosure Regulation ("SFDR") in March 2021.

The SFDR requires asset managers to disclose how sustainability risks are integrated into risk analysis at both the company level and for specific investment products. Regulatory Technical Standards that provide more detail on the content, methodologies, and presentation of the relevant information to be disclosed are expected to come into force on January 1, 2023.

iii) Third Party Service Provider ESG Auditing/Reporting Services

There are numerous third-party service providers that offer a variety of audit, measurement and reporting services. These services may be of some assistance in the overall ESG investment process.

The challenge for investors is to understand a specific provider or product, and how it can be integrated into a particular investment program. Understanding any limitations, possible biases, and the investment or measurement philosophy will be critical to a successful implementation of the service.

Consistent with other aspects of a well-designed investment strategy, care should be taken to understand the purposes of the ESG audit/reporting within the overall context of the investment strategy. Some of the products or services may be more applicable to some investor strategies than others.

Accordingly, it is necessary to proceed with a fulsome understanding of the benefits and limitations of product or service.

KEY TAKE-AWAYS

(1) Any ESG reporting guidance should be principles based and should consider the following factors:

(i) Reporting should be clear, transparent, and consistent;

(ii) Reporting should not be too onerous, especially for small pension plans;

(iii) There should be clear reasoning for the level of detail and format (e.g., standalone report, funding valuation report, SIPP, member statements) of reporting. It may be reasonable to develop separate standards for plans with different levels of assets or minimum required standards and optional additional guidance.

[45] https://www.osc.ca/sites/default/files/2022-01/csa 20220119 81-334 esg-related-investment-fund-disclosure.pdf.

(2) It is also important to understand that most pension plans in Canada do not invest assets directly. Pension plan administrators typically work with consultants to choose institutional asset managers based on their expertise. Detailed reporting on ESG by pension plan administrators will only be relevant and useful if downstream ESG reporting is uniform and consistent:

(i) First, ESG reporting at the company level should follow consistent global standards;

(ii) Second, a national sustainability disclosure framework for the investment industry should be developed with input from key stakeholders, including regulatory bodies and institutional investors such as pension plans;

(iii) Only once there is comparable disclosure across the investment industry will pension plans be able to effectively disclose appropriate sustainability metrics.

5. ESG AND GOVERNANCE

From a pension plan governance perspective, ESG is best viewed as a tool for, or component of, the ongoing risk management assessment conducted by a plan's administrator in achieving acceptable financial returns and plan sustainability. ESG is one relevant factor in achieving such objectives to the extent that it can be demonstrated that ESG factors impact the long-term financial returns of investments. If so, consideration of ESG factors will be an appropriate element of the assessment of individual investments, seen from the perspective that achieving the best long-term risk-adjusted financial returns from the plan's investments is the best way to ensure plan sustainability.

How a plan's administrator understands and assesses the implications of addressing ESG factors must, like all governance decision-making, be done prudently and in the context of the particular plan. This contextual approach then requires recognition of the unique governance arrangements and broader environment of the particular plan. Such an approach also makes the application of "one-size-fits-all" regulatory requirements related to ESG more complicated and suggests that a principles-based regulatory framework would be most appropriate.

The ability of a plan's administrator to directly address and control a preferred approach to addressing ESG factors will, as noted, depend on the governance framework and context of the plan. Relevant factors include the plan's governance structure, investment structure, size, and plan type:

- A plan's **governance structure** determines which parties are responsible for decision-making regarding the application of ESG factors and how any decision to apply ESG factors will be implemented:
    - *Single plan, unicameral governance* – Where a plan has one primary decision-making body (such as with single-employer private sector plans outside of Manitoba and Quebec, or most private sector multi-employer pension plans), the plan's governing body is able to develop and apply a single perspective to the issue in addressing its fiduciary duties.
    - *Single plan, bicameral governance* – Where a plan is governed by two decision-making bodies each with distinct roles and authorities (such as with certain jointly sponsored pension plans, certain multi-employer pension plans and single employer pension plans in Manitoba and Quebec), the separation of roles (often between a non-fiduciary

"sponsor" body and a fiduciary "administrator" body) requires understanding and reconciling the scope of such roles as they relate to decisions regarding the use of ESG factors. The sponsor body may have competing views with those of the fiduciary administrator on the application of ESG factors in decision-making. Their respective roles may dictate the level at which the plan's approach to ESG is determined or could result in a shared determination (for example, where the sponsor body sets the funding policy and/or risk appetite and the administrator body sets investment policy).

- The **investment vehicle(s) or structure** through which a plan invests will also significantly influence its ability to control its ESG approach:
  - *Common multi-client manager* – Where a group of plans are required or chose to invest through a common multi-client asset manager (for example, AIMCo, IMCO, BCI, Vestcor, NSPSC, Caisse de dépôt et placement du Québec[46]), the purpose of doing so is often to achieve efficiencies and economies of scale. Those goals may then dictate a centralized approach to the handling of ESG factors at the manager level. However, that centralized approach may be at odds with, or not fully satisfy, the individual client plan's desired approach to ESG, particularly if the client plan lacks the right to choose its asset manager. The asset manager's willingness or ability to provide multiple options satisfying different plans' ESG needs, without negatively impacting returns (due to scale challenges), may be a necessary trade-off in order for each client to achieve its own desired ESG goals.
  - *Investing in funds* – Where a plan invests its assets through one or more managers' funds, the plan's ability to adequately implement its desired approach to ESG will be dependent on its ability to find funds that satisfy both its ESG and return requirements. If the plan is of sufficient size, it may be able to directly influence the fund manager's approach to ESG, though smaller plans will more likely be challenged in that regard. That said, fund managers are increasingly[47] sensitive to and aware of the needs of plans and are communicating their ESG integration efforts or fund options, from which plans can now choose (again, subject to the plan's assessment of its fiduciary duty).
  - *Direct investing* – Plans with the internal capacity to carry out their own direct investing activities (such as larger JSPPs and the larger single-employer plans) will, of course, have the greatest degree of control in implementing their desired approach to ESG. However, even for those plans, there can be practical issues in applying ESG screens to public equity investments (as opposed to larger private investments), given the quantitative approach often employed in public equity trading.

- **Plans of different sizes** – As noted above, the largest plans often manage all or a portion of their own assets and can as a result, have a greater degree of control over their ESG approach. Other

[46] The « Caisse » is established by Quebec legislation with the mission to receive moneys on deposit as provided by law and manage them with a view to achieving optimal return on capital within the framework of depositors' investment policies while at the same time contributing to Québec's economic development. It manages the funds of 42 depositor groups, including the Québec Pension Plan and many public and parapublic sector pension plans. The Caisse manages over $365 billion in assets, and nearly 90% of its investments are managed in-house. In addition to more typical investments such as private equity, fixed income, real estate, and equity, since 2017 the Caisse has also been focused on stewardship investing which includes decreasing its portfolio's carbon intensity (aims to achieve a carbon-neutral portfolio by 2050) and conducting rigorous ESG analyses.

[47] Based on information obtained, many plan administrators report that today over 95% of fund managers include ESG criteria in investment decisions. This percentage has increased enormously over the past 5 years.

large plans investing through multi-client manager(s) or through funds are also more likely to have greater influence on the manager's approach to ESG. However, smaller plans lack the same degree of direct influence or control, may only have an ability to implement their desired ESG approach if they are free to choose their asset managers. Where no manager choice exists, such plans will have the most difficulty achieving their own independent ESG goals.

- **DB vs. DC** – Traditionally, DB plans have had the ability to exert more direct control over their investments, enabling implementation of an ESG approach through direct investing, influence on a multi-client manager or through the choice of funds. DC plan members are limited by the funds offered by the plan administrator and its chosen fund provider(s), which historically were limited. However, as ESG/ethical/SRI/Fossil Fuel Free fund options are becoming more common, DC plan members now have greater choice over the type of funds their accounts will be invested in. Of course, that choice comes with a greater obligation on the plan administrator and fund provider to educate members regarding the potential impact on returns depending on the ESG/ethical/SRI/ Fossil Fuel Free orientation of the particular funds, to avoid members experiencing "buyer's regret" at retirement.

Implications

As this discussion highlights, there is significant disparity among pension plans in Canada on how ESG decisions are made and their ability to effectively implement those decisions. That disparity, which can also vary by factors such as region, industry type, and degree of member interest, will need to be addressed in any regulatory framework developed to require pension plan administrators to consider and disclose their approach to ESG. A one-size-fits-all approach to regulation has the potential to impose a significant burden on the sponsors and administrators of small plans, DC plans with member-directed investments or plans with limited ability to control or influence their asset manager's implementation of a desired ESG approach.

Other potential implications from a governance perspective that may result from the imposition of a regulatory framework relating to ESG include:

Pension coverage – Members interested in a direct role in choosing an ESG approach for their retirement savings may be more comfortable in individual or group RRSPs and other savings vehicles where more control over investment choice can be exerted. However, this must be balanced against any increase in complexity or regulatory burden for pension plan sponsors and administrators resulting from the imposition of an ESG regulatory framework. A plan's administrator will need to balance the fiduciary duty to achieve the best risk-adjusted financial result with new ESG regulatory obligations and members' desire for say on the ESG approach applicable to their retirement assets. That increased complexity may be another factor impacting plan sponsors' willingness to maintain or increase pension coverage. Plan sponsors/administrators should be able to rely on ESG disclosure at the investment level. Plan sponsors/administrators cannot be expected to provide detailed information to members or regulators if they lack direct control over the investment or if the investments are not subject to consistent reporting obligations.

What pensions are for – Pension plans are pooled retirement vehicles, intended to produce the best possible risk-adjusted financial result for members (including in relation to cost, return, and benefit security). The introduction of ESG as a new factor independent of existing obligations as noted above is

contrary to the fiduciary duties imposed on pension plan administrators, except where ESG is seen as a factor relevant to the long-term return of an investment.

Managing organizational and external pressures to increase exclusionary (e.g., SRI or Fossil Fuel Free) investments – in some cases pension plan administrative staff may be pressured by management to invest in a manner consistent with the sponsor organization's publicly declared philosophy on specific social issues. Plan administrators could also be pressured publicly by an employer's customers or other stakeholder groups with some ties to the organization groups. In either case, the administrator may have to defend its rationale for not bowing to such pressures and for maintaining an appropriate and legally supportable investment approach consistent with their fiduciary duties.

KEY TAKE-AWAYS

(1) The governance structure of the pension plan affects how decisions relating to ESG matters are considered.

(2) The structure through which a pension plan invests, as well as the size of the pension plan, effects the ability of the pension plan to implement ESG investing.

(3) How ESG investing may affect pension plan coverage must be considered.

6. ESG AND DC RETIREMENT ARRANGEMENTS – MEMBER DIRECTED INVESTMENTS

Much has changed in recent years in respect of DC Retirement Arrangements with respect to ESG investment options, both with respect to the information provided by DC plan providers and the options being sought by DC plan members.

<u>Access to ESG investment options and information provided by DC plan providers</u>

Some DC provider platforms offer plans access to funds and managers that will allow them to integrate ESG factors in their investment policy decision-making process. The aim is to provide plan sponsors and administrators with the necessary tools to enable them to properly meet their responsibilities as plan sponsor and plan fiduciary.

The integration of ESG factors is part of the sub-criteria that should be considered in the selection and evaluation of the funds offered on DC platforms. Investment Managers can be asked to indicate how resources are assigned to responsible investing within the firm and detail how they consider and integrate ESG factors in the context of their investment process.

Some insurance companies produce an overview document of the integration of ESG considerations for all DC investment funds offered on their platform. Such documents present the degree of integration applicable to each fund, determined according to an evaluation of the practices and processes deployed by the manager in terms of responsible investing. It can also indicate if the manager is a PRI signatory and, when applicable, its adherence year. In addition, the document can provide the funds' latest available ESG overall score as well as environmental (E), social (S) and governance (G) scores based on portfolio holdings rated by MSCI. This information is available for most actively managed funds that are invested in traditional asset classes, with the exception of more complex fund-of-funds portfolios.

In addition to the ESG integration framework and reporting tools provided, some insurance companies offer a full range of responsible investment solutions, including broadly diversified funds and thematic funds. The diversified funds are built as multi-manager funds of funds for sponsors/members looking for diversified, turnkey responsible investment options. These funds can be integrated into flexible lifecycle environment to create a "responsible investing" target date solution. The "à la carte" thematic funds focus specifically on E, S or G criteria. Finally, some insurance companies include some ESG portfolios by default in their standard fund lineup proposal, as they believe it is important for plan members to have access to ESG-focused investment options.

As noted above, as fiduciaries, plan sponsors must be looking for funds with Value and not Values.

Access to ESG investment options and information being sought by DC plan members

As noted above, in DC retirement arrangements members are often requesting access to ESG investments. A DC plan member survey found that 79% were interested in sustainable investing. In addition, 72% said they were likely to contribute more if their plan offered these investments.[48]

The results from Sun Life's May 2021 DC member survey conducted on sustainability and the importance of sustainable investing is particularly interesting. In the course of the survey, responses were received from 403 Canadians, 70% of whom were pre-retirees or retirees (50-65+), and 38% of those aged 18-34 had already purchased sustainable investments (vs 19% overall). Some of the key findings were:

- Large majority of members (especially younger members) care about strong financial return when investing sustainably.
- Majority of members are interested in seeing more sustainable investments offered.
- Majority of members are interested in learning more about sustainable investing from their investment providers.
- Over half would consider changing their current contributions to sustainable investments, if they knew these existed in plans. Over one-third are willing to increase their current contribution level, if put towards sustainable investments.
- A third did not consider sustainable factors when they invested because they did not know/ were not aware it was offered. This presents an opportunity for DC providers to educate members on ESG integration in current funds offered in their plans.
- It's not just "E": Human rights (42%), strength of management (39%), protecting the environment (39%), and fraud/corruption (38%) were listed as the top factors when making sustainable investment decisions.
- Sustainable investments are perceived to be more expensive, especially among younger members.

Record-keepers are working with DC plan sponsors to meet the evolving member needs. Some members are keen and have strong views on ESG investing, some are neutral, and some might be skeptical. Increasingly information is being provided to assist members find opportunities that support desired

[48] Source: MFS: April 2020 survey of 4,000 plan members, including 1,000 Canadians

sustainability goals. In addition, more information is being provided for members where their plan already offers at least one ESG investment option (ESG integration).

As a result, communication to members in self-directed DC plans surrounding ESG investment issues is critical from the perspective of both risk management by the plan administrator and helping members to achieve good investment outcomes.

As this area continues to involve it will be important to evaluate whether traditional investments truly integrate ESG factors.

KEY TAKE-AWAYS

(1) As fiduciaries, plan sponsors must be looking for funds with Value and not Values.

(2) Alternative methods of DC ESG investing are available to DC plans.

(3) Greater reporting and evaluation of the ESG integration within DC investment options are developing.

(4) Member interest in ESG investing, where there are also strong financial returns, is high.

(5) Clear and accurate communication to members in self-directed DC plans relating to ESG investment issues is critical to plan administrators meeting their fiduciary duties.

(6) Plan administrators need to inform members of how the funds available to them integrate ESG factors, in the same way members have access to information regarding fund objectives, asset class, performance, fees, style, etc.

7. IMPLEMENTATION

The following outlines the main tasks, issues, and considerations that should be considered when fiduciaries are implementing an ESG factor program or regime into an institutional investment program.

The specifics of integrating or implementing an ESG factor program will necessarily vary by the specifics of the portfolio under consideration (size, resources available, Statement of Investment Policies and Procedures ("SIPP") objectives and constraints, applicable legislation, etc.). There are a multitude of reasonable approaches to implementing ESG into an institutional portfolio by fiduciaries with the assumed purpose of improving the portfolio's returns and/or risk management objectives. It is to be expected that there will be variation in approaches to implementation. It is important to be careful to avoid naïve comparisons between other portfolios and approaches. Any implementation must be assessed within the whole investment framework including investment beliefs, investment strategy, applicable legislation, size of portfolio, available investment management resources, investment governance structure, investment objectives, and constraints.

Pension plan sponsors and administrators should consider using this opportunity to scrutinize other aspects of the portfolio investment strategy and/or governance process and consider other ideas to improve the probability of meeting the portfolio's objectives.

Purpose of Implementing an ESG Program into the Portfolio

It is vitally important that the organizational purpose and objectives of implementing an ESG factor/program be clearly articulated, and the fiduciary guidelines recognized. A clearly defined purpose will help guide the numerous decisions that will need to be made in developing an ESG program, monitoring the ESG program (within the broader portfolio management), and making the necessary adjustment or modifications to the ESG program over time.

Responsibility for the development of the purpose and objectives of an ESG program would typically reside with a Board or the Pension Committee in Quebec and Manitoba (referred to as "Board" for the sake of simplicity) who are fiduciaries under Canadian law. In the situation where a Board has an investment committee to which it has delegated the detailed investment work, the Board still retains the responsibility to oversee the work of the investment committee.

Input from the investment program stakeholders should be sought. Examples of stakeholders would be, legal counsel (both internal and external), plan actuary (if applicable), Chief Investment Officer (if applicable), external investment consultant, auditor, and current investment managers. Again, the specifics of which stakeholders' views are sought will vary depending on the particular circumstances.

The views of the stakeholders may vary considerably, and they might focus on different aspects of the purpose of implementing an ESG program into the portfolio. These views will need to be reviewed, collated, and integrated into a cohesive purpose. This might prove to be difficult to accomplish but if done reasonably well will provide a guide for subsequent decisions.

In general, the typical purpose of implementing a formal ESG regime on an institutional portfolio by fiduciaries is to add additional factors (the factors being the specifics of the ESG program) that are believed to be associated with superior investment outcomes (i.e., higher return and/or lower risk). To be clear, ESG factors are meant to complement the existing fundamental investment analysis that is currently being undertaken.

Investment Beliefs

Irrespective of whether an Investment Beliefs document exists for the portfolio or not, the management of a portfolio is guided by certain investment beliefs. Simple examples of such beliefs would be active vs. passive, value vs. growth, public vs privates, etc. It is worthwhile to revisit the portfolio investment beliefs when an ESG factor program is being embedded into the overall management of the portfolio.

After the purpose of implementing ESG factors has been developed (see above), beliefs about ESG factors should also be developed. This will help guide the focus of the program to those areas believed to be associated with the purpose of the ESG program.

It will then need to be determined which ESG factors are identifiable and measurable to enhance the investment management process. This will not be an easy task.

Depending on the organization's resources and how much has already been achieved in this area it might be more effective to start with broad factors and add additional factors over time within the investment strategy.

Applicable Legislation

Once the purpose of the ESG program has been established but before the development of the SIPP, a thorough understanding of the applicable legislation as it relates to the fiduciaries and ESG should be garnered. It would be expected that legal counsel with experience in such matters be asked to assist with this task. Knowing what is required, permitted, and prohibited from applicable legislation will assist in the formation of the Investment Policy components.

Balancing the "E", "S" and "G"

As has been identified, ESG factor investing is not a simple switch that gets turned on (or off). It is based on the belief that various ESG factors (the specific factors that the investors must determine) will lead to better portfolio outcomes. Each investor will have to define, for each of the three sub-components of ESG investing, what those specific factors are.

It is not necessary and would be unusual to weight the E, S & G by 1/3, 1/3, 1/3. The three ESG sub-components will be additional factors within other qualitative and quantitative factors such as financial statement analysis.

Again, there is no one specific right approach. The approach chosen would complement the whole of the investment process. Conflicts and trade offs will occur.

While balancing E, S, & G within the ESG program the fiduciary must now balance the ESG framework with other important investment factors. This obviously makes investment decisions more multi-faceted. One must be alert to the potential that the new investment criteria (i.e., ESG), because of its new role and potentially lack of understanding, has an outsized influence on the overall investment decision making. Balance is key. There will be some over/under emphasis that will be adjusted over time.

A fiduciary will be required to balance the practical realities of how much or how little detail to provide. In general, more detailed constraints limit the investment manager's opportunity set when investing. Conversely, looser constraints provide an investment manager with a broader opportunity set but might result in a more significant drift in manager style than was anticipated. This is a challenge and there is no one best approach. The investment governance process will have to establish the criteria, and then monitor and adjust over time as necessary.

Investment Policy

After the investment beliefs have been articulated and the applicable legislation has been reviewed, the detailed investment strategy should be developed and documented in the SIPP.

A SIPP can help define how ESG considerations may support overall plan objectives and constraints (in the context of applicable legal and regulatory provisions). These constraints may include factors such as investment time horizon, liquidity, opportunity sets and diversification. It may also include the level of, and measurement period for, return targets and corresponding corrective actions.

The SIPP should contain enough detail so that the portfolio investment managers have a clear understanding of what and how they are expected to manage the assets entrusted to their management.

Basic provisions would include (preferably by asset class) at a minimum, the objectives and constraints which would further identify permitted and prohibited assets.

It is here that the detailed ESG criteria would be documented for the investment managers.

Thought should be given to how any conflicts between managing return expectations, risk management and ESG factors will be balanced. There will most likely be differences between asset classes in which these conflicts need to be balanced. As well, balancing asset class compliance and compliance at the total portfolio level will need to be addressed.

Investment Governance

The investment governance process will need to be adjusted to reflect the additional ESG objectives and requirements imposed on the investment strategy. At a minimum, additional time will be required of an investment committee (or Board) to implement and monitor the ESG factors. As well, depending on the size of the plan, internal resources or external consultants will need to be identified, hired, and associated responsibilities confirmed in order to assist in the development, implementation, and monitoring of the ESG program.

The Board and investment committee will need to budget additional time for education, research, design, implementation, monitoring, reviewing, and making adjustments to the investment program.

The Board or investment committee might decide, depending on the extent of internal resources, to engage with an external service provider to provide assistance with some of the development of strategies, policies and detailed ESG criteria.

Transition of Existing Portfolio to Reflect ESG Requirements

The process of implementing or modifying a current ESG regime within an existing portfolio will necessarily take time. The Board or investment committee will have to balance the speed to which the implementation occurs against other investment governance priorities. An assessment of the existing portfolio compliance with the new investment strategy (i.e. with the ESG factors) should also be conducted. A plan to transition the portfolio to fully reflect the ESG factors over time (such as 2-4 years) should be developed. Investments made via closed end/Limited Partnership might take longer as the best course would be to transition once the capital is returned at the end of the life of the investment.

Transitioning over time will provide the advantage of prioritizing those asset classes and/or investment managers that are most non-compliant with the current strategy (or have other reasons for termination) and/or have the most opportunity to benefit from replacement.

As well, the transition over time will provide education, feedback, and experience to the Board or investment committee in implementing the investment governance changes required. There will be some lessons learned that can be utilized to enhance changes to other asset classes/investment managers.

Investment Manager Selection, Review and Termination

The existing investment manager review and search process will require modifications to meet the requirements imposed by the ESG program. This may require additional staff or hiring of service providers. It is important to be alert to naïve analysis of investment manager marketing efforts to ascertain if the investment managers investment belief, style, and process are consistent with the plan's specific ESG requirements.

Once ESG factors (again the specifics will be portfolio dependent) are embedded into the overall portfolio management process, the selection, review and termination of investment managers will need to reflect the ESG factors.

Whoever is responsible for investment manager research will need to add the desired ESG criteria to their investment manager evaluation criteria.

The following key criteria when selecting investment managers/funds can be considered:

- The definition of each respective investment mandate, including the benchmark, opportunity set, investment style and constraints;
- The manager's resources and considerations that drive security selection, including investment time horizon; data sources and depth of analysis/stress testing; cross functional collaboration; ongoing education and training;
- The manager's framework around portfolio construction, including breadth, diversity and sustainability of alpha sources, liquidity, data availability and risk management;
- The manager's approach to active ownership, including proxy voting, issuer engagement, feedback loops and potential divestment;
- The manager's governance structure, both with regard to investment and overall firm management, clear definition of accountabilities and effective alignment of incentives;
- The resilience of the manager itself and its alignment with the plan's overall philosophy and objectives, including active stewardship, industry and policy engagement and alignment with international standards.

It will be necessary for the pension plan fiduciary to then monitor the investment managers to ensure that the ESG mandates are being properly executed.

KEY TAKE-AWAYS

(1) The implementation phase should be viewed by pension plan fiduciaries as an opportunity to enhance the overall investment governance program with the objective of seeking additional return and/or mitigating risk. The ESG program should ultimately be designed, implemented, monitored, and managed to achieve a net benefit to the portfolio given the obligations of pension fiduciaries.

(2) Implementing ESG factors into a portfolio will not be easy, it will take more time and resources, but fiduciaries are obligated to evaluate and understand how ESG factors area source of risk and opportunities.

8. CALL TO ACTION

(1) Regulatory guidance should be provided for plan fiduciaries on how and to what extent ESG ought to be considered in relation to pension assets recognizing the legal fiduciary duties which exist and that lifetime retirement income is the primary goal for pension plan administrators.

(2) Minimum pension standards legislation should define ESG factors.

(3) Minimum pension standards legislation should expressly authorize ESG considerations in investment decisions.

(4) Any ESG reporting guidance should be principles based and should consider the following factors:

- Reporting should be clear, transparent, and consistent.
- Reporting should not be too onerous, especially for small pension plans.
- There should be clear reasoning for the level of detail and format (e.g., standalone report, funding valuation report, SIPP, member statements) of reporting.

(5) ESG reporting requirements should recognize that most pension plans in Canada do not invest assets directly. Pension plan administrators typically work with consultants to choose institutional asset managers based on their expertise. Detailed reporting on ESG by pension plan administrators will only be relevant and useful if downstream ESG reporting is uniform and consistent:

- First, ESG reporting at the company level should follow consistent global standards.
- Second, a sustainability disclosure framework for the investment industry should be developed with input from key stakeholders, including regulatory bodies and institutional investors such as pension plans.
- Only once there is comparable disclosure across the investment industry will pension plans be able to effectively disclose appropriate sustainability metrics.

(6) There is significant disparity among pension plans in Canada on how ESG decisions are made and their ability to effectively implement those decisions. That disparity should be addressed in any regulatory framework developed to require pension plan administrators to consider and disclose their approach to ESG. A one-size-fits-all approach to regulation has the potential to impose a significant burden on the administrators of small plans, member directed DC plans or plans with limited ability to control or influence their asset manager's implementation of a desired ESG approach.

(7) With respect to member-directed DC pension plans it is important for sponsors to:

- Identify investment options in each asset class on the DC platform.
- Understand the level of ESG integration in their fund options.
- Develop an appropriate ESG member communication strategy.

(8) With respect to climate-related risks we attach our recent submission to the OSFI consultation.

We endorse the following statements from OSFI following that consultation:

For Federally Regulated Pension Plans ("FRPP"), OSFI will continue collaborating with the Canadian Association of Pension Supervisory Authorities to develop guidance on integrating ESG factors in pension investment decisions where they are relevant to the financial performance of an investment pursuant to the plan administrator's fiduciary duty to act prudently. OSFI will assess the need for additional guidance thereafter.

…

Respondents indicated that it would be appropriate for FRPP administrators to consider climate-related risks and other ESG factors in investment decisions where they are relevant to the financial performance of an investment pursuant to their fiduciary duty to act prudently. They indicated that:

- It would be useful for FRPP administrators to use scenario analysis to assess a plan's exposure to climate-related risks but it can also be challenging as building in-house scenarios is complex and may not be feasible for all FRPPs; and
- Plan administrators could review the approaches used to evaluate ESG factors (including climate change) when selecting investment managers. Key selection criteria can include assessing the investment manager's approach to portfolio construction, governance and risk management practices, and stewardship activities.

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ACPM | ACARR
The Association of Canadian Pension Management
L'Association canadienne des administrateurs de régimes de retraite

April 16, 2021

Office of the Superintendent of Financial Institutions (OSFI)
Kent Square 255 Albert Street, 12th Floor
Ottawa, ON K1A 0H2
Via email: Climate-Climat@osfi-bsif.gc.ca

Re: ESG Consultation

To Whom It May Concern:

ACPM (The Association of Canadian Pension Management) is a national, non-profit organization acting as the informed voice of plan sponsors, administrators and their service providers in advocating for improvement to the Canadian retirement income system. Our membership represents over 400 companies and retirement income plans that cover millions of Canadian plan members.

ACPM appreciates the opportunity to provide our feedback on the questions posed in OSFI's discussion paper, *Navigating Uncertainty in Climate Change: Promoting Preparedness and Resilience to Climate-Related Risks.* We note that much of the analysis in the paper and many of the questions do not relate to pension plans. ***As such, we have only provided responses to the questions posed in the paper that relate to federally registered pension plans (FRPPs)***.

We urge OSFI to be mindful of unintended consequences or impact on FRPPs (especially smaller pension plans with more limited resources) of any guidance or legislation relating to climate change risks primarily targeted at financial institutions. Financial institutions in Canada are subject to an entirely different regulatory regime than FRPPs and also have significant resources (as compared to private sector pension plans) to implement complex management strategies relating to climate change risks.

1. **What are your views on the characterization of climate-related risks as drivers of other risks? How do climate-related risks affect FRFIs and FRPPs? Do you have other views on the characterization of climate-related risks set out in this paper?**

We agree with the risks as described on Figure 6 of the paper. Considering climate-related risks in the setting of overall asset allocation and risk appetite for FRPPs may materially impact return outcomes over a long-term horizon.

2. **What steps can FRFIs and FRPPs take to improve their definition, identification and measurement of climate-related risks and the impact of these risks?**

FRPPs can apply the recommendations made by the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-Related Financial Disclosures (TCFD) and leverage the tools provided by these organizations to help improve their definition, identification, and measurement of climate-related risks.

8. What are the key considerations for incorporating climate-related risks into the FRPP's Statement of Investment Policies and Procedures (SIP&P)?

FRPP plan administrators have fiduciary duties at common law and the *Pension Benefits Standards Act, 1985* ("PBSA"). To discharge its fiduciary duties in investment decision making, the PBSA requires a plan administrator choose investments "in accordance with the regulations and in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund." The prudent investor rule requires a pension plan administrator to select the investment that is in the best financial interests of the members. In our view, ESG factors like climate change can play a part in this regard in assessing the economic value and future performance of an investment over the short, medium and long term and should be taken into account together with other appropriate investment assessment criteria.

The following are key considerations for a plan administrator evaluating how to incorporate such risks into the FRPP's SIP&P:

- Where an ESG factor is directly relevant to the financial performance (risk and return) of an investment, it is a relevant and proper investment consideration and should be included in the SIP&P with respect to both investment assessment, selection and monitoring.

- Any conclusion as to whether an investment or divestment is prudent and in the best financial interest of the beneficiaries should be rationally based on appropriate due diligence.

- As FRPPs are typically expected to continue for an extended period, the best financial interest of the beneficiaries should be assessed over the long term. The short term return of competing possible investments is not determinative.

- When weighing different investments (as opposed to setting an investment policy with absolute bars), the integration of ESG factors can be relied upon when deciding between otherwise equally financially prudent investments. Despite some American case-law that ESG factors can be relied upon where the negative financial impact is only *de minimis*, that principle is not supported by UK case-law and should not be assumed to be applicable in Canada without legislative changes to support it. It is worth noting that we are not aware of any Canadian case-law directly on point.

- We believe it is appropriate to incorporate a plan administrator's approach to risks, including climate-related risks, in the SIP&P, but as part of the investment selection process, it is not appropriate to overly emphasize climate risks as compared to other risks that would affect the financial performance of an investment. All material risk and assessment factors are to be taken into account as part of the FRPP investment decision-making process.

9. For FRPPs where the administrator directly invests in assets, are scenario analysis and stress testing used to assess the pension plan's exposure to climate-related risks? If so, how useful are they? What are some other measurement tools that FRPP administrators should consider?

In theory, scenario analysis is an appropriate risk management technique for climate-related risks because of the uncertainty of future outcomes. However, in practice it is currently difficult to extract meaningful results from scenario analysis. Off-the-shelf tools are often inappropriate for the unique characteristics of each pension plan and building in-house scenarios is a complex undertaking that is not feasible for most plan administrators. In fact, the TCFD's 2020 Status Report states that the percentage of companies disclosing scenario analysis was significantly lower than that of any other recommended disclosure due to the challenges of disclosing this information.

10. For FRPPs where individual investments are delegated to an investment manager, should consideration be given to climate-related management when plan administrators select investment managers? If so, what are the key climate-related criteria for selecting investment managers? If not, why not?

We are already seeing FRPPs undertaking the following actions in this regard:

- Evaluating external managers' sustainability risk policies;

- Reviewing whether the risks that have been identified as relevant are sufficiently addressed and reported on by external investment managers; and

- Engaging with external investment managers to stimulate improved policies, processes, and reporting on relevant sustainability risks, including, where relevant, the introduction of a time-bound plan to address them.

We believe such actions are prudent and should be considered for all sustainability risks, including climate change risks.

As for specific key climate-related criteria for selecting investment managers, individual plan administrators establish this criteria based on the characteristics and circumstances of their individual FRPPs. Therefore, we do not have, nor recommend, a prescriptive list of criteria in this regard.

13. Given OSFI's role as the prudential regulator and supervisor of FRPPs, what other work do you think OSFI should consider in relation to climate-related risks?

It would be very helpful to FRPPs if there were standard disclosure requirements that all external investment managers were required to comply with related to climate-related risks and other ESG matters. The availability of easily accessible, standard climate-related measures for all investment funds would allow FRPPs to have appropriate information they can use to better integrate climate-related considerations into their decision-making.

16. What factors should OSFI consider in designing its guidance, supervision process and reporting requirements to promote FRPPs preparedness and resilience to climate-related risks?

As noted in response to Question 8 above, FRPPs have the fiduciary responsibility to act in the best financial interests of their plan beneficiaries. Fiduciary duty requires a plan administrator to consider all factors relevant to financial performance and the financial risk of a plan investment. Any guidance, process and reporting requirements OSFI develops regarding climate-related risks should be built around this fundamental principle.

With respect to FRPP reporting requirements, in our view, they should take the following factors into account:

- reporting should be clear, transparent, and consistent;

- reporting should not be too onerous, especially for small pension plans; and

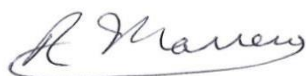
- there should be clear reasoning for the level of detail and format (e.g. standalone report, funding valuation report, SIP&P, member statements) of reporting.

Detailed reporting on climate risks should start with the investment managers and reporting for pension plans be implemented later after asset managers are already reporting on these risks. FRPPs will need sufficient time to incorporate any required disclosures.

To help promote the preparedness and resilience of FRPPs to climate-related risks, efforts should be deployed to develop a reliable and consistent national climate data hub, stemming from curated data generated by various institutions using an established, consistent methodology and terminology.

Thank you for the opportunity to provide our feedback on the questions posed in OSFI's discussion paper. Please let us know if we can be of further assistance to you in this endeavor.

Sincerely,



Ric Marrero
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cc: Tamara DeMos, Managing Director, Private Pension Plans Division
Kim Page, Director, Private Pension Plans Division