Challenges For Pension Fiduciaries In Managing ESG Information [Overload]

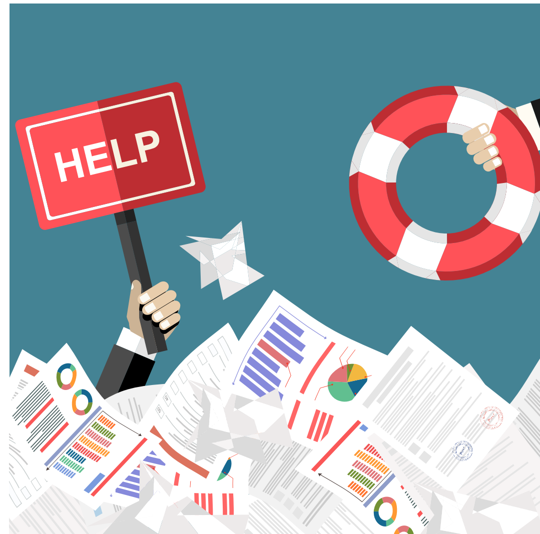
BY: **SCOTT McEVOY**

Canadian investors of all kinds would be forgiven for feeling overwhelmed trying to navigate the large amounts of information relating to climate change and devastating climate events around the world that are affecting their investments. The release of the United Nations Intergovernmental Panel on Climate Change Sixth Assessment Report on March 19 highlighted many positive developments in reducing climate risks, such as progress in adaptation planning and implementation across regions and the growing public and political awareness of climate impacts and risks. However, there is much to be done to ensure the success of mitigation pathways that limit warming to 1.5°C. How we accelerate climate action will require fiscal, financial, institutional, and regulatory reforms, all having an impact on investors such as pension plans.

What appears to be an outsized 'E' in environmental, social, and governance (ESG) information, with its focus on climate change mitigation, energy, and air and water quality management, among other factors, may have diverted attention from social factors including human equity and capital management, and governance with its emphasis on oversight of risk management through boards of directors and other accountability structures.

Pension plan fiduciaries, including trustees and administrators, may feel some frustration in managing the many challenges from this growing information overload. Large sophisticated plans in Canada that are well advised and have the resources are being kept busy meeting challenges that include uneven, undeveloped, and inconsistent disclosures and reporting frameworks and an ever-changing landscape of new initiatives on climate policy, as well as keeping track of international developments.

But for the many smaller pension plans in Canada that invest indirectly through investment funds and other pooled vehicles, the tasks probably seem even more daunting. According to Statistics Canada, as of 2021, while there were more than 16,000 registered pension plans in Canada with over $2.2 trillion in assets, 32 of those plans accounted for 50 per cent of all plan membership, with many smaller plans that do not invest assets directly accounting for the rest.



This means there are some key issues that pension plan administrators should consider in addressing ESG.

Despite plan administrators and other investors having a sense of being overwhelmed, there have been many positive regulatory and other developments, including the increasing maturation of sustainability disclosure standards and the recently published Taxonomy Roadmap Report that will serve to provide certainty to investors.

• Prudent Person Rule and the Plan Administrator as Fiduciary

Investment of the assets of a pension fund is subject to a number of restrictions including: standards of prudence, care diligence, and skill; compliance with the terms of the documents establishing the pension plan; compliance with the pension plan's statement of investment polices and procedures; investment limits contained in Schedule III to the Pension Benefits Standards Regulations, 1985 (Canada) that have been incorporated into most provincial pension legislation; and limits under the Income Tax Act (Canada).

It is the administrator's responsibility as a fiduciary to act prudently to identify risks and opportunities that may impact the plan.

The Prudent Person Rule is a substantive rule of law that is intended to lead to balanced decision-making, rather than dictate particular outcomes.[1]

When administering and investing pension fund assets, an administrator must satisfy the requirements of the prudent person standard, or the requirements of a higher standard if imposed by applicable legislation. Both these standards impose fiduciary obligations on an administrator to act in the best interests of a fund's beneficiaries.

The federal standard is provided for in s. 8 of the Pension Benefits Standards Act, 1985 (PBSA). The PBSA sets out the duty of care to be followed in both the administration and the investing of pension fund assets, requiring an administrator to exercise "the degree of care that a person of ordinary prudence would exercise in dealing with the property of another person" and act in a "manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund."[2] The federal rules make it clear that the duty is owed to the employer, members of the pension plan, former members, and any other persons entitled to pension benefits under the plan.[3] In Canada, certain provinces, such as Ontario and Manitoba, have adopted the federal standard, while other provinces, such as British Columbia, for example, have variations of this standard.[4]

In the pension fund context, the temporal scope of the prudent person rule is measured according to short-, medium-, and long-term time horizons. An administrator must act impartially in the best interests of both present and future beneficiaries when managing and implementing investment policy. The emphasis on inter-generational equity and balancing long-term perfor-

mance of investments against present and medium-term beneficiaries is set against the pension plan's primary risk of not being able to pay pensions and fulfill the plan's promise to members, former members, and other persons entitled to benefits under the plan.

For many years, the historical categorization of ESG matters as non-financial created a legacy perception among boards, investment committees, and advisors that weighing ESG considerations transgressed fiduciary duty. That is, the pension promise – embedded into our Income Tax Act that the primary purpose of a pension plan must be to provide retirement income – is the also the pension's plan's primary risk – not being able to pay pensions and, therefore, managed when implementing investment policy.

• Clarifying that fiduciary duty today does not preclude the consideration of relevant climate change factors – A Done Deal?

Canada's Expert Panel of Sustainable Finance (CEP) produced a report in 2019 that tackled this legacy perception – that ESG factors, such as climate change, are non-financial and, therefore, outside of, or in opposition to, the remit of fiduciary duties.

The panel:

• cited legal analysis indicating that fiduciaries who fail to consider relevant long-term ESG matters, such as climate related risks or potential stranded assets, expose themselves or their firms to legal liability from claims of negligence in the event that risks materialize

• referred to the growing evidence that appropriate consideration of material ESG factors can lead to better investment decisions and superior risk-adjusted returns, particularly over a longer term horizon

It recommended that the Canadian government clarify that fiduciary duty today does not preclude the consideration of relevant climate change factors.[5]

In a recent report by the Institute of Sustainable Finance that sought to measure the progress made on the CEP's recommendations, it found "clarifying the scope of fiduciary duty in practice and law tied for the second most frequently cited need for action in the short term" by participants in its survey.[6]

In early 2021, the Office of the Superintendent of Financial Institutions Canada (OSFI) published a discussion paper – 'Navigating Uncertainty in Climate Change – Promoting Preparedness and Resilience to Climate-Related Risks' (OSFI consultation) – seeking feedback on risks relating to climate change that can affect the safety and soundness of federally regulated pension plans (FRPPs) as well as federally regulated financial institutions (FRFIs).

The consultation noted that although OSFI's current guidance does not reference climate-related risks specifically, it

FOR MANY YEARS, THE HISTORICAL CATEGORIZATION OF ESG MATTERS AS NON-FINANCIAL CREATED A LEGACY PERCEPTION . . . THAT WEIGHING ESG CONSIDERATIONS TRANSGRESSED FIDUCIARY DUTY.

includes principles and expectations that are relevant to FRPP's management of these risks. For example, an administrator that directly invests plan assets can consider the plan's exposure under a variety of potential climate transition scenarios.[7]

Among other things, the consultation set out OSFI's expectation that FRPP administrators consider a wide range of factors affecting their ability to prudently administer their pension plans, including risks that could impact long-term investment performance. Feedback from respondents on the consultation that was published in late 2021 "indicated that it would be appropriate for FRPP administrators to consider climate-related risk and other ESG factors in investment decisions where they are relevant to the financial performance of an investment pursuant to their fiduciary duty to act prudently." Respondents also stated that plan administrators review the approaches used to evaluate ESG factors (including climate change) when selecting investment managers.

There has been a growing call that climate change considerations lie squarely under the fiduciary responsibilities of pension plans. In June 2022, the Canadian Association of Pension Supervisory Authorities (CAPSA) published a draft guideline on ESG considerations in pension plan management[8] which addressed the issue head-on.

This draft guideline is the most significant contribution in terms of regulatory guidance on ESG and pension plan oversight. Three principles and underlying guidance from the draft guideline are set out, including that:

● Pension plan administrators (either directly or through their delegates) should consider ESG characteristics that may have material relevance to the financial risk-return profile of the pension fund's investments.

The first principle highlights that using ESG factors to provide financial insight is consistent with an administrator's fiduciary duty and ignoring or failing to consider ESG factors that may be potentially material to the pension fund's financial performance could be a breach of fiduciary duty.

● Plan administrators, as part of their standard of care, need to assess whether their plan governance, risk management, and investment decision-making practices are sufficient to identify and respond to material ESG information in a manner proportionate to their plans and appropriate for their investment beliefs.

Among other tools, plan administrators could consider developing written policies expressing investment beliefs or principles about ESG factors and their application to investment performance. Plan administrators could consider their processes for identifying and taking into account material ESG considerations with respect to asset allocation, benchmark selection, and use of external managers.

● Pension plan administrators should disclose in their SIPP information about the pension fund's investment policies in relation to ESG considerations. Where appropriate, plan administrators should also provide reports on their stewardship activities as well as request companies in which they invest to disclose their ESG-related policies.

The draft guideline encourages plan administrators to ensure they are keeping pace with disclosure developments and industry best practices including guidelines or recommendations for pension funds set out by the International Sustainability Standards Board (ISSB) and Task Force

on Climate-Related Financial Disclosure (TCFD).

• **Task Force on Climate-Related Financial Disclosure**

The need to adopt TCFD has been identified by both private and public sector participants in Canada. In its Budget 2019, the federal government expressed its support for the framework and encouraged phased adoption by major Canadian companies and federal Crown Corporations.[9] On November 25, 2020, the CEOs of Canada's eight largest pension plan investment managers joined together to issue a request that Canadian corporations measure and disclose their performance on material, industry-relevant ESG factors by leveraging the Sustainability Accounting Standards Board (SASB) standards and the TCFD framework to further standardize ESG-related reporting.

The CEP has made a number of recommendations in relation to TCFD, including a phased comply-or-explain regime, in which the default expectation is for companies to disclose in line with TCFD recommendations (comply). A two-phased implementation approach was also recommended so that by the end of phase two, issuers would be prepared to report on underlying assumptions, calculations, estimates, and scenarios, including their use of established standards or industry-specific guidance. The CEP's report dated in 2019 has been given TCFD adoption in Canada a marginal progress rating by the Institute for Sustainable Finance.

Respondents to the OSFI 2021 consultation also agreed that climate related financial disclosure should follow TCFD recommendations and there was general agreement that any new OSFI climate-related guidance be principles-based and aligned with global standards.

• **Sustainability Taxonomies**

Sustainability taxonomies (systems designed by jurisdictions for determining which economic activities should be considered sustainable) are one of the most important tools to clear up confusion over what is considered sustainable and what is not.

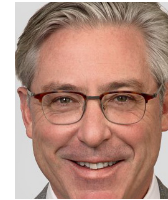
One of the recommendations of the CEP was to establish a standing Canadian Sustainable Finance Action Council (SFAC) to advise and assist the federal government in implementing the CEP's recommendations. In May 2021, the government of Canada launched the SFAC and, in support of the CEP's recommendation No. 9 in its 2019 final report supporting the development of Canadian green and transition-oriented taxonomies, a Taxonomy Technical Experts Group (TTEG) was convened. The TTEG published the Taxonomy Roadmap Report[10] on March 3.

The roadmap report is an exciting and informative start, providing a high level framework to establish a single, standardized, and market-informing taxonomy for Canada with common principles defining green and transition investment in a form that that is easy to use and promotes confidence with transition to net zero. End users of the taxonomy – including investors such as Canadian pension plans, banks and other financial institutions, and intermediaries as well as issuers – will soon have a tool and common definitions to help mobilize the allocation of capital to economic activities that are consistent with national transition pathways and climate mitigation objectives. The roadmap report advocates a running start led by the SFAC to publish a short form taxonomy covering priority sectors and activities [to be completed by the end of 2023], with full implementation led by the federal government and SFAC establishing a taxonomy custodian that will develop a draft taxonomy for consultation in 2025 and full approval by the end of 2025.

• **Other tools here or on the way**

In Canada, a number of other regulatory guidelines have been published or will soon be republished including OSFI's Guideline B-15 Climate Risk Management in respect of FRFIs in March 2023 which encompasses both climate risk management guidance and disclosure requirements that apply to FRFIs. Proposed National Instrument 51-107 Disclosure of Climate Related Matters will introduce disclosure requirements regarding climate-related matters for reporting issuers (other than investment funds). Investment fund managers will be familiar with CSA Staff Notice 81-334 ESG-Related Investment Fund Disclosure, providing guidance on compliance with existing requirements and recommended best practices concerning disclosure for regulatory documents and sales communications.

While there is no shortage of regulatory initiatives in the sustainability information ecosystem in Canada to review and become familiar with, there are many positive developments for Canada's pension plan administrators in relation to ESG matters, including clarification of fiduciary duty in respect of relevant climate change factors and, very recently, a proposed framework for a single standardized and market-informing taxonomy for Canada with common principles defining green and transition investment. BPM



Scott McEvoy
is a partner whose practice at Borden Ladner Gervais LLP (BLG) focuses on pension fund investments, compliance, ESG, and sustainable investing. He is also a member of the firm's environmental, social, and governance (ESG) initiative.

1. Canadian Association of Pension Supervisory Authorities, Guideline No. 6 (November 15, 2011). P. 7
2. Pension Benefits Standards Act RSC 1985, c 32 (2nd) Supp., 8(4) and 8.(4.1)
3. Pension Benefits Standards Act RSC 1985, c 32 (2nd) Supp., ss. 8(3)
4. In Ontario this two-fold standard is provided for in s. 22(1), and in Manitoba in sections 28.1(2) and 28.1(2.1). Manitoba's legislation also provides that "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 the Pension Benefits Act (Manitoba) if, in formulating the policy or making the decision, he or she has complied with the standard [of care]" (see. s.28.1(2.2) Pension Benefits Act (Manitoba))
5. Government of Canada (2019), "Expert panel on sustainable finance," https://www.canada.ca.en/environment-climate-change/services/climate-change/expert-panel-sustainable-finance.html
6. Institute for Sustainable Finance (2021), "Changing Gears: Sustainable Finance Progress In Canada"
7. Office of the Superintendent of Financial Institutions, "Navigating Uncertainty in Climate Change: Promoting Preparedness and Resilience to Climate Related Risks" (January 2021)
8. CAPSA Guideline Environmental, Social & Governance Considerations in Pension Plan Management (June 9, 2022)
9. Budget Plan 2019, Government of Canada
10. Taxonomy Roadmap Report: Mobilizing Finance for Sustainable Growth by Defining Green and Transition Investment, Sustainable Finance Action Council (September 2022)