Pension Fund Investment and Disclosure: Acknowledging Environmental, Social and Governance Considerations

Submission to the Joint Expert Panel on Pension Standards For Alberta and British Columbia

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Summary of Recommendations

There is a growing consensus in the investment community that environmental, social and governance (ESG)[1] factors are an important component of risk management and a potential source of value creation over the long-term.[2] The materiality of ESG factors, such as climate change, corporate trust and occupational and public health, requires that they be considered within investment decision-making processes so that the highest standards of due diligence are met. Yet, in spite of the evidence that ESG factors can have a material impact on investment performance, fiduciaries are reluctant to incorporate these criteria into their investment decisions because they fear that doing so will constitute a breach of their statutory or common law duties to plan beneficiaries.

Clarifying that pension plan trustees may consider environmental, social and governance factors in their investment decisions will provide them with an important risk management tool. Fiduciaries that elect to evaluate plan investments and asset managers with a full range of risks and opportunities in mind will be in a better position to guard against loss and enhance gains. Therefore our first recommendation is that pension funds be provided with the statutory authority to take ESG factors into consideration in formulating investment policy and making investment decisions provided that such considerations are made in the context of fiduciary duty obligations and that the tests of prudence otherwise applicable to Trustees are satisfied.

This paper also recommends that pension funds be required to disclose the extent to which, if at all, ESG considerations are taken into account in the selection, retention and realization of investments, and in the exercise of proxy voting rights. This kind of disclosure would enhance the security of pension investments and strengthen pension plan accountability and transparency. Mandating such disclosure helps clarify the potential materiality of ESG issues for fiduciaries and also encourages pension fund investment managers and other capital market agents to improve investment practices by integrating ESG factors into their investment analysis. Eight countries with similar mature pension systems, all members of the Organization for Economic Cooperation and Development, have adopted such regulations or statutes (See Appendix 3 for relevant excerpts from their respective regulations).

Greater transparency, or disclosure, about this aspect of pension investment is suggested as a practical, affordable and feasible method of improving the position of pension funds

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[1] The terms environmental, social and governance (ESG) and social, environmental, and ethical (SEE) are frequently used to describe the non-financial considerations in investment analysis. These terms each appear in materials cited in this paper and are often used interchangeably. The term ESG has developed more recently and explicitly references governance issues.

[2] See National Roundtable on the Economy and the Environment, "Capital Markets and Sustainability: Investing in a Sustainable future," 2007. See http://www.nrtee-trnee.ca/, UNEP Finance Initiative, "Materiality of Social, Environemntal and Corporate Governance Issues to Equity Pricing," 2004. Accessible at: http://www.unepfi.org/fileadmin/publications/

in Alberta and British Columbia. For pension fund trustees who are reluctant to take ESG factors into account only because of a lack of legislative and judicial direction on the matter, unequivocal direction from the legislatures of Alberta and British Columbia will enable more complete and astute investment decision-making.

Our final recommendation is for the Superintendents of Pensions in the respective provinces to provide guidance to pension trustees on how ESG considerations may be incorporated into investment analysis and risk management. We note that the ingrained nature of the contrary view merits the issuance of specific direction from pension lawmakers of the amendments made with respect to the permissibility of the use of ESG considerations in pension plan administration.

Recommendations

1. **Clarify that the standard of care governing pension plan trustees under the British Columbia *Pension Benefits Standards Act* and the *Alberta Employment Pension Plans Act* (the Acts) does not preclude trustees from considering environmental, social and governance criteria as part of the investment decision-making process provided that such considerations are made in the overall context of fiduciary responsibility and the tests of prudence otherwise applicable to trustees. It is recommended that this be achieved by:**

   Incorporating the language set out in Section 28.1(2.2) of the Manitoba *Pension Benefits Amendment Act* (2005) into the Acts. (See Appendix 1 for the relevant sections of the Manitoba legislation.)

2. **That the Alberta *Employment Pension Plans Regulations*, 35/2000, *Section 50(3)* and the British Columbia *Pension Benefits Standards Regulation*, 433/93, Section 38(2) be amended to require provincially registered pension funds to disclose the extent (if at all) to which environmental, social and governance considerations are taken into account in proxy voting activities, and the selection, retention and management of investments; and require pension funds to annually disclose their proxy voting guidelines and voting records.**

3. **That the Superintendent of Pensions in British Columbia and the Superintendent of Pensions in Alberta issue Policy Bulletins or similar explanatory documents indicating that, without limiting their decision-making power, pension fund trustees may consider environmental, social and governance criteria by employing any or all of the following responsible investment practices: investment screening, targeted investment and active ownership, including shareholder engagement.**

1. Introduction

The Shareholder Association for Research and Education ("SHARE") welcomes the opportunity to submit this brief to the Joint Expert Panel on Pension Standards (the Joint Expert Panel). SHARE is a national non-profit organization dedicated to assisting institutional investors in their consideration of the long-term social, environmental and economic impacts of their investment decisions. Since its creation in 2000, SHARE has carried out this mandate by providing active ownership services, including responsible investment training, proxy voting, and shareholder engagement. SHARE undertakes research on emerging responsible investment issues and advocates for public policy that supports responsible investment practices.

Defined benefit pension plans in Alberta and British Columbia are a cornerstone of retirement security for many of the province's workers and their dependents. They are also widely recognized as one of Canada's most important and efficient pools of investment capital.[3] In considering the security, viability and sustainability of defined benefit pension plans in Alberta and British Columbia, and how to maintain and encourage their continuation, the social and economic context of investment policy and practices merit particular attention**.** The capital allocation decisions made by pension funds and their managers over the long-term, determine both the benefits to plan members and, to a significant degree, the shape of each provinces' economy.

The following discussion outlines the importance of a supportive legislative environment in British Columbia and Alberta to help fiduciaries incorporate environmental, social and governance factors into investment analysis and risk management processes. The discussion will illustrate the link between the long-term nature of pension liabilities and the tendency of ESG factors to have their greatest material impact on business performance over this same long-term timeframe. In light of this, the paper emphasizes the need for capital markets to shift away from short-termism approaches and to refocus on long-term performance and value creation. This brief also supports greater disclosure and accountability by pension funds to plan members, beneficiaries and broader stakeholders around the degree to which ESG considerations are taken into account in the selection, retention and realization of investments and in the exercise of proxy voting rights. Such disclosure is seen as a crucial component of good pension plan governance and supports greater pension plan accountability and transparency.

[3] Remarks by David Dodge, Governor of the Bank of Canada to the Conference Board of Canada *2007 Pensions Summit,* Toronto, Ontario, 10 May 2007. Last accessed February 22, 2008. http://www.bank-banque-canada.ca/en/speeches/2007/sp07-10.html

2. Pension Funds are long-term investors

Pension funds are by definition long-term investors because the obligations the funds are required to meet will come due over the course of many years. Solid returns on investments are crucial to maintain and encourage defined benefit pension plans and ensure their affordability. The best investments for pension funds, therefore, are those that provide reliable inflation-adjusted income streams over time while contributing to a sustainable economy. Controlling risks is essential if pension funds are to achieve these optimal investment outcomes. Pension funds, therefore, have a keen interest in fostering long-term business stewardship through incorporating relevant risks into their investment decisions.

Alberta's and British Columbia's larger pension funds have an additional and complementary imperative for a long-term investment horizon: as investors of large pools of capital, their assets are less mobile and more diversified than the assets of smaller investors. Pension funds hold investments in many enterprises and, in some cases their holdings in individual firms may constitute a very large portion of the firm's share capital. As a result, they are less able to reduce or eliminate their holdings when an enterprise fails to provide adequate returns. To do so risks destabilizing the market for a particular security while at the same time having limited reinvestment options for those funds.

3. The Pervasive Problem of Short-Termism

Many observers have noted that capital markets today exhibit a strong short-term bias. Consequently, pension fund investment decision-makers face the challenge of investing in capital markets where a short-term approach predominates. As Peter Drucker noted in *The Pension Fund Revolution*: "Pensions by definition, are long-term, [and therefore] pension fund management requires long-term strategies for true performance. It is an axiom proven countless times that a series of short-term tactics, no matter how brilliant, will never add up to a successful long-term strategy".[4]

An over-emphasis on short-term investment potentially harms both the long-term investor and the economy generally. Corporate short-termism is characterized by firms that direct resources primarily to maintaining stable cash flows, meeting or exceeding quarterly earnings targets and paying high dividends. This approach results in missed opportunities in long-term value creation through careful management of risks and the pursuit of complex multi-year projects and technical innovation. Corporate decision-makers turn their attention to growth by mergers and acquisitions instead of organic growth, increasing payouts for themselves and shareholders in the short run but sacrificing potentially superior and certainly longer-term financial prospects in the

[4] Peter F. Drucker, *The Pension Fund Revolution*, Transaction Books, Edison N.J., 1995. p. 71

process.[5] At the extreme, managers appear willing to make decisions aimed at meeting quarterly earnings targets even at the expense of doing real damage to the long-term prospects of the business.[6]

A short-term focus is not solely the doing or the choice of corporate executives. Corporations may choose short-termism in response to the activities of other capital markets participants. Investment analysts, for example, focus on anticipating what a company will announce rather than on its business strategy. For pension funds, the compensation of external managers of plan assets is typically based on quarterly performance measured in relation to a benchmark that reflects the short-term market cycle. Consequently, pension fund consultants also focus on quarterly performance when they review investment manager performance.

4. Re-focusing on the longer term

Pension funds are not alone in identifying the problems created by short-termism. Both the business community and institutional investors increasingly recognize the challenge this presents. Last year in the U.S., the Aspen Institute brought together representatives of pension funds, corporations and the labour movement and capital markets professionals to create a set of principles designed to promote "a long-term orientation in business decision-making and investing."[7]

William Donaldson, former chair of the U.S. Securities and Exchange Commission noted in a recent speech marking the publication of a major corporate sector report[8] that moving from chronic short-termism to a healthier longer-term approach requires the attention of all capital market players:

> We hope that these groups – shareholders, the managers of pooled assets, research analysts, members of the accounting profession and even government regulators – can look within their own range of influence and responsibility and in a similar manner to the [Committee on Economic Development] process, they can ask and answer the question 'What can we do to counter short-termism and promote the long-term view'.[9]

Evidence suggests that asset owners' and asset managers' are already re-thinking traditional ways of operating. A recent survey of pension funds, academics, investment

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[5] Trades Union Congress, "Investment Chains: Addressing corporate and investor short-termism, March 2006. p. 7.

[6] Committee for Economic Development, *Built to Last: Focusing Corporations on Long-Term Performance*, Washington, DC, 2007. p. 7.

[7] The Aspen Institute, "Long-Term Value Creation: Guiding Principles for Corporations and Investors", 2007. p. 2, Last Retrieved February 22, 2008. http://www.aspeninstitute.org/atf/cf/%7BDEB6F227-659B-4EC8-8F84-8DF23CA704F5%7D/FinalPrinciples.pdf

[8] Committee on Economic Development, *Built to Last: Focusing Corporations on Long-Term Performance,* 2007.

[9] William Donaldson, Keynote Speech, "CED Releases Built to Last: Focusing Corporations on Long-Term Performance, Urges end to 'Short-Termism'". Retrieved October 9, 2007 (http://www.ced.org/)

consultants and regulators commissioned by the Rotman International Centre for Pension Management found that 80% of survey respondents believe it to be 'somewhat important' (44%) or 'very important' (36%) that investment mandates run for longer than the typical 3-year horizon.[10] Three-quarters of those responding to the survey believe it is 'very important' that pension funds 'review [the] performance of fund managers over [a] long[er] time horizon than the typical quarterly cycle'.[11] Overall, the results show strong support for longer mandates and performance review periods as a way to reorient investment managers to a longer investment horizon.

5. Pension funds as 'Universal Owners'

The term 'universal owner' describes the concerns and motivations of highly diversified institutional investors such as large pension funds.[12] Typically, universal owners' investments are broadly distributed internationally and across many asset classes. To the degree that the assets of smaller pension funds also implement investment policies with these characteristics, they too may be considered universal owners.

Because of this, universal owners suffer when a company contributes to or detracts from the general economy, environment or social fabric and benefit when the opposite occurs. For example, if one company externalizes costs to other companies, the universal owner may experience a reduction in overall returns because the negative impact on other businesses weakens the economy generally, passing on or 'externalizing' its costs to other entities in which the fund also has an ownership interest. In this way,

> Universal Owners … have an incentive to reduce negative externalities (e.g. pollution, and corruption) and increase positive externalities (e.g. from sound corporate governance and good human capital practices) across their investment portfolios.[13]

Universal owners share a common interest with the long-term investors in increasing the attention paid to social, environmental and ethical practices of enterprises. This is because "[f]actors like these are likely to have at least a long-term effect on business results, but seldom get integrated into investment decisions".[14]

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[10] Danyelle Guyatte, Results of a Survey on "Identifying Priorities for Collaboration amongst Pension Funds and their Agents", June 2007. p. 7.
[11] Ibid.
[12] Hawley, James P. and Williams, Andrew T., "Universal Owners: Challenges and Opportunities". Corporate Governance: An International Review, Vol. 15, No. 3, pp. 415-420, May 2007
[13] Raj Thamotheram and Helen Wildsmith, "Putting the Universal Owner Hypothesis into Action: Why large retirement funds should want to collectively increase overall market returns and what they can do about it", *Corporate Governance: An International Review*, Vol. 15, No. 3, May 2007. p. 438.
[14] Raj Thamotheram and Helen Wildsmith, Op. Cit.

6. The Relevance of ESG Factors to Long-Term Investment

The information investors need to make good long-term decisions is not necessarily the same for short-term decisions. A 2003 Deloitte/Euronext survey of European financial market professionals found that 79% of fund managers and analysts believed the management of social and environmental risks has a positive impact on a company's market value in the long-term, but no impact in the short-term.[15]

The view that long-term thinking and practice in the capital markets requires increased attention to ESG factors is reinforced by the conclusion of the National Roundtable on The Environment and the Economy's Task Force on Capital Markets and Sustainability. The February 2007 Task Force report noted that:

> Since many environmental, social and governance factors become material only in the long-term, an obsession with short-term performance may profoundly mask the extent to which such factors can play a meaningful role in investment decision-making.[16]

The Canada Pension Plan Investment Board's (CPPIB) Policy on Responsible Investing clearly reflects the Board's attentiveness to ESG factors:

> Recognizing that the importance of environmental, social and governance (ESG) factors varies across industries, geography and time, responsible corporate behaviour with respect to ESG factors can generally have a positive influence on long-term corporate performance.[17]

One way that the Canada Pension Plan Investment Board is encouraging the integration of ESG factors into the investment decision-making process is through its participation in the Enhanced Analytics Initiative (EAI). EAI members undertake to direct five percent of their trading activity to sell-side firms identified as doing the best job of integrating extra-financial factors into their investment analysis. In this way, the EAI provides a financial incentive to investment research providers to incorporate what it terms extra-financial indicators into their reports and recommendations.

The EAI defines extra-financial indicators as 'fundamentals that have the potential to impact companies' financial performance or reputation in a material way, yet are generally not part of traditional fundamental analysis", including social, environmental and ethical factors.[18] Future political or regulatory risks, the alignment of management and board with long-term company value, the quality of human resources management, risks associated

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[15] CSR Europe, Deloitte, Euronext, "Investing in Responsible Business", 2003. p. 3

[16] National Round Table on the Environment and the Economy, "Capital Markets and Sustainability: Investing in a sustainable future", February, 2007. p. 1.

[17] CPP Investment Board, "Policy on Responsible Investing", February, 2007. p. 2.

[18] Enhanced Analytics Initiative website: http://www.enhancedanalytics.com/

with governance structure, the environment, branding, corporate ethics and stakeholder relations are all identified by the EAI as examples of extra-financial indicators.

Three case studies on the financial materiality of extra-financial factors are provided in Appendix 2 of this report.

As described above, pension funds are motivated to raise the level of consideration given to environmental, social and governance factors by the long-term nature of their liabilities. In addition, particularly for larger pension funds, a second factor is encouraging them along the same path.

7. Fiduciary Duty and the Consideration of Non-Financial Factors

One of the most durable barriers to the implementation of investment policies that take ESG factors into account is the lack of clarity about the latitude pension fund trustees have in this respect. Despite the trends described in this paper, pension fund trustees consistently cite their concern that applying ESG factors to investment decisions may breach their fiduciary duties.

SHARE encountered this problem first hand at a Canadian pension trustee roundtable we held in Vancouver, British Columbia in May 2007. A number of participants made reference to the 'wall' that is erected by pension consultants, investment managers, fellow trustees and employers around incorporating ESG factors into pension investment practices. Trustee participants indicated that greater legislative clarity around their ability to consider ESG issues would be "extremely valuable", giving them the clarity that they need in order to set investment policy that integrates ESG considerations and to communicate these expectations to their investment managers.

In 2005, the United Nations Environment Programme Finance Initiative asked the large European law firm Freshfields Bruckhaus Deringer whether the law permits, requires or hampers fiduciaries, primarily those related to pension funds, integrating ESG issues into investment policy (including asset allocation, portfolio construction and stock-picking or bond-picking).[19] The result was a comprehensive survey of the legal regimes of many OECD countries including Canada. The authors firmly concluded that: "integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions."[20]

Despite the Freshfields opinion and the implementation of responsible investment policies by some of Canada's largest pension funds, trustees in Canada still seek further guidance on this point. As the National Roundtable on the Environment and the Economy's Taskforce on Sustainability and Capital Markets concluded:

[19] Freshfields Bruckhaus Deringer, "A legal framework for the integration of environmental, social and governance issues into institutional investment", New York/Nairobi: United Nations Environmental Programme Finance Initiative, Oct. 2005. p. 6.
[20] Ibid. p. 13.

> Pension fund trustees must be made aware — perhaps via regulators issuing guidelines or, where appropriate, enacting regulations and/or legal changes by government — that considering ESG factors in capital allocation decisions is not *in conflict* with established fiduciary duties and that, in fact, not considering them may actually be a potential breach of such duty.[21]

Pension legislation in Canada must make it very clear that no breach of duty occurs when pension fund investment policy and investment selection involve the consideration of non-financial factors.

8. A Canadian Precedent for the Consideration of ESG Factors

In one Canadian jurisdiction, Manitoba, legislation has enabled pension fund trustees, absent a specific mandate to the contrary, to consider ESG factors in investment policy making and investment decisions on a discretionary basis.

The relevant sections of the Manitoba Pension Benefits Act are set out in Appendix 3. The Manitoba provision is not prescriptive. It permits fiduciaries to consider non-financial criterion without thereby contravening their duties under the Act, but does not require that they do so.

Pension legislation in Alberta, British Columbia and Manitoba each sets out the duties that apply to pension trustees. The addition of the provision we recommend does not alter the required duty of care that applies to fiduciaries. It simply clarifies that the duty does not preclude the consideration of ESG factors in the formulation of investment policy or in decisions with respect to investments.

British Columbia trustees will benefit particularly from this clarification because, unlike Acts in other jurisdictions, Section 44(1) of the British Columbia *Pension Benefits Standards Act* provides that:

> 44(1) Pension plan investments, loans and other pension plan financial decisions must be made in accordance with this Act and the regulations and in the best *financial* [emphasis added] interests of plan members, former members and other plan beneficiaries.

The uncertainty that plagues pension fund trustees who appreciate that the assessment of ESG criteria is necessary to the full and proper exercise of their duties to plan beneficiaries must be removed. We recommend that Alberta and British Columbia follow the example of Manitoba and clarify the law is this regard to enable pension fund trustees to discharge their obligations.

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[21] National Round Table on the Environment and the Economy, op cit. p. 8.

9. Pension Fund Disclosure of ESG Considerations in Investment Decisions

In addition to developing policies and practices that expand the consideration of ESG factors in the investment decision-making process, some pension funds also are reporting to plan members, beneficiaries and the public on their performance in integrating ESG factors into their investment analysis and decision-making.

Increased pension fund disclosure has been prompted in part by the United Nations Principles for Responsible Investment (PRI).[22] The PRI were developed at the invitation of the United Nations Secretary-General as a framework within which investment professionals can address environmental, social and corporate governance (ESG) risks in their investment activities. The signatories are asset owners, investment managers and service providers. The goal of the PRI Initiative is to mainstream responsible investment practices and disclosure around the world. Principle Six requires that signatories "each report on [their] activities and progress towards implementing the Principles". In its 2007 Report on Progress, the PRI Secretariat indicated that, "Just as investors expect adequate disclosure from investee entities, so too, investors themselves must set an example."[23]

In Canada, disclosure of ESG policies and practices is supported by the CPPIB Policy on Responsible Investing, which sets out the following principle:

> "Employees, customers, suppliers, governments and the community at large have a vested interest in positive corporate conduct and long-term business performance – therefore, disclosure of ESG factors should be public."[24]

Voluntary disclosure of policies and practices related to the application of ESG factors by individual pension plans in Canada today is limited primarily to a few very large public sector pension plans.[25]

10. ESG Disclosure Regulations in OECD Countries

The first jurisdiction to establish a formal obligation for pension fund ESG disclosure was the United Kingdom. Beginning in 2000, most pension funds there have been required to disclose "the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realization of investments."[26] Over the ensuing seven years, Austria, Australia, Belgium, France, Germany, Italy and Sweden have put similar rules in place. The specific legislative provisions setting out the details of these

[22] United Nations Principles of Responsible Investment: www.unpri.org.
[23] Principles for Responsible Investment, "PRI Report on Progress", 2007. p. 32.
[24] CPP Investment Board, Op Cit. p. 2.
[25] See for example the quarterly and annual reports of the British Columbia Investment Management Corporation: http://www.bcimc.com/ResponsibleInvesting/
[26] The Occupational Pension Schemes (Investment and Assignment, Forfeiture, Bankruptcy, etc) Amendment Regulations 1999, SI 1999 No. 1849. Regulation 11A.

pension disclosure requirements and contextual materials for each of these jurisdictions are attached as an Annex to this submission.

In 1999, Stephen Timms, then the Pensions Minister in the U.K. government, pioneered the pension fund SEE disclosure idea. The regulation includes no specific reporting requirement, leaving it up to each fund to describe the actions they are taking. Timms later wrote, "it was light touch legislation, designed to promote cultural change".[27] The U.K. Government saw this as a simple way of focusing pension fund decision-makers on extra-financial issues that ultimately increase corporate responsibility and benefits for all stakeholders. Their view was that when companies are attentive to their SEE performance, they will be better managed and produce superior financial results.[28]

Initially, many were skeptical. The non-profit organization Just Pensions concluded in 2002 that the "pensions and investment management industries seem to be stuck in a paradigm of rewards based solely on hard measures of share price performance, and these are often very short term".[29] But four years later, a survey by the same group found that "[investment managers] are already gearing up to respond to continued signals from UK pension trustees that appropriate consideration of ESG issues is important".[30] The regulation is now viewed as having contributed to the culture change Timms sought, amplified internationally by its adoption in other OECD jurisdiction.

11. Conclusion

The regulations to the Alberta *Employment Pension Plans Act* and the British Columbia *Pension Benefits Standards Act* describe the information to be made available by pension plans established under each Act. Given the importance of encouraging greater emphasis on a long-term approach to pension fund investment, and the central role ESG factors play in such an approach, we make the following recommendation:

1. *Clarify that the standard of care governing pension plan trustees under the British Columbia Pension Benefits Standards Act and the Alberta Employment Pension Plans Act (the Acts) does not preclude trustees from considering environmental, social and governance criteria as part of the investment decision-making process provided that such considerations are made in the overall context of fiduciary responsibility and the tests of prudence otherwise applicable to trustees. It is recommended that this be achieved by:*

[27] Just Pensions "Will UK Pension Funds Become More Responsible?", 2006. p. 1.
[28] David Wheeler, Jane Thomson, Therese Woodward and Priti Shokeen, "Comparative Study of UK and Canadian Pension Fund Transparency Practices", Schulich School of Business & York Institute for Research in Innovation and Sustainability with Kingston Business School, May 2004. p. 10.
[29] Just Pensions, "Do UK Pension Funds Invest Responsibly?", 2002. p. 9.
[30] Chris Gribben and Matthew Gitsham, "Will UK Pension Funds Become More Responsible? A Survey of Trustees", *Just Pensions*, 2006, p. 25 accessed at http://www.uksif.org/cmsfiles/jp/ukpf2006-justpens.pdf

Incorporating the language set out in Section 28.1(2.2) of the Manitoba Pension Benefits Amendment Act (2005) into the Acts. (See Appendix 1 for the relevant sections of the Manitoba legislation.)

The adoption of an ESG disclosure requirement for pensions governed under legislation is an effective catalyst for bringing about positive changes to the viability of defined benefit pensions while enhancing benefits to the economies of Alberta and British Columbia.

For closely related reasons, we also make the following recommendation:

2. *That the Alberta Employment Pension Plans Regulations, 35/2000, Section 50(3) and the British Columbia Pension Benefits Standards Regulation, 433/93, Section 38(2) be amended to require provincially registered pension funds to disclose the extent (if at all) to which environmental, social and governance considerations are taken into account in proxy voting activities, and the selection, retention and management of investments; and require pension funds to annually disclose their proxy voting guidelines and voting records.*

Mandated disclosure will focus the minds of pension fiduciaries and prompt discussion and analysis of what information should be reported and how that information is to be attained and communicated. As long-term investors highly sensitive to risk, pension funds and their beneficiaries stand to benefit greatly from an ESG disclosure requirement. As large investors, an accelerated demand for information about non-financial investment information will undoubtedly prompt increased attentiveness to the subject.

Finally, trustees require guidance from regulators on how environmental, social and governance considerations could be incorporated into investment policy and practice and how this information can be effectively communicated to beneficiaries, plan members, and other stakeholders. As such, we make the following recommendation:

3. *That the Superintendent of Pensions in British Columbia and the Superintendent of Pensions in Alberta issue Policy Bulletins or similar explanatory documents indicating that without limiting their decision-making power, pension fund trustees may consider environmental, social and governance criteria by employing any or all of the following responsible investment practices: investment screening, targeted investment and active ownership, including shareholder engagement.*

Our three recommendations are consistent with the Joint Expert Panel's mandate from the Governments of Alberta and British Columbia to make recommendations for sustaining and improving the pension system. Each of our recommendations supports the important goal of maintaining the system of defined benefit pension plans and promoting the security, viability and sustainability of the pension system in Alberta and British Columbia.

Our recommendations are practical, affordable, and implementable. They focus on legislative clarity and disclosure, respectively. Neither prescribes specific standards or behaviours, nor presents significant new costs. Disclosure, as experience in Austria, Australia, Belgium, France, Germany, Italy, Sweden and the United Kingdom demonstrates, is simple to implement. Pension trustees hear more and more about how corporate performance on social, environmental and governance issues effects the value of the investments of pension funds, and yet they are in great doubt about whether they are allowed to consider these factors when formulating investment policy and making investment decisions.

Appendix 1: The Manitoba's *Pension Benefits Act*, Sections 28.1(2),(2.1),(2.2)

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).

Appendix 3: Case studies on the financial materiality of extra-financial factors

Sub-prime lending and crisis in the short-term credit market

Sub-prime lending targets borrowers who cannot obtain credit in the prime market; such loans often carry higher costs for borrows in order to offset lenders' higher risks. Properly extending credit can assist borrowers to build assets, purchase homes, and build a better credit history. The growth of the sub-prime market in the United States has been fuelled largely by its profitability and the relationships between lenders and purchasers of opaque derivative products linked to sub-prime mortgages.

The effects of sub-prime lending are now damaging investments and activities in adjacent sectors of the economy. Many investors were unaware of the broader risks associated with sub-prime lending. However, by including extra-financial factors in their analysis, some were able to avoid or minimize the fallout. One firm that provided this analysis was Innovest Strategic Value Advisors.

Greg Larkin, an Innovest analyst, said that he and his colleagues were "intrigued" by data showing that between 2001 and 2005, the value of loans made to sub-prime borrowers increased five-fold. This information led them to explore the implications of such huge and relatively sudden shift in lending practices. What they foresaw was not good: "People were going to be less able to afford debt, much less the structures they were being sold."[31] As one analyst noted, the "entire sub prime real estate market was headed for a fall … [because of] information that our clients did not get from either Wall Street and/or the traditional rating agencies until well after the fact." [32]

[31] Suzanne McGee, "Lone Voice Warned of Subprime Mess", *New York Post*, September 17, 2007, Accessed October 9. 2007 http://www.nypost.com/seven/09172007/business/lone_voice_warned_of_subprime_.htm
[32] Peter Wilkes, Innovest Strategic Value Advisors, quoted in Hugh Wheelan, "Good credit after bad: The subprime crisis shows the value of extra financial research", *Responsible Investor*, September 7, 2007. Accessed October 9, 2007 http://www.responsible-investor.com/beta/article/good_credit_after_bad/

Meridian Gold and social license to operate

The long-term financial impact on companies of their relations with local communities is a significant concern for companies in the extractive sector. In jurisdictions where state environmental and other related regulations are lax, companies have a relatively free hand from a legal perspective. Failure to ensure the local population's support for, or at least acquiescence toward, a development may have a very negative financial impact on a company.

Meridian Gold Inc., a Canadian incorporated company, acquired development rights to a mine near the town of Esquel, Argentina in July, 2002. Over the ensuing year, the company failed to obtain support for its proposed mining activity from the people living in Esquel. The local population had no prior experience with industrial mining and was concerned about the proposed activity close to their mountain town of 30,000. Although opposition to Meridian's plans was not organized, the community had developed a sustainability plan that articulated its view of how they wanted to see their community develop. Although aware of this plan, Meridian appears to have taken the view that it was not relevant. The company also failed to act on the conclusions of two studies of the potential impact of its mining operation produced by a local university and an advisory group to local government on family and children's issues.

As Meridian began exploring its new property in preparation for extraction activities, questions and concerns of the Esquel residents were dismissed. As a result, organized opposition to the mining activities grew. In February 2003, less than a year after Meridian acquired the rights to mine at Esquel, the town held a public referendum on the mine proposal. Eighty-one percent of ballots cast were against the development of the mine.

In response to the vote, Meridian issued an apology for its failure to take the local population's concerns into account and resolved to engage in more open dialogue before continuing with the development of the mine. Although some alternative methods of extraction are being considered, development has been suspended since 2003.

Meridian Gold's failure to consult with and involve the local community in the development of the Esquel Gold Project at each stage did not manifest itself on the company's balance sheet until early 2006. Only when accounting regulations required Meridian Gold to write down the value of the Esquel property to its fair commercial value without mineral resources was the impact put in financial terms. The total reduction in value was US $542.8 million before tax adjustments.[33]

Full and informative analysis of Meridian's financial prospects at Esquel required information about the attitudes of the local population to mining activity and the company's efforts to deal with those concerns. Traditional analysis of information about

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[33] Steven Herz, Antonida Vina and Jonathan Sohn, "Development Without Conflict: The Business Case for Community Consent", World Resources Institute, Washington, 2007. pp. 27-30.

the property, the expense of proposed mining activities and the projected gold extraction is of little use to an investor because the project has not proceeded.

Varying exposure to environmental regulation in the pulp and paper sector

Among extra-financial investment considerations, environmental issues are analyzed most frequently. One recent study examined the preparedness of thirteen pulp and paper companies for the implementation of various pending environmental regulations. The authors sought to discover the likely financial impact of the regulations, and found them to be quantifiable and highly variable among the companies.[34]

Specifically, the study found that for two of the thirteen companies, the financial exposure of operations to pending environmental regulations was estimated to have a negative impact of over 10% on the market value of the issuers' shares. For companies that elected to prepare for some or all applicable pending legal requirements in advance, or that had lesser exposure to the specific requirements, the forecast financial consequences of regulatory implementation were found to be far less severe. In one case, an increase in market value of nearly 3% was estimated to result from efforts the company made to comply in advance of new regulations. For analysts and investors, careful study of extra-financial factors reveals that not all companies affected by a particular SEE consideration are equally impacted, and the variations can be significant.

[34] Robert Repetto and Duncan Austin, "Pure Profit: the Financial Implications of Environmental Performance", World Resources Institute, 2000.

Appendix 3: Disclosure Regulations in OECD Countries

Australia

The Superannuation Guarantee system was introduced in 1992 by the Labour government. Occupational pensions existed previously, but by the 1980s, covered less than half the workforce. Under the new regime, employers contribute at a set rate on behalf of employees aged 18 to 70 who earn AUD$450 (C$412) per month or more. Current superannuation assets total approximately AUD$945 billion (C$865 billion).

The Financial Services Reform Act (FSR) went into effect on March 11, 2002 and applies to the superannuation system. This legislation was the culmination of an extensive reform program examining the regulatory requirements that apply to the financial services industry. The FSR has been incorporated into the 2001 Corporations Act. The objective of the FSR is to set out a regulatory framework for harmonised licensing, disclosure and conduct in the financial services industry, covering products, markets and service providers.

The Act also applies to life insurance, general insurance, managed investment schemes, derivatives and banking products. It establishes reporting requirements on "the extent to which labour standards or environmental, social or ethical considerations" are taken into account as a component of Product Disclosure Statements for the investments governed under the Act. The disclosure requirement applies to all pension assets.

> ***The Financial Services Reform Act***
> *1013D Product Disclosure Statement content—main requirements*
>
> *(1) Subject to this section, subsection 1013C(2) and section 1013F, a Product Disclosure Statement must include the following statements, and such of the following information as a person would reasonably require for the purpose of making a decision, as a retail client, whether to acquire the financial product:*
>
> ….
>
> *(k) any other statements or information required by the regulations; and*
>
> *(l) if the product has an investment component—the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment.*
>
> ….
>
> *(4) The regulations may:*
>
> *(a) provide that a provision of subsection (1) does not apply in a particular situation; or*

(b) provide that particular information is not required by a provision of subsection (1), either in a particular situation or generally; or
(c) provide a more detailed statement of the information that is required by a provision of subsection (1), either in a particular situation or generally.

The applicable Regulations address the matters that the legislation leaves open to it as follows:

Corporations Regulations 2001

7.9.14C Labour standards and environmental, social and ethical considerations

For paragraph 1013D (4) (c) of the Act, the more detailed information to be included in a Product Disclosure Statement about the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of an investment is:

(a) a statement that the product issuer does, or does not, take into account labour standards for the purpose of selecting, retaining or realising the investment; and

(b) a statement that the product issuer does, or does not, take into account environmental, social or ethical considerations for the purpose of selecting, retaining or realising the investment; and

(c) if the Product Disclosure Statement includes a statement that the product issuer does take into account labour standards for the purpose of selecting, retaining or realising the investment — a statement outlining:

i. the standards that the product issuer considers to be labour standards for that purpose; and
ii. the extent to which the product issuer takes those standards into account in the selection, retention or realisation of the investment; and

(d) if the Product Disclosure Statement includes a statement that the product issuer does take into account environmental, social or ethical considerations for the purpose of selecting, retaining or realising the investment — a statement outlining:

i. the considerations that the product issuer regards as environmental, social or ethical considerations for that purpose; and
ii. the extent to which the product issuer takes those considerations into account in the selection, retention or realisation of the investment.

Occupational Pension Law

Ch. VIII,. Art 42 - Transparency

The pension provider must also produce an annual report that contains information about:

1. the financing of the plan,
2. the long-term and short-term investment and how social, ethical and environmental aspects are being taken into account
3. investment returns,
4. expenses,
5. and profit sharing, if applicable.

Austria

Until 1990, Austrian pensioners received most of their payments from the mandatory pay-as-you go first pillar of the pension system. Since that time, major pension reforms have increased participation in voluntary occupational schemes called Pensionskassen in the public and private sectors. The SEE disclosure requirement applies to pensions formed under the Pensionskassen regulations. The section is 25(a) 1(6).

Federal Act on the Establishment, Administration and Supervision of Pensionskassen

Declaration on the investment policy principles

Section 25a. (1) The Pensionskasse shall draw up a written declaration on the investment policy principles for every investment and risk sharing group. At any rate, said declaration shall include:

1. the procedures for assessing the investment risk;

2. the risk management;

3. the strategies with regard to the selection of assets as well as in relation to the mix and diversification of assets depending on kind and length of theliabilities undertaken;

4. the admissibility and the strategies of investments in derivative products;

5. the admissibility and the strategies of investments in assets which are not admitted to trading on a regulated market and/or are traded on venture capital markets; as well as

6. the potential selection of assets according to ethical, ecological and/or social criteria.

Belgium

Occupational pensions are not mandatory, but the recently enacted Occupational Pension Law (2003 Loi Pensions Complémentaires or LPC) had, as one of its legislative intentions, increasing the numbers of people covered by workplace pensions.

In January 2004, a provision of the LPC came into effect that requires SEE disclosure for occupational pension schemes in Belgium. It requires that pension fund managers disclose in their annual reports the extent to which they take ethical, social and/or environmental criteria into account in their investment policies.

France

The Fonds de Reserve pour les Retraites (Retirement Reserve Fund or FRR) is a public body established in July 2001 to help fund France's first pillar pension funds. The FRR is to serve as a buffer fund for the period in which it is projected that workers' contributions will not cover the pension payouts due to retirees. With assets of approximately €31.1 billion (C$48 billion), the FRR is now the largest pension fund in France. The following provision applies to the FRR:

> ***Law on Public Pension Reserve Fund (2001)***
>
> *The relevant provision reads, in part: "The management board ... implements the investment policy guidelines … and regularly reports to the supervisory board and particularly relates on how these guidelines have taken into account social, environmental and ethical considerations."*
>
> *In the private sector, the Fabius Act of 2001 was aimed at increasing long-term savings with tax-exempt, voluntary Employee Savings Plans. The law established a voluntary partnership employee savings scheme (Plan partenarial d'épargne salariale volontaire, or PPESV). It is partly a substitute for voluntary company pension schemes.*
>
> ***Fabius Act of 2001 (law n. 2201-152, art. 21)***
>
> *Requires that the employees' saving funds "specify the social, environmental or ethical considerations the fund management company must take into account when buying or selling securities. The fund's annual report must indicate how these considerations have been taken into account."*

Germany

Germany has introduced environmental and social reporting requirements based on the British model for some segments of the second and third pillars of its pension framework.

All private pensions savings and some occupational plans are subject to regulation under the Insurance Supervision Act.

The Insurance Supervision Act

Section 115 (1) The […] capital of pension funds has to be invested in a way which guarantees the highest possible security and profitability, a sufficient liquidity and an adequate spread of risks.

Section 115 (4) The pension fund must inform the beneficiaries in principle at the time of the conclusion of the contract and annually in writing if and how it takes ethical, social and environmental considerations into account in its investment policies.

Italy

Italy's pension system consists of a basic, mandatory state pension, a voluntary, supplementary occupational scheme and a third pillar, voluntary private pension plans. The SEE disclosure requirement will go into effect for large companies from 2008 and from 2009 for small and medium-sized enterprises.

Legislative Decree n° 252 (December 5th 2005)
Article 6, Paragraph 14

Pension funds are requested to show in their yearly reports, as well as in their periodical communications to all scheme's members, whether and to what extent any social, ethical and environmental investing aspects have been considered in their asset and resource management.*
**annual reports*

Sweden

In Sweden, environmental and ethical reporting requirements have application in the mandatory first pillar of the Swedish pension system, also referred to as the state pension.

Public Pension Funds Act 2000 (2000:192)

Each fund "must describe how environmental and ethical considerations are taken into account in investment activities…", without detracting from the fundamental objectives of fund management.

United Kingdom

The British SEE disclosure provision fits within a broader pre-existing set of requirements. The ***Pensions Act* 1995 (Ch 26 19 July 1995)** established a comprehensive statutory framework for the administration of occupational pension schemes. This Act requires that trustees ensure that a written statement of investment principles (SIP) be prepared. The SIP must address various characteristics of the fund's investments as well as "…such other matters as may be prescribed".

The following U.K. pension legislation also includes an SEE disclosure provision:

The Occupational Pension Schemes (Investment and Assignment, Forfeiture, Bankruptcy, etc) Amendment Regulations 1999, SI 1999 No. 1849

Regulation 11A:

One other matter to be disclosed in the SIP is "…the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realization of investments".

The Local Government Pension Scheme (Management and Investment of Funds) (Amendment) Regulations 1999, SI 1999 No. 3259

Regulation 9A:

(1) *An administering authority must, after consultation with such persons as they consider appropriate, prepare, maintain and publish a written statement of the principles governing their decisions about investments.*

(2) *The statement must cover their policy on-*

….

(f) the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realization of investments….

Stakeholder Pension Schemes Regulations 2000

Regulation 9(4)(f):

The statement must cover the manager's policy about the following matters

….

(f) the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realization of investments;…