Regulating pension fund disclosure of environmental, social and governance practices

Submission to the Ontario Expert Commission on Pensions

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Executive Summary

Pension funds in Ontario are long-term investors. But chronic short-termism in capital markets presents challenges to their security and sustainability. This paper argues that pension plans will be strengthened by introducing a regulatory amendment requiring each pension plan to disclose the extent to which, if any, environmental, social and governance (ESG) considerations are taken into account in the selection, retention and realization of investments.

There is increasing awareness that ESG characteristics of businesses represent significant sources of risk that pension funds, in particular, should monitor carefully. Highly diversified investment portfolios make pension funds "Universal Owners", giving them an interest in broader economic performance and a concern for firm-level externalities. Some Canadian pension funds are beginning to incorporate ESG considerations into their decision-making. Other funds stand to benefit enormously from paying attention to these issues as they present real, long-term risks to all investors. Mandating disclosure brings these issues into clear focus not only for pension funds, but also for their investment managers and other agents.

About SHARE

The Shareholder Association for Research and Education ("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.

Recommendation:

That the *Pension Benefits General Regulations, R.R.O. 1990 Regulation 909 Section 78* 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.

1. Introduction

The Shareholder Association for Research and Education welcomes the opportunity to submit this brief to the Ontario Expert Commission on Pensions. Defined benefit pension plans in Ontario 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 pool of investment capital.[1] As the Commission has noted, "the accumulation and investment of huge assets of occupational pension plans is a significant factor in determining the strength of financial markets and the availability of investment capital."[2]

In considering the security, viability and sustainability of defined benefit pension plans in Ontario, 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 the provinces' economy.

In addition, as pension funds become increasingly visible economic players and as their broader economic and social impact is subject to greater scrutiny[3], maintaining their social license to operate will become increasingly important. If defined benefit pension coverage as a percentage of the overall workforce continues to decline, the reputational aspects of pension plans will grow even more in importance as plans seek to maintain popular support. Under such circumstances, attention to greater public accountability becomes increasingly important.

This paper argues that requiring pension plans to disclose the extent to which, if at all, environmental, social and governance (ESG)[4] considerations are taken into account in the

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

[2] Expert Commision on Pensions, *Reviewing Ontario's Pension System: A Discussion Paper for Interested Ontarioans"*, February 2007. p. 4.

[3] See for example the Greenpeace and Sierra Club of Canada "It's my future" campaign http://www.sierraclub.ca/national/media/item.shtml?x=569 and Amnesty International Canada's "Sharepower" project http://www.amnesty.ca/campaigns/sharepower/

[4] 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.

selection, retention and realization of investments, and in the exercise of proxy voting rights, enhances the security of pension investments and strengthens public support for robust and efficient defined benefit pension funds. Mandating such disclosure helps to clarify the potential materiality of ESG issues for fiduciaries and also encourages pension funds' 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 1 for relevant excerpts from their respective regulations).

The long-term nature of pension liabilities and tendency of environmental, social and governance (ESG) factors to play their greatest role in the performance of businesses represented in pension fund portfolios over the same period creates a strong link between them. At the same time, for the largest of the province's pension plans, the sheer breadth of their investments make them "universal owners", exposing them to ESG factors across the economy. For these "universal owners", costs externalized to the advantage of one firm may show up on the negative side of the balance sheet of other firms in which the pension fund invests. Greater transparency, or disclosure, about this aspect of pension investment is suggested as a practical, efficient method of improving the position of pension funds in Ontario.

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.

The province'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*: "by definition, pensions are long-term. Pension fund management therefore 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".[5]

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 process.[6] 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.[7]

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.

Is such short-termism in pension investment structural? What must change if a pension fund is to re-focus on achieving long-term results? In March 2003 the Universities Superannuation Scheme, Britain's second largest pension fund, and Hewitt Bacon & Woodrow, the UK arm of global pension consultant Hewitt and Associates, sponsored a global competition. They asked contestants to describe how they would manage pension fund assets "As if the Long Term Really Did Matter".[8]

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

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

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

[8] Hewitt Bacon & Woodrow, "Investing Pension Funds as if the Long Term Really Did Matter", January, 2004.

What the contest's sponsors observed at the outset was that most pension investment mandates are subject to rolling three-year performance objectives. This structure forces investment managers onto a short-term performance treadmill. Similarly, they observed, the fee structure commonly established for pension fund mandates does not foster long-term money management. Assessed annually, the fee is equal to a fixed percentage of assets under management, plus additional fees if the investment manager is able to out-perform a specified benchmark. Like corporations, managers' attention is directed to the near future.[9]

4. Re-focusing on the longer term

Pension funds are not alone in recognizing the problems created by short-termism. Both the business community and institutional investors increasingly recognize the challenge this presents. Earlier this year in the U.S., the Aspen Institute brought together representatives of pension funds, corporations, 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."[10]

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[11] 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'.[12]

Evidence suggests that asset owners' and asset managers' are already re-thinking traditional ways of operating. A recent survey of pension funds, academics, investment 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.[13] 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

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[9] Ibid.
[10] The Aspen Institute, "Long-Term Value Creation: Guiding Principles for Corporations and Investors", 2007. p. 2, Retrieved October 9, 2007 http://www.aspeninstitute.org/atf/cf/%7BDEB6F227-659B-4EC8-8F84-8DF23CA704F5%7D/FinalPrinciplesAug07.electronic.pdf
[11] Committee on Economic Development, *Built to Last: Focusing Corporations on Long-Term Performance*, 2007.
[12] 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/)
[13] Danyelle Guyatte, Results of a Survey on "Identifying Priorities for Collaboration amongst Pension Funds and their Agents", June 2007. p. 7.

typical quarterly cycle'.[14] 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. The relevance of extra-financial 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 importance to the long-term investor of extra-financial factors has been well and fully articulated by the Universities Superannuation Scheme in the U.K.:

> The fund has a commitment to encourage responsible corporate behaviour and this reflects our view that good management of [extra-financial] issues is good for long-term corporate performance, helping to protect and enhance the value of the Fund's investments.[17]

Similarly, the Canada Pension Plan Investment Board's (CPPIB) Policy on Responsible Investing clearly reflects the Board's attentiveness to 'extra-financial' 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.[18]

[14] Ibid.
[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] Sir Graeme Davies, Chairman, USS, "Total Risk", *0.618*, Issue 5, United Nations Environmental Programme Finance Initiative, January 2005. pp. 2-3.
[18] CPP Investment Board, "Policy on Responsible Investing", February, 2007. p. 2.

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.[19] Future political or regulatory risks, the alignment of management and board with long-term company value, the quality of human resources management, risks associated 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 the Appendix to 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.

6. Pension funds as 'Universal Owners'

The term 'universal owner' describes the concerns and motivations of highly diversified institutional investors such as large pension funds.[20] 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 also 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 others in which the fund also has an ownership interest. In this way,

[19] Enhanced Analytics Initiative website: http://www.enhancedanalytics.com/
[20] 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

> 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.[21]

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".[22]

7. 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).[23] 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."[24]

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."[25]

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[21] 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.
[22] Raj Thamotheram and Helen Wildsmith, Op. Cit.
[23] United Nations Principles of Responsible Investment: www.unpri.org.
[24] Principles for Responsible Investment, "PRI Report on Progress", 2007. p. 32.
[25] CPP Investment Board, Op Cit. p. 2.

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.[26]

8. Fiduciary duty and ESG 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.

In 2005, the United Nations Environment Programme Finance Initiative asked the large European law firm Freshfields Bruckhaus Deringer whether the law restricts asset managers from seeking to attend to broadly accepted extra-financial interests of savers in conjunction with their financial interests.[27] 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."[28]

Despite the Freshfields opinion, the emergence of the UN PRI 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:

> 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.[29]

Of the various options for providing such guidance, the method that has been most widely adopted in countries with similar pension and legal structures as Canada is a mandatory ESG disclosure requirement for pension funds.

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[26] See for example the quarterly and annual reports of the British Columbia Investment Management Corporation: http://www.bcimc.com/ResponsibleInvesting/

[27] 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. 3.

[28] Ibid. p. 13.

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

9. 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."[30] 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 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".[31] 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.[32]

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".[33] 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".[34] The regulation is now viewed as having contributed to the culture change Timms sought, amplified internationally by its adoption in other OECD jurisdiction.

[30] The Occupational Pension Schemes (Investment and Assignment, Forfeiture, Bankruptcy, etc) Amendment Regulations 1999, SI 1999 No. 1849. Regulation 11A.
[31] Just Pensions "Will UK Pension Funds Become More Responsible?", 2006. p. 1.
[32] 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.
[33] Just Pensions, "Do UK Pension Funds Invest Responsibly?", 2002. p. 9.
[34] 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

10. Conclusion and recommendation

The regulations to the Ontario Pension Benefits Act describe the information to be made available by pension plans established under the 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:

> **That the *Pension Benefits General Regulations, R.R.O. 1990 Regulation 909 Section 78* 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.**

The adoption of an ESG disclosure requirement for pensions governed under Ontario legislation is an effective catalyst for bringing about positive changes to the viability of defined benefit pensions while enhancing benefits to the Ontario economy as a whole.

Mandated disclosure will focus the minds of pension fiduciaries and prompt discussion and analysis of what and how should be reported. 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.

The proposal is consistent with the Guiding Principles set out by the Expert Commission. It supports the important goal of maintaining and encouraging the system of defined benefit pension plans and promotes the security, viability and sustainability of the pension system in Ontario.

This recommendation is practical, affordable, and implementable. It focuses on disclosure rather than on the prescription of specific standards or behaviours, presents no significant new costs and, as experience in Austria, Australia, Belgium, France, Germany, Italy, Sweden and the United Kingdom demonstrates, is simple to implement.

The Ontario Expert Commission on Pensions has identified harmonization as one of the factors to consider in the review. The adoption in Ontario of the Federal *Pension Benefits Standards Regulation* in 2000 was undertaken with a view to harmonizing and streamlining pension administration and regulation in Canada. Currently, the Federal *Pension Benefits Standards Regulation* does not have a disclosure requirement similar to what is recommended in this submission. In our view, the introduction of this regulatory amendment would not constitute a significant departure from the principle of harmonization.

Appendix 1: 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):

(4) 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;…

Appendix 2: 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."[35] 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." [36]

[35] 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
[36]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.[37]

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 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.[38]

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.

[37] Steven Herz, Antonida Vina and Jonathan Sohn, "Development Without Conflict: The Business Case for Community Consent", World Resources Institute, Washington, 2007. pp. 27-30.
[38] Robert Repetto and Duncan Austin, "Pure Profit: the Financial Implications of Environmental Performance", World Resources Institute, 2000.