



2022 PENSION LAWYERS ANNUAL CONFERENCE

ESG and Climate Change: Advising Pension Scheme Fiduciaries

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Overview

- 1. Focus on Value, not Values**
 - Pension funds v. Corporations
- 2. Investment Policy Development**
- 3. Managing the Information Inflow**
- 4. Stakeholder Communications & Management**
- 5. Specific Issues:**
 - Must We/May We Consider ESG Issues?
 - Systemic Risks and Opportunities
 - Climate change
 - Net Zero Emission Targets
 - Additional Fees or Costs – the “Greenium”
 - DC Funds Offering Investment Choice
- 6. Discussion**
- 7. Conclusion**



Focus on value, not values

Baseline Legal Advice: Focus on Value, not Values !

Basic Legal Sources

(a) ***The common-law***

- Two basic principles
 - Standard of Care
 - Duty of Loyalty
- *Cowan v. Scargill [1985] Ch 270*

(b) ***Legislation (Canada)***

- *Minimum Pension Standards Legislation*
- *Income Tax Legislation*

(c) ***Other***

- *Regulatory and other guidance*



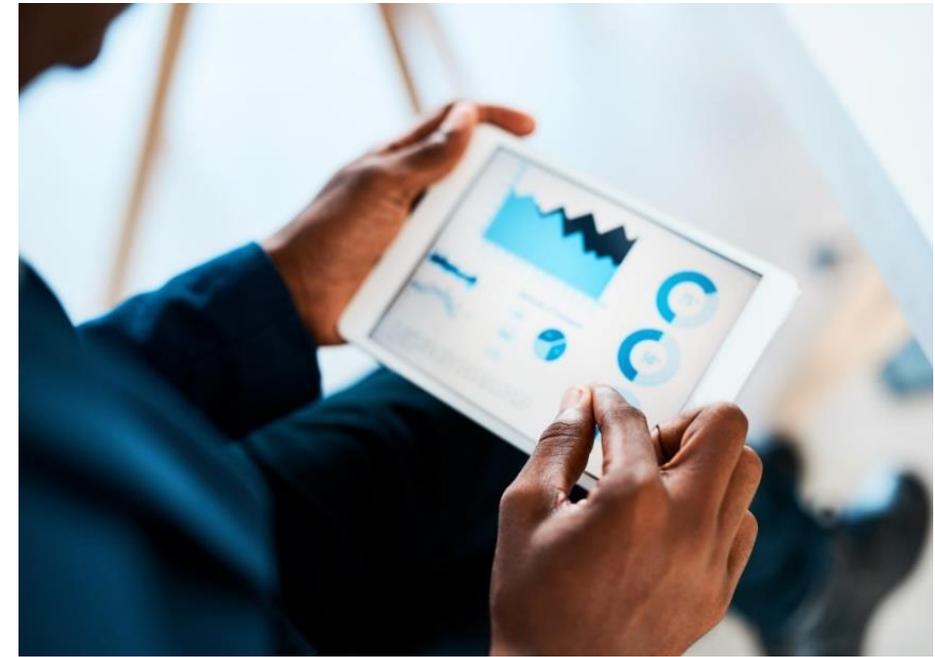
Pension Fund vs. Corporation Legal Parameters

Pension fund:

- Value, not values
 - Pension funds have a primary financial purpose
 - ∴ Financial performance considerations, not impacts will always be legally sound

- For pension funds, this perspective is driven by:
 - Common-law (and civil law) fiduciary considerations
 - *Canadian Income Tax Act* requirements
 - Supported by Canadian pension standards laws

- Does not preclude other considerations
 - As tie-breakers
 - Trust directions
 - Secondary considerations





Pension Fund vs. Corporation

For Corporations:

- Fiduciary purpose is typically much broader
- Corporations statutes:
 - ❑ E.g.: directors and Officers must “act honestly and in good faith with a view to the best interests of the corporation” (ss. 122(1) of *Canada Business Corporations Act*)
 - ❑ Case law in North America (and elsewhere) indicates this obligation to the corporation does not mean the best interests of the shareholders – the so-called duty of “shareholder wealth maximization” ...
 - See also: Supreme Court of Canada decisions (*Peoples Dept. Stores* (2004); *BCE v 1976 Debentureholders* (2009))



Pension Fund vs. Corporation

Example:

- 2019 Amendments to Federal Business Corporation Statute (ss. 122(1.1) of *Canada Business Corporations Act*.

(1.1) When acting with a view to the best interests of the corporation under paragraph (1)(a), the directors and officers of the corporation may consider, but are not limited to, the following factors:

- (a)** the interests of
- (i)** shareholders,
 - (ii)** employees,
 - (iii)** retirees and pensioners,
 - (iv)** creditors,
 - (v)** consumers, and
 - (vi)** governments;
- (b)** the environment; and
- (c)** the long-term interests of the corporation.



Investment Policy Development

Consider the Context

1. Fund Governance

- Investment discretion
- Delegation

2. Size of Pension Scheme

- Advising large Schemes
- Advising other Schemes

Canada has 17,000 tax qualified workplace pension schemes, more than 2/3rds of which have fewer than 10 members! The 32 largest schemes account for more than 50% of all members and more than 58% of all pension assets. Less than 37% of Canadian workplaces provide tax qualified pension schemes, and only about 12% of those are in the private sector.

3. Type of Pension Scheme

- DB v. DC
- If DC, member investment choice dramatically increases fiduciary risk
 - See, January 24th 2022 interim decision of U.S. Supreme Court in *Hughes v. Northwestern University*
 - *Can you offer choice which permits impacts to trump financial purpose?*





Managing the Information Flow

Theoretically, more and better information will enable better investment decision-making.

What duty do fiduciaries have to obtain or apply ESG information ?

- For most clients, ESG information can feel like drinking from a fire-hose.
- The jargon alone is often difficult to understand, interpret or apply
- Ignoring ESG information that is relevant and material to financial purpose could be a breach fiduciary duty.

Much depends on the sophistication and size of the fund:

- Judicial deference will be given to a process that is articulated and followed
 - Reference briefly how ESG factors are taken into account in an investment policy or similar document
- Large sophisticated funds making direct investments should focus on creating internal capacity and an ability to assess relevance to purpose and materiality
 - Most have expert internal ESG resources as well as multiple external resources with ESG expertise
- Others should focus on satisfying themselves about the capability, competence and reliability of their professional advisors and investment managers, and be satisfied that fees are appropriate.





Stakeholder Communications Management

- 1. Recognizing legitimate reputational and stakeholder values and concerns**
 - A balancing act between financial purpose and impacts
 - A careful, legally reviewed communication will position financial purpose as the priority
- 2. Clear and Succinct Communications**
 - Investment policy
 - Promotional material
 - Other scheme communications
 - Employee booklets, annual reports ... etc....
 - ESG impacts, ratings, and rankings?
 - Often employed by third parties to measure sustainability and ESG or ethical impact of the organization -- including large investors that are pension schemes





Specific Issues

1. Can we / must we consider ESG issues?

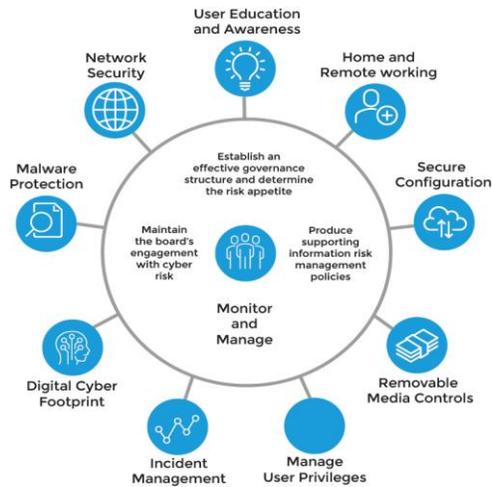
- Yes you **may**, if
 - It's relevant to financial purpose
 - Maintain appropriate file notes or minutes
 - It's used as a tie-breaker between investments with equivalent rate and return characteristics
 - Other recognized exceptions apply – but get legal advice
- Yes, you **must** if it's relevant and material to financial purpose
 - Ignoring ESG information that is relevant and material to financial purpose is actionable (if there is evidence of financial loss)
 - Useful practice to articulate it in investment policy, even if it is only referenced as a criteria in considering the merits of any particular investment, or retention of any expert investment advisor
- Legal issues or concerns will arise whenever impact goals or concerns are, or may be perceived to be part of the decision
 - ∴ relate any questionable ESG related exercise of fiduciary discretion to a financial concern in minutes or file memoranda wherever there might be a concern that the impact goal may be perceived to be equivalent to or greater than financial purpose



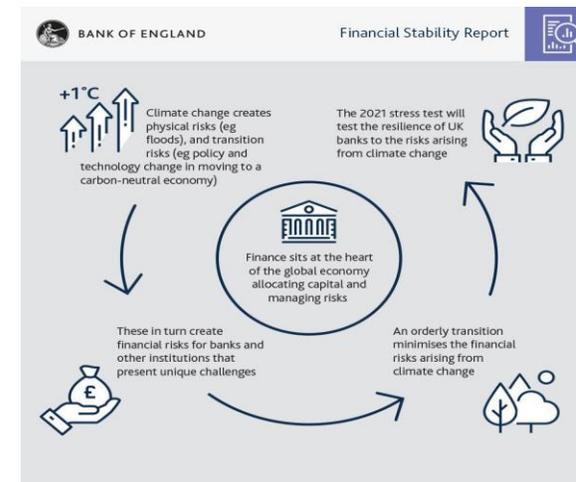
2. Systemic Risks

- Two levels of legal concern
 - Investment risks
 - Organizational risks
- Two prime examples

Cybersecurity



Climate Change





Specific Issues

3. Climate Change Issues

- **There are several aspects often overlooked by fiduciaries in articulating or executing on investment policy relating to climate change, including the following:**
 - Litigation risks: it's not just physical and transition risks
 - not only in the context of devaluing or disrupting investee entities, but to the fund itself !
 - Can create reputational and confidence issues among stakeholders that can result in operational disruptions, distracting legal or labour-relations disputes, and distracting adverse public relations issues.
 - Reference financial opportunities; it's not merely a financial risk issue.
 - Reference short- and medium term implications: it's not only a long-term issue
- **Net zero statements: (e.g., fund intends to be net zero by 2050)**
 - Presumptively an impact purpose, not a financial purpose. As such, it is presumptively inconsistent with the exercise of proper fiduciary investment discretion
 - Distinguish investment discretion from the fund's operational/organizational goals
 - Relate the use of it in investment discretion decision-making to a financial metric or tool to assess or guide financial objectives (i.e., in addition to TCFD recommendations)
 - There appears to be considerable economic evidence (and expert advice) that an orderly transition to net-zero minimizes financial risk arising from climate change, so it seems to be helpful to reference it in that context.



Specific Issues

3. Climate Change Issues (continued)

The Greenium :

- Securities that have higher expense ratios or charge a premium for being environmentally responsible. Is the added cost – the “greenium” justified or legitimate?
 - Mostly a “green bond” issue, but applies to all investment products, including ETFs, mutual funds and stocks.
- Pension fund clients should understand the cost and return implications of paying a premium or accepting a lower net return for investment instruments purporting to be “green” as compared with conventional alternatives
 - Review the legitimacy of the “green claim”
 - What is the manager doing? Many issuers of “green securities” declare themselves to be green without any external verification
 - Clients should be aware of, and monitor, disputes – some of which arise in the public media, such as reports of competition bureau fines and penalties, securities regulatory proceedings, or class actions).
 - Consider participation regulatory or other proceedings by claiming compensation or joining class actions, as a class participant or lead plaintiff.
 - Confirm evidence that the additional expense or lower return reduces, or is likely to reduce, financial risk or increase financial return over whatever the relevant investment period is – i.e., short-, medium- or long-term.
 - Promotional material relating to bonds issued to respond to climate change or corporate social responsibility concerns often do not relate the merits of the investment to the promoted reduction of financial risk or increased financial opportunity.

Greenwashing:

- Representing a product, service or institution as being more environmentally or ecologically friendly than it is.
 - Not as environmentally friendly as advertised
- Lawsuits and regulatory proceedings – relating to deceptive claims



Specific Issues

4. DC Pension Schemes

Member Directed Investments

- Giving investment choice to members is more likely to increase fiduciary risk because the fiduciary selects the menu of options.
 - Fiduciary duty to provide sufficient information/education to enable members to understand the options offered, to identify their own risk tolerances and to match the choices to their individual tolerances
 - Funds themselves must be selected on the basis that they are reasonably prudent investments to provide or secure lifetime retirement income, with reasonable expenses
 - Duty to continuously monitor each option and the menu of options to ensure it is, and remains, prudent
 - Duty to promptly eliminate options that are no longer prudent (and replace them appropriately and provide appropriate information and transition for those in them)
 - Cannot transfer fiduciary responsibility to members by granting a menu of all-encompassing options (see for example, U.S. Supreme Court interim decision in *Hughes v. Northwestern Univ.* (01/24/2022))
 - Must each fund selected for the menu prioritize financial return over other goals ?
 - Argument that impact funds could be provided to respond to particular member choice preferences
 - Safer legal course is to ensure financial implications trump ESG impacts (i.e., value trumps values)



Questions and Comments?

Any particular concerns you have that have not been addressed ?

Any comment or discussion of the material presented?



Conclusion

For pension funds ESG must be primarily about value, not values.

I advise clients to use “value, not values” as a mantra whenever they are considering ESG factors in the context of pension investment decision making and administration – as a sort of beacon or radar to properly address ESG and “responsible investment” issues.

Value, not values

Value, not values

...

THANK YOU

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