



**SOCIAL INVESTMENT ORGANIZATION**

*The Canadian Association for Socially Responsible Investment*

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August 25, 2005

Diane Lafleur  
Financial Sector Policy Branch  
Department of Finance  
L'Esplanade Laurier  
20<sup>th</sup> floor East Tower  
140 O'Connor St.  
Ottawa ON K1A 0G5

Dear Ms. Lafleur:

**Re: Consultation on defined benefit pension plans and the Pension Benefits Standards Act**

I am writing on behalf of the members of the Social Investment Organization, the national association for socially responsible investment. Our members include more than 400 staff and directors of financial institutions, asset management firms and fund companies, as well as financial advisors and investors. Our members are committed to the development of socially responsible investment, which is the application of social and environmental analysis to investment selection and management. Our members serve more than half a million Canadian depositors and investors.

With this letter, we are responding to your request for comments on regulatory and legislative issues regarding defined benefit pension plans under the federal Pension Benefits Standards Act. We welcome the opportunity to contribute to this debate and give you permission to post this brief on the Department of Finance website to enhance the transparency of the consultation.

We want to commend the Department of Finance for this initiative. Concerns around solvency issues and pension deficits are of great interest to the investment industry. Clarifying the rules around these issues would be of benefit to the industry and pension plan members across Canada.

However, we believe that your consultation paper on regulatory issues is deficient in two key areas:

- o It fails to discuss the importance of requiring pension funds under PBSA to disclose their social and environmental policies and practices, an area of increasing interest to plan members;
- o It fails to raise the issue of disclosure of proxy voting policies and voting records by pension funds.

Additional disclosure in these two areas would provide transparency in the emerging fields of social and environmental investment management and transparency on the use of the voting power of pension funds. These are two areas of fiduciary responsibility that will grow in importance in the future, and it is critical that current pension legislation require funds to be transparent to their plan members and the investing public on these issues.

### ***Social and Environmental Investment Policies, Fiduciary Responsibility and Pension Transparency***

There is a growing consensus in the investment community that social and environmental factors are an important component of prudent risk management and a source of added portfolio value. The emerging view is that investment fiduciaries must incorporate an element of social and sustainability analysis into their portfolio assessments in order to be responsible fiduciaries. Yet, in spite of the evidence about the importance of social and environmental factors, and the growing responsibility of fiduciaries to account for social and environmental factors, pension plan members still have no access to information on how their plans incorporate – or fail to incorporate – such strategies. This is an important deficiency in pension plan accountability and transparency.

Social and environmental analysis is an integral part of a well-managed portfolio. A growing body of evidence shows that corporations with positive social and environmental records can have superior stock performance over the long term.

For example, numerous socially responsible stock indexes, including the the Domini Social Index in the US ([www.kld.com](http://www.kld.com)) and the Jantzi Social Index ([www.jantziresearch.com](http://www.jantziresearch.com)) in Canada, have outperformed their conventional benchmarks.

Research studies have also found that there is no sacrifice for investing in a socially responsible way. Most recently, a report commissioned by the Asset Management Working Group of the United Nations Environment Programme Finance Initiative (UNEP FI) found that there is investment value in integrating responsibility and sustainability issues into portfolio analysis. The report, entitled *The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing*, compiles research by 12 internationally-recognized investment companies. ([www.unepfi.net/stocks](http://www.unepfi.net/stocks)).

This growing body of evidence indicates that long term investment returns can be enhanced through the incorporation of non-financial criteria. Increasingly, this view is also suggesting that trustees, managers and other fiduciaries of pension plans have an obligation to take into account such criteria.

Currently, investment management is focused on short-term results based on financial criteria only. These criteria involve issues such as growth and momentum factors, quarterly profit forecasts, near-term commodity price forecasts and other financial predictions of stock prices. While these issues are obviously important for short-term returns, it is a neglect of fiduciary duty for pension funds to concentrate solely on these near-term financial factors. Pension funds need to match their long-term assets with their long-term liabilities. A long-term horizon is necessary, often -- for pension funds – 10, 20 or 30 years into the future. Such a horizon obviously needs to include social and environmental factors that help to predict which companies and sectors will be successful over the long term.

What's more, a focus on the short-term to the exclusion of the long-term builds in incentives for the creation of conflicts of interest, both by financial intermediaries such as asset managers or consultants, and corporations themselves through the falsification of balance sheets to exaggerate short-term profit. Again, a longer-term focus is needed to provide some balance to these short-term risks.

In a recent article in the Journal of Business Ethics, City University of New York Business Professor S. Prakash Sethi argues that the limitations on short-term thinking create a fiduciary obligation on the part of pension funds to incorporate social and environmental considerations.

*Pension fund trustees have a broad mandate and discretion, which must encompass socio-economic as well as environment-related issues in so far as they meet the criteria of the long-term improvement in micro corporate performance, and also the macro socio-political and economic environment, which is essential to the growth of private enterprise. By the same token, companies that engage in practices that put them in conflict with broad societal consensus of acceptable conduct increase the risk and volatility of their future stream of earnings. Hence, it is reasonable, even necessary, that pension funds take these factors into consideration when making their investment choices.*

*(S. Prakash Sethi, Investing in Socially Responsible Companies is a Must for Public Pension Funds – Because There is no Better Alternative. In Journal of Business Ethics 56:99-129 2005.) available at [http://www.tbli.org/featurearticles/sri\\_jobse\\_012005.pdf](http://www.tbli.org/featurearticles/sri_jobse_012005.pdf)*

Gil Yaron, Director of Policy and Law for the Vancouver-based Shareholder Association for Research and Education, states that trustees could be holding themselves open to liability by ignoring social and environmental considerations:

*I argue that prudence requires that pension trustees consider non-financial indicia as part of portfolio risk analysis. Failure to consider non-financial indicators, such as climate change or corporate operations in zones of conflict, could constitute a breach of fiduciary duty where it is determined that trustees ought to have had a reasonable expectation that such factors could influence materially the long-term performance of plan investments.*

*(Gil Yaron, Fiduciary Duties, Investment Screening and Economically Targeted Investing: A Flexible Approach for Changing Times, a research project of the University-Union Alliance on the Social Investment of Pension Funds.) available at [http://www.pensionsatwork.ca/english/project\\_pages/project\\_5.php](http://www.pensionsatwork.ca/english/project_pages/project_5.php).*

While the exact nature of socially responsible investment and fiduciary duty by pension trustees remains subject to debate, there is a growing consensus that trustees must at least consider these issues as part of their investment policies and practices. Therefore, it is necessary for pension funds to be required to demonstrate to their members that the trustees have at least considered these issues and come to a consensus on how to incorporate them – if at all – in their investment policies and practices.

Around the world, numerous jurisdictions are recognizing the importance of this principle. Governments and securities commissions are coming to the view that SRI disclosure represents an important new form of consumer protection for investors and pension plan members.

In July 2000, the UK Pensions Act was amended to require trustees of occupational pension plans to disclose their policy on socially responsible investment as part of their Statement of Investment Principles (SIP). Before this amendment, pension fund trustees were under no obligation to inform their members of their SRI stance. Since then, France, Germany, Belgium and Sweden have adopted similar regulations.

An excellent review of the British rules and their possible adoption in Canada has been commissioned by the Capital Markets Program of the National Roundtable on the Environment and Economy. It can be found at

[http://www.nrtee-trnee.ca/eng/programs/Current\\_Programs/Capital-Markets/Documents/UK-Canada-Pension/UK-Canada-Pension\\_Index\\_E.htm](http://www.nrtee-trnee.ca/eng/programs/Current_Programs/Capital-Markets/Documents/UK-Canada-Pension/UK-Canada-Pension_Index_E.htm).

Amendments to the 2001 Australian Financial Services Reform Act stipulate that all products with an investment component – including pension funds and mutual funds -- must include disclosure of “the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention and realisation of the investment”. More recently, the Australian Securities and Investments Commission (ASIC) released Practice Statement 175, which requires advisors providing personal financial advice to enquire whether environmental, social or ethical considerations are important to their clients.

Social investment disclosure by pension funds is quickly becoming the standard for public policy around the world. It is expected that this policy will soon become quite commonplace among countries of the Organization for Economic Development and Co-operation (OECD). As social investment disclosure regulation spreads around the world, we expect growing numbers of pension funds to disclose their social investment practices as this policy increasingly becomes the industry standard.

Canada risks falling behind its OECD partners on this policy initiative. Action by the federal government to include such disclosure in the regulations of the Pension Benefits Standard Act would provide a new standard of transparency in federally-regulated pension funds.

It could be argued that members of defined benefit pension plans are not entitled to enhanced disclosure, including information on social and environmental policies, because they have a right to the income stream produced by the pension assets, not the assets themselves. It strikes us that this is an outdated and paternalistic view of plan members. Certainly plan members have an *interest* in the health of their pension plans, even if they don't have *ownership* of the assets. As such, poor pension management could affect future pension payouts, the viability of the pension sponsor, or future contribution rates, all of which would have direct impact on plan members.

Pension plan members have a vital interest in knowing that their pension plans are being properly managed – including knowledge of the important long-term non-financial factors that could increase the risk to their pension assets or future added value. Pension plan members have a right to access such information.

### ***Proxy Voting Policies and Records***

Many institutional investors – including a substantial number of pension funds – fail to understand the importance of their power as shareholders. In spite of direction from federal regulators, many pension funds fail to vote their shares, or routinely support management on shareholder resolutions. According to Michelle Tan in the Corporate Governance Review (January 2004) published by ISS Canada Corp., the average voter turnout for companies listed on the S&P/TSX Composite Index was 63.5 per cent in 2003, a figure that has remained relatively constant over the past seven years. This means that one-third of those votes go uncast, essentially disenfranchising Canadian pension plan members and investors from their shareholder rights.

The Canadian Securities Administrators (CSA) have recently recognized the principle that proxy voting is an important part of good asset management by mutual funds, and that mutual funds have a fiduciary duty to vote their assets on behalf of their unitholders. Further, the CSA has determined that unitholders have a right to know what policies are being used to determine how these votes are cast, and have a right of access to the records of these votes to determine for themselves whether the funds are following their policies.

In the CSA's recent National Instrument 81-106 and Companion Policy 81-106CP, the CSA established new rules requiring mutual funds to disclose their proxy voting policies, and to keep records on how they have voted their shares in the companies held in their portfolios, and that they provide these records to unitholders.

These proposed rules are similar to new rules recently put in place for US mutual funds and investment advisors by the Securities and Exchange Commission.

Similarly, it has been widely understood in the investment community for the last decade that pension funds also have a fiduciary duty to vote their shares on behalf of their plan members. In the February 23, 1994 letter from the US Department of Labour on ERISA Fiduciary Standards, Deputy Assistant Secretary Alan Lebowitz writes that pension funds cannot relinquish their voting rights to their investment managers. In fact, managers must keep records of proxy voting to ensure that decisions are made according to the policy of the pension fund.

*The Department notes that section 404(a)(1)(8) requires the named fiduciary appointing the investment manager to periodically monitor the activities of the investment manager with respect to the management of plan assets. In general, this duty would encompass the monitoring of decisions made and actions taken by investment managers with regard to proxy voting. In this regard, it is the opinion of the Department that section 404(a)(1)(B) requires proper documentation of the activities of the investment manager and of the named fiduciary of the plan in monitoring the activities of the investment manager. Specifically, with respect to proxy voting, this would require the investment manager or other responsible fiduciary to keep accurate records as to the voting of proxies.*

*(US Department of Labor's Letter on ERISA Fiduciary Standards, known as the 'the Avon letter,' February 23, 1994)*

In Canada, according to the *Guideline for the Development of Investment Policies and Procedures for Federally Regulated Pension Plans*, published by the Office of the Superintendent of Financial Institutions, proxies are to be considered important plan assets. The Guideline states:

*Plan administrators should not ignore the value of voting rights acquired through plan investments... Failure to describe in the investment policy how these rights will be used leaves plan administrators open to charges of either negligence or arbitrary action, possibly in violation of the standard of care requirement. Investment policies should describe and require the use of voting rights, whether directly or through proxy.*

*(Section 1.6.6, Appendix 1, endnote 4, Guideline for the Development of Investment Policies and Procedures for Federally Regulated Pension Plans, OSFI)*

The corporate scandals of the last few years have underlined the importance of vigorous proxy voting by institutional investors. If mutual funds, pension funds and other institutional investors had used their power on governance issues more aggressively, it is believed that many of the abuses that led to the massive share price collapse may have been avoided.

Some analysts have even suggested that mutual fund companies have conflicts of interest in voting their stock in companies in which they manage pension asset business or are seeking to manage that business. In fact, a recent study by Gerald F. Davis and E. Han Kim of the University of Michigan found a positive relation between the volume of pension business conducted by a mutual fund's parent company and a fund's propensity to vote with management on shareholder resolutions. (*Would Mutual Funds Bite the Hand that Feeds Them? Business Ties and Proxy Voting* available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=667625](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=667625).)

The authors of that study suggest that it would be naïve to think that such conflicts reside only with the mutual fund industry. Recent research by the US Government Accountability Office (GAO) suggests that pension funds also face conflicts with their proxy voting obligations. (*US Government Accountability Office, Additional Transparency and other Actions Needed in Connection with Proxy Voting*, available at <http://www.gao.gov/new.items/d04749.pdf>).

As a result, the GAO recommends that the US government introduce pension rules similar to the SEC rules for mutual funds; namely that pension funds under federal jurisdiction be required to disclose their proxy policies and records.

We at the SIO believe that while the potential for actual conflicts is much less in the pension industry than in the mutual fund industry (which does seek to manage pension business), conflicts cannot be entirely ruled out. As well, we feel that it is important to have full transparency across all institutional investors. To our way of thinking, it is not fair to impose a burden of proxy disclosure on mutual funds without imposing the same burden on the pension industry and other large institutional players in the capital markets. Otherwise, one player representing less than one-fifth of the stock market's capitalization would be accountable for its voting, but the remaining four-fifths can continue to hide behind a veil of secrecy.

We believe it is time for regulators to move the pension industry to similar disclosure, and the regulations of the Pension Benefits Standards Act are the first place to start this process.

The SIO believes that not only do pension funds have a fiduciary duty to vote their shares on behalf of their plan members, but that plan members have a right to know how their assets are being voted. The fiduciary duty that funds have to cast their votes appropriately is only meaningful if it is accountable, and the accountability mechanism is through the trustees that oversee the plans. Without disclosure of voting policies and records, pension plan members and their trustees have no way of knowing if plans are in fact acting according to their fiduciary duty when voting their shares. Transparency on voting policies and records is essential.

In addition, voting disclosure will bring an important element of transparency to the shareholder resolution process, leading to fuller, more informed debate on issues of corporate governance and social and environmental responsibility. Reduced long-term risk and higher long-term added value will result.

### ***Recommendations***

The SIO would like to make two broad recommendations to the PBSA consultation. We would like to recommend that the Pension Benefits Standards Regulation (PBSR) be amended to require pension funds under PBSA jurisdiction to provide information to plan members on the extent that social, environmental and ethical considerations are taken into account in the investment management process; and to require pension funds to disclose their proxy voting policies and records directly to plan members upon request, or publicly through their websites.

We have chosen to recommend these changes through regulation or directives of the Superintendent of Financial Institutions rather than legislative amendment to speed the process of reform. Given the current tight legislative agenda, we understand that amending legislation may be years away. We understand that these changes can be made through regulation or directive rather than legislation.

### **SEE Disclosure**

We recommend that Section 7.1 of the PBSR concerning the Statement of Investment Policies and Procedures be amended to include “a statement on the extent (if at all) to which social, ethical and environmental (SEE) issues are taken into account in the selection, retention and management of investments.” Such a statement would require trustees to consider their social and environmental policies and, if they choose to adopt such policies, to include them in the SIPP. If no such policies are adopted, the SIPP would have to note this.

Following amendments to the PBSA in 2001, plan members are able to request a copy of their pension’s SIPP upon request. We feel that this is insufficient disclosure since so few plan members are aware of this right and make use of it.

Therefore, the disclosure of the SEE provisions of the SIPP, and in fact the SIPP itself, should be part of the annual reports to members that are required under sections 22-23 (Information to be Provided) of the PBSR. This would provide a higher level of annual reporting to pension plan members, giving them a greater understanding of the overall investment policies of their pension (including the SEE provisions). We recommend that, in addition to the change above, that sections 22-23 of the PBSR be changed to provide for inclusion of the pension’s SIPP in the annual report.

### **Proxy Voting Policies and Records**

In terms of proxy voting and policies, we recommend the following:

- In Section 12.1 of the PBSR, that the administrator or a manager delegated by the administrator keep records on the voting of proxies on all shareholder votes in which the pension plan would receive materials as a securityholder. The records would include information on the name of the company, a description of the matter voted and whether the pension plan voted its shares for or against or abstained on the proposal.

- In Section 7.1 (Statement of Investment Policies and Procedures), that the SIPP should include a statement on the policies of the pension fund with regard to the voting of its proxies. These policies would also be included in the annual report to members under new rules requiring the SIPP to be included in the members' annual statements (see above).
- In Sections 22-23 (Information to be Provided), that the administrator of a pension plan shall provide to each plan member a copy of the voting record of the pension fund free of charge on request once a year. Alternatively, the pension fund may post its complete voting record on its website and refer plan members to this for information on the plan voting record.

We recommend that pension funds be given the choice of providing records on request or through their websites to discourage frivolous requests, to aid in fuller disclosure and to reduce the waste of paper. The costs of this proposal should be minimal given the fact that pensions are already under a fiduciary duty to vote their holdings on behalf of plan members. Whatever mechanisms are already in place to ensure due diligence in the voting process will not change under our proposals. Pension funds will simply be required to report to their members about their policies and their voting records.

For pension funds that are now voting their shares, or are routinely voting with management, these recommendations may lead to some additional costs. However, such pension funds are now operating outside of current best practices on fiduciary duty and need to update their proxy voting activities in any case.

## **Conclusion**

In this brief, we have made three key points:

- Social and environmental policies and proxy voting benefit pension plans by reducing long-term risk and enhancing returns
- Pension plans have a fiduciary duty to take social and environmental factors into account, and to vote their holdings on behalf of their beneficiaries
- Pension plan members have a right to know what social and environmental policies are in place, and how their pension plans have voted their assets.

SEE disclosure would ensure that pension funds regulated under the PBSA in Canada are required to disclose whether they take into account critical long-term, non-financial factors into their risk management and value-added strategies. Proxy voting disclosure would require PBSA-pension funds to review their policies on their voting obligations, to keep records on their votes and to disclose those records to their plan members.

Such disclosure would provide important new information to plan members about the long-term management of their pension assets. As well, it would provide a level of transparency that would enhance the practice of social and environmental assessment and proxy voting through the investment community in Canada. This would result in better risk management in the future and improve long-term pension fund returns.

Sincerely,

Eugene Ellmen  
Executive Director