



SOCIAL INVESTMENT ORGANIZATION

The Canadian Association for Socially Responsible Investment

184 Pearl St. 2nd floor
Toronto, Canada M5H 1L5
416-461-6042 t
416-461-2481 f
info@socialinvestment.ca
www.socialinvestment.ca

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Harry W. Arthurs
Commissioner
Ontario Expert Commission on Pensions
777 Bay St., PO Box 102
Toronto ON M5G 2C8

Dear Mr. Arthurs:

Re: Brief to the Ontario Expert Commission on Pensions

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 issues regarding the future of the pension system in Ontario. We welcome the opportunity to contribute to this debate and give you permission to post this brief on your website.

We want to commend the Ontario Government for this initiative. As your Discussion Paper points out, there are many issues around the changing social and economic environment, around the economic security of Ontarians, around the provision of defined-benefit pension plans, and around the funding, solvency and regulation of pension plans.

On behalf of our members, who manage billions of dollars of retirement savings for Canadians, we want to confine our remarks in this brief to investment issues. In this brief, we make some specific recommendations for regulations that would help to ensure steady, reliable returns to pension funds in the future, and that would help to provide a higher level of transparency to plan members on the investment policies and practices of their pensions.

Environmental, Social and Governance Policies, Fiduciary Responsibility and Pension Transparency

There is a growing consensus in the investment community that environmental, social and governance (ESG) factors are an important component of prudent risk management and a source of portfolio value. The emerging view is that investment fiduciaries must incorporate ESG analysis in order to ensure that they are meeting the highest standards of due diligence. Yet, in spite of the evidence about the importance of social and environmental factors, and the growing responsibility of fiduciaries to account for ESG 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.

ESG 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 Domini Social Index in the US (www.kld.com) and the Jantzi Social Index (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. In fact, some research states that careful attention to climate change and other particular ESG factors can result in portfolio outperformance. Most recently, a major new global study by Innovest Strategic Value Advisors (www.innovestgroup.com) found that companies with the most robust risk management profile on climate change issues outperformed their same-sector peers significantly over the past three years.

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 ESG factors that help to predict which companies and sectors will be successful over the long term.

Furthermore, the legal environment for investment fiduciaries on the consideration of ESG factors is rapidly changing. The traditional view of the legal community was that consideration of strictly “non-financial” factors in investment analysis is not permissible, and may even leave fiduciaries open to liability. However, just in the last two years, the legal consensus has changed dramatically.

A comprehensive legal analysis published in 2005 conducted by the prestigious UK law firm of Freshfields Bruckhaus Deringer found the traditional consensus to be untrue. The study found that, contrary to widespread belief that incorporation of ESG factors is prohibited by fiduciary obligation, the law permits the integration of ESG issues and, arguably, requires such integration. (http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf)

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.

Canada risks falling behind other countries on this policy initiative. Action by the Ontario government to include such disclosure in the regulations of the Ontario Pensions Benefits Act would provide a new standard of transparency in Ontario-regulated pension funds.

It could be argued that members of defined benefit pension plans are not entitled to enhanced disclosure, including information on ESG 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.

We also believe that investment committees, administrators and managers of pension funds would be promoted to review their investment policies if such disclosure was required. Such a review would help to bring all pertinent long-term investment policies under consideration, leading to stronger investment policy-making.

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 a recent study of major Canadian mutual fund companies conducted by the Social Investment Organization (<http://www.socialinvestment.ca/documents/ProxyVoting.pdf>), mutual fund companies voted with management two-thirds of the time on significant shareholder proposals. While no equivalent study has been done on Canadian pension fund proxy voting, we suspect the results would be similar to the mutual fund industry.

The Canadian Securities Administrators (CSA) have 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 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)

We at the SIO believe 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 its proxy voting without accountability to their beneficiaries.

The fiduciary duty that pensions 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 would bring the pension industry into a fuller public debate on ESG issues and the corporate sector. Some pensions, such as the Ontario Teachers Pension Fund, are already leaders in this debate, and voluntarily disclose their votes. This has led to many improvements in corporate practice in Canada and around the world. This has resulted in reduced long-term risk and higher long-term value. Regulations requiring all pension funds to do this would help to create an even higher standard of corporate performance.

Recommendations

The SIO has two broad recommendations. We would like to recommend that regulations of the Ontario Pensions Benefits Act be amended to require pension funds under PBA 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 Services rather than legislative amendment to speed the process of reform.

ESG Disclosure

Specifically, we recommend that provincial pensions under Ontario PBA jurisdiction be required to include "a statement on the extent (if at all) to which environmental, social and governance (ESG) issues are taken into account in the selection, retention and management of investments. This should include a statement on the policies of the pension fund with regard to the voting of its proxies."

Such a statement would require trustees to consider their ESG and proxy voting policies and, if they choose to adopt such policies, to include them in the statement of investment policies and procedures (SIPP). If no such policies are adopted, the SIPP would have to note this.

Furthermore, we recommend that disclosure of the ESG and proxy voting provisions of the SIPP, and, in fact the SIPP itself, should be made available to members through the internet. The SIPP should be available on the website of each pension plan. If plans do not have websites, they should be required to provide their SIPPs to plan members on request.

Proxy Voting Policies and Records

In terms of proxy voting and policies, we recommend that the pension 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.

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.

ESG disclosure would ensure that pension funds regulated under the PBA in Ontario 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 PBA-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.

We have made similar recommendations to the federal consultation on defined-benefit pension plans that was held in 2005. We are hopeful that the federal government will adopt similar rules at some time in the future, and believe that federal-provincial harmonization of such policies would be in the national interest.

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 ESG 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,

A handwritten signature in blue ink, appearing to read "E. Ellmen". The signature is fluid and cursive, with a large initial "E" and a long, sweeping underline.

Eugene Ellmen
Executive Director