

November 2009

Best Practices in Responsible Investment for Canadian Pension Funds

*Commissioned by the
Social Investment Organization with
funding from Environment Canada*



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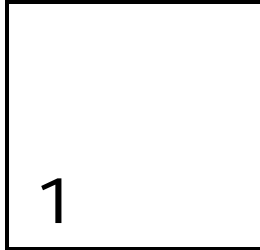


MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

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Introduction

This report provides an overview of responsible investment (RI) in Canada – the trends, the drivers, the global initiatives and how the Canadian pension community is involved. More importantly, however, it provides recommendations that could help pension funds move from consideration of RI to implementation.

The report begins with a discussion of RI in general, its development globally and in Canada, the adoption and adaptation of responsible investment insights into pension fund strategies, and some of the lingering barriers to greater environmental, social, and corporate governance (ESG) integration.

This is followed by a section outlining recommendations that would encourage further implementation of responsible investment. These recommendations are directed towards legislators, regulators, industry groups, and leading RI practitioners.

The following section, on individual pension fund implementation, outlines a general approach to responsible investment that many Canadian pension funds could adopt. One of the key supports for implementation is collaboration with other pension funds.

The penultimate section outlines some of the key collaborative investor initiatives before focusing on the leading forum facilitating and encouraging the global expansion of responsible investment – the UN-sponsored Principles for Responsible Investment.

This report is the result of a collaborative process involving Mercer's Responsible Investment Team as well as valuable input from external reviewers. We hope that this document will contribute to a broader and richer debate about the future of responsible investment in Canada.

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State of the Debate

Not long ago, the concept of “socially responsible investment” (SRI) and the analysis of environmental, social, and corporate governance (ESG) factors were generally met with scepticism by the financial community. That scepticism is fading away, as broader awareness of the issues emerges and investors see value added – for both risk management, and opportunity identification – from ESG analysis. In addition, many institutional investors recognize that responsible corporate behaviour, considered from an ESG perspective, can have a positive influence on the financial performance of corporations.

While a vibrant, and growing, community of ethical investors continues to influence the development of the field, recent interest among large institutional investors, like pension funds, has affected the approach it takes. These institutions concentrate on their fiduciary duties and financial results before considering, if at all, ethical concerns. We will use the term, “responsible investment” (RI), to refer to the developments among institutional investors. RI can be defined as any area of the financial industry that integrates ESG issues into investment decision-making or ownership practices.

Three areas on which RI research and action focus are transactions (e.g. consideration of ESG factors when buying and selling securities), stewardship (e.g. active monitoring and feedback on corporate practices), and externalities (e.g. regulatory and litigation risk).

These issues, and corporate governance in particular, are coming into clearer focus with the recent market turmoil caused, in part, by regulatory failure and, arguably, some misalignment of interests between investors, their investments, and the financial industry intermediaries that manage the relationship between the two.

The erosion in funded status of many pension plans since the onset of the global financial crisis has prompted closer examination of existing risk-management models and greater consideration of systemic risk factors. This reconsideration may extend to the basic assumptions that have traditionally supported regulatory and industry approaches to retirement planning. Of particular importance is the renewed interest in pension plans shown by policy makers and academics – a reflection of the expanded

influence that pension fund management practices are exerting over the wider global economy.

In a June 2009 report CR Strategies examined recent events from a Canadian ESG perspective and concluded that, although few predicted the timing and severity of the financial crisis, core issues like governance, compensation, transparency, and ESG risks related to underlying investments were well developed within the RI community.¹ They make recommendations, some of which are included in this report, for both long-term investors and policy-makers in order to help mitigate future crises.

The same conclusion – that the financial crisis underscores the importance of RI-related issues and themes – is reflected in a myriad of international reports, discussions, and initiatives. There is a growing consensus that responsible investment insights should be integrated into mainstream investing strategies if fiduciary duties to current and future beneficiaries are to be respected.

¹ CR Strategies, “The Financial Crisis: An Environmental, Social and Governance Perspective,” June 2009. Commissioned by the Social Investment Organization. Source: <http://www.socialinvestment.ca/documents/FinancialCrisis-AnESGPerspective-CRStrategies-June2009.pdf>, retrieved on August 31, 2009.



Responsible Investment in Canada

With increased research, education and dialogue under way, there is a growing trend toward adoption of responsible investment practices by Canadian institutional investors. This is supported by a growing number of RI service providers, and Canada can claim with pride some of the global leaders in the field. Similarly, many of our largest and highest-profile pension plans have also taken a leading role among their peers in moving from theory to action. However, there are indications that adoption by the broader pension fund community in Canada lags behind that of other leading jurisdictions.

For example, Australia, with a similar federal structure, legal system and financial clout, has 28 asset owner (asset owner signatories in both Australia and Canada are primarily pension funds) and 43 investment manager signatories to the UN Principles for Responsible Investment (UN PRI).² With \$954 Billion in total pension assets, this represents 3 asset owner signatories per \$100 Billion assets.³

By contrast, Canada has seven asset owner and 11 investment manager signatories. With \$847 Billion in total pension assets, this represents less than one asset owner signatory per \$100 Billion assets. Much needs to be done to ensure the broader pension community is represented and active in the global move towards RI.

Growth of RI in Canada

To track the adoption of RI, the Social Investment Organization (SIO) distinguishes between *core* and *broad* forms of socially responsible investment. Core SRI explicitly recognizes a normative element to the investment process and includes strategies that exclude sectors or companies on ethical grounds. It also includes investments in local economies including community-based financial institutions, cooperatives, and

² Australia's GDP is roughly 70% of Canada's; and its stock capitalization is just under 75% of Canada's. Signatory statistics retrieved on July 23rd, 2009 from <http://www.unpri.org/signatories/>

³ December 31 2007 data, retrieved on July 23rd, 2009 from <http://www.oecd.org/dataoecd/63/30/42565598.pdf> and <http://www.oecd.org/dataoecd/63/51/42565480.pdf> AUD converted to CAD at 2007-12-31 rate.

community-oriented businesses. Core SRI is more likely found among retail mutual funds, for individual investors, and screened or targeted strategies, for foundations and endowments.

Broad SRI is synonymous with RI and includes the incorporation of ESG factors within a fiduciary framework driven primarily by financial risk and return characteristics rather than normative concerns. In addition, the long-term nature of the liabilities facing most pension funds and the long-term investment programs developed to match liabilities places emphasis on maximizing returns over the many years. This is one of the reasons why many pension funds seek to incorporate ESG information and to explore corporate engagement through proxy voting policies and direct communications. This approach, motivated by a focus on long-term returns rather than any ethical framework, is more typical of Canadian pension funds.⁴

That being said, the table on the following page shows the dramatic increase in RI (or Broad SRI) in recent years. Until 2006, the assets under management (AUM) in Core SRI were considerably higher than those in the Broad SRI category. With the adoption of elements of responsible investment by some of Canada's largest pension funds, Broad SRI AUM now dwarf Core SRI AUM. It is important to recognize that this is a reflection of assets of a vastly different scale, not necessarily a reflection of *influence* on the direction of or issues covered by responsible investment.

⁴ However, it is important to recognize that some pension funds have limited screens in place and some mutual funds incorporate ESG factors in a meaningful fashion without a clearly stated ethical position. In a very general sense, core SRI places more emphasis on transactions while broad SRI tends to focus on stewardship and externalities.

Socially Responsible Investment Assets in Canada (\$Billion)

	2008	2006	2004	2002	2000
Core SRI Strategies					
Asset managers employing social and environmental screening ⁵	27.6	36.5	21.2	16.7	11.3
Retail investment funds	22.2	18.1	14.8	9.9	10.4
Community Investment and social finance	1.4	0.81	0.55	0.07	0.09
Socially Responsible Lending	3.0	1.9	1.3	0.13	
Total Core SRI	54.2	57.4	37.9	26.9	21.7
Broad SRI Strategies					
Asset managers employing ESG integration ⁶	10.3	12.7	NA	NA	NA
Pension funds employing ESG integration, ESG proxy voting or corporate engagement, or economically targeted investment	544.1	433.1	25.5	24.1	27.2
Shareholder Advocacy ⁷	NA	NA	2.1	0.453	1
Sustainable Venture Capital	0.64	0.45	0.05	NA	NA
Total Broad SRI Strategies	555.1	446.2	27.6	24.6	28.2
Total Core and Broad SRI	609.2	503.6	65.5	51.4	49.9

Source: Canadian Socially Responsible Investment Review, 2008

RI and Canadian Pension Funds

Since 2004, there has been impressive growth in pension fund activity and assets invested using responsible investing guidelines have ballooned from \$25.4 billion to \$544.1 billion in 2008. The primary reason for the dramatic increase is the adoption of responsible investment policies by a number of public and private pension funds and endowments including large funds like the BC Investment Management Corporation, the Caisse de dépôt et placement du Québec, and the Canada Pension Plan Investment Board.

Growing awareness of the potential financial and fiduciary implications of issues such as climate change have had a tremendous effect in mobilizing pension managers and trustees to consider the ESG factors. This growth was also strengthened by the launch, in 2006, of the UN PRI. As suggested above, recent market disruptions seem to be bolstering, rather than undermining, institutional support for RI.

While the growth in absolute assets is impressive, two caveats should be mentioned. First, the most prevalent form of integration has been the adoption of proxy voting policies – comprehensive integration of ESG information into decision-making remains a work in progress. Second, the number of Canadian funds with a commitment to RI

⁵ Net of assets invested in SRI mutual funds.

⁶ This category was created in 2006. Previous surveys failed to distinguish between screening and integration. Some integration assets may have been included under screened assets in previous years. Net of assets in integrated mutual funds.

⁷ Assets involved in SRI shareholder activism were included under ESG integration in 2006 and 2008.

reflects only a small fraction of the pension funds that could reasonably be expected to have the capacity to implement RI. Greater participation rates should be achievable.

Even if a pension fund has a separate RI policy, or references responsible investment within its Statement of Investment Policies and Procedures, it can be quite difficult or impossible to assess how the policy is being implemented and monitored. That being said, larger pension funds are increasingly reporting on their responsible investment activities on a regular basis.⁸

One of the advantages of the UN PRI is that it requires all signatories – regardless of size – to document and report on their progress integrating responsible investment into mainstream decision-making processes. We end this section with a chart showing the distribution of pension funds in Canada, based on assets under management, with the corresponding number of pension fund signatories to the UN PRI.

Category	Total # of Funds	Total AUM \$Billions	UN PRI Signatories
Over \$10 Billion	17	\$489.8	3
From \$1 Billion to \$10 Billion	97	\$255.9	1
From \$500 Million to \$1 Billion	79	\$54.4	1
Under \$500 Million	944	\$72.2	2

Source: Canadian Institutional Investment Network database and Mercer (Data as of July 15, 2009)

Barriers to Integration

Notwithstanding the leading role taken by some of Canada's largest pension funds, many institutional investors continue to lag behind in incorporating ESG factors into the decision-making process.

For some of these investors, the confusion about the metrics appropriate for the measurement and analysis of ESG information has been a significant barrier as has a lack of consensus about the ability of RI to add value in a persistent manner. For others, lingering concerns about fiduciary duty are a serious impediment – and these are addressed in this section. It does seem clear, however, that these concerns are exacerbated by a lack of legislative and regulatory clarity regarding responsible investment and basic disclosure by pension plans about ESG integration (or lack thereof).

Without dismissing the concerns above, the reality is that many pension plans have introduced responsible investment policies and practices. It is certainly possible that the

⁸ For local examples, see the dedicated pages and reports produced by the British Columbia Investment Management Corporation (<http://www.bcimc.com/ResponsibleInvesting/Default.asp>), the Canada Pension Plan Investment Board (http://www.cpipb.ca/Responsible_Investing/), and the Caisse de dépôt et placement du Québec (<http://www.lacaisse.com/fr/responsabilite/Pages/responsabilite.aspx>) – all retrieved on August 31, 2009.

concerns listed above may help mask a basic lack of interest in or commitment to exploring responsible investment or simply competing priorities.

Nonetheless, the passage of time – and the growth of responsible investment combined with a lack of contrary jurisprudence – has weakened the most fundamental objection: the fiduciary case against responsible investment. The number of cases in which, for example, a trustee is legally pursued for the application of ethical considerations is vanishingly small, in Canada and in other jurisdictions. As the UN Environment Program Finance Initiative notes:

*investment, financial and business institutions have adopted a number of voluntary obligations which provide for ESG considerations to figure highly in investment, financial and business decision-making without legal challenge or concerns being voiced over a breach of fiduciary duties. For example, the Principles for Responsible Investment, the Equator Principles, and the UN Global Compact Principles, have been adopted by over 550 investment institutions, 60 lending institutions and thousands of companies, respectively, without sparking controversy about the fiduciary limits of such institutions and companies.*⁹

In the next section, the report focuses briefly on the issues of materiality and fiduciary duty, in general, and in the Canadian context.

Materiality and Corporate Disclosure

In assessing a company's investment eligibility, investment managers study published corporate documents, meet with company management and conduct site visits (among other due diligence steps). In reviewing all of this information, investment managers need to decide what information in their research findings is material in order to determine a valuation and make an investment decision.

In Canada, securities law falls within provincial jurisdiction. However, the definition of what is considered 'material' information is essentially the same across the country. In Ontario, the materiality test consists of whether the fact "would reasonably be expected to have a significant effect on the market price or value" of an issuer's securities¹⁰. Given the focus on market price, some could argue that the definition lends itself to an interpretation that focuses on the short-term.¹¹

⁹ Asset Management Working Group (UN Environment Programme Finance Initiative), "Fiduciary Responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment," July 2009, page 25.

Source: <http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf>, retrieved on August 31, 2009.

¹⁰ "Bill 198 and Ontario's Securities Act: Giving Investors and the OSC Added Muscle," H. Garfield Emerson, Q.C.; Geoff A. Clarke; Fasken Martineau DuMoulin LLP presented at the 3rd Annual Directors' Governance Summit (November 17, 18 & 19, 2003).

¹¹ Some examples of developments likely to require prompt disclosure include: take-over bids or issuer bids, major corporate acquisitions or dispositions, new issuance of securities, significant discoveries by resource companies, significant changes in management, significant litigation.

<http://www.tsx.com/en/pdf/PolicyStatementOnTimelyDisclosure.pdf>

While there is increasing interest in having corporations address ESG issues, a sustained focus on RI-related disclosure has yet to be embraced by most brokerage house analysts. Although many of leading firms have distinguished themselves with their research, others perceive a gap in sell-side research and analysis and this can be a significant practical and psychological barrier to increased industry uptake.

In response, the United Nations Environment Program Finance Initiative (UNEP FI), in 2004, launched a “*Materiality Series*” initiative. This project encouraged leading brokerages to examine internal and external research on how ESG issues impact company share price and to report back to the group. This led to the publication in 2004 of “*The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing.*”¹²

The follow-up publication, titled *Show Me the Money*, was released following a review of 1,000 pages of analyst research drawn from more than 20 global financial service firms. Illustrating the links between ESG issues, financial value and company profitability across eight industry sectors, the report provides strong independent support for the view that effective attention to environmental, social and governance issues can enhance shareholder value.¹³

The highlights of the report are three key findings:

- They are material as there is robust evidence that they affect shareholder value in both the short and long term;
- That the impact of ESG issues on share price can be valued and quantified; and
- That material ESG issues are becoming apparent, and that their importance can vary between sectors.

This approach has recently received a measure of support from the Ontario Securities Commission (OSC) which, in responding to a call for greater disclosure from the Ontario Legislature in 2009, has announced a review of the materiality of governance and environmental factors. The increasing interest of regulators regarding the materiality of ESG factors is another encouraging sign.

RI and Fiduciary Duty

There is a growing body of evidence that ESG issues can have a material impact on financial returns.¹⁴ Despite the increasing recognition of the importance of evaluating

¹² http://www.unepfi.org/fileadmin/documents/amwg_materiality_equity_pricing_report_2004.pdf, retrieved on August 31, 2009.

¹³ http://www.unepfi.org/fileadmin/documents/show_me_the_money.pdf, retrieved on August 31, 2009.

¹⁴ See for example, the two previously cited documents, *The Materiality of Climate Change* (2009 - http://www.unepfi.org/fileadmin/documents/MatIII_executive_summary.pdf), and the CFA Institute’s 2008 *Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors*, discussed below and available online: <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2008.n2.1>, retrieved on August 31, 2009.

and incorporating ESG related risks into investment decision making, some investment managers that are interested in taking ESG issues into account within their portfolios do not do so, or feel it necessary to cloak this aspect of due diligence, precisely because of lingering concerns within institutions about fiduciary duty.

This ambiguity stems from the fact that trustees of pension funds have a fiduciary duty to act prudently and in accordance with the purpose for which their investment powers are granted.¹⁵ Therefore, absent a specific mandate to invest ethically and consider ESG issues, some investors and lawyers believe that in order to comply with these duties, investment intermediaries must only choose investments that maximize financial returns for beneficiaries. Failure to do this, they believe, would lead to a breach in their duty. However, fiduciary responsibilities evolve over time and the relationship between portfolio management and ESG analysis continues to develop.

Historically, fiduciaries were expected to evaluate the risks and returns of each individual investment, with emphasis of portfolio management being on income and capital preservation. This was known as the Prudent Man Rule and later the Prudent Investor Rule.

Today, mainstream investment theory – adherence to which would presumably be prudent – is strongly influenced by Modern Portfolio Theory, in which investments are considered based on their overall risk and return contribution to the portfolio as opposed to focusing solely on the risk and return of an individual security. Under this theory, portfolio diversification is a key priority and a well diversified portfolio can offer a higher rate of return with lower overall risk than a portfolio where investments are combined without consideration to how their returns are correlated. Diversification is created through the use of different types of assets (e.g. equities, bonds, and real estate) as well diversification across geographies and industrial sectors.

As mentioned above, fiduciary duty has generally been interpreted to mean that trustees must make investment decisions based exclusively on maximizing the financial interests of beneficiaries. However, possible “benefits”, from a beneficiary’s perspective, may arguably extend beyond immediate financial returns. If beneficiaries share a moral objection to a particular form of investment, it could be considered to their benefit if the trust avoided that investment, possibly even at the cost of lower financial returns¹⁶. There is no reason why an investment strategy should not include investments with positive ESG characteristics as long as the decisions are motivated by the interests of

¹⁵ For an excellent overview of the concepts discussed in this section, see Freshfields Bruckhaus Deringer, “A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment,” prepared for the Asset Management Working Group (UN Environment Programme Finance Initiative), October 2005.

Source: http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf, retrieved on August 31, 2009.

¹⁶ Benjamin J. Richardson, Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?. Banking and Finance Law Review, Forthcoming. Source: <http://ssrn.com/abstract=970236>, retrieved on August 31, 2009.

the fund's beneficiaries and not the personal views of the decision-maker¹⁷. Certainly, there is little jurisprudence to suggest otherwise.

It should be remembered that these questions are moot for many institutional investors that have concluded that ESG analysis can improve investment decision making and ownership practices.

Another approach to fiduciary duty is most applicable to large institutional investors that, because of their size, own holdings across entire markets and have limited ability to divest easily and economically. These large investors are diversified across asset classes, sectors and geographies and are therefore tied to the economy as a whole. As a result, their returns – and their ability to meet their fiduciary duty – depend on the health and sustainability of the entire economy, rather than on the profitability of any company¹⁸. This is consistent with the long-term nature of pension funds' financial liabilities. Since liabilities are long-term, pension fund administrators have a fiduciary obligation to consider actions that might protect and enhance their long-term returns.

Furthermore, given that institutional investors own large cross-sections of the economy, their large investment portfolios will internalize both the financial and non-financial externalities¹⁹ created by individual company action or inaction on ESG issues. Given the interactive effects of firm or industrial sector behavior on other firms and/or sectors, the interests of members and beneficiaries are likely best served when ESG issues are considered.²⁰

Arguably, institutional investors that completely ignore ESG issues may be breaching their fiduciary obligations. Some environmental and human rights issues are becoming so pervasive and serious it is difficult to see how investors can continue to be indifferent to their impact.²¹ This seems especially true of climate change scenarios – which could radically reshape human existence on the planet. However, even investment managers that decline to take a position on the reality and implications of climate change recognize that government and consumer decisions, both announced and anticipated, related to climate change will have a tremendous impact on investment risks and opportunities.

Leading practices in some asset classes already incorporate certain ESG factors. In real estate, for example, it is largely accepted that higher upfront costs to bolster energy efficiency pay future dividends in the form of lower utility bills and higher client demand.

¹⁷ Freshfields Bruckhaus Deringer, op. cit.

¹⁸ Richardson, op. cit.

¹⁹ Externalities are costs or benefits arising from an economic activity that affect somebody other than the people engaged in the economic activity. Source: www.economist.com. Emitting greenhouse gases would be an example of externality.

²⁰ This concept – that externalities for long-term institutional investors are difficult, if not impossible, to avoid – is explored in greater detail in *Universal Ownership: Exploring Opportunities and Challenges* (2006). Source: <http://www.community-wealth.org/pdfs/articles-publications/sri/report-hawley-williams.pdf>, retrieved on August 31, 2009.

²¹ Richardson, op. cit.

The private equity industry association has adopted a voluntary code of responsible investment practices and some of its leading members have become PRI signatories.²²

Finally, consider infrastructure; an asset class of great interest to both pension plans, with their long-term, inflation-sensitive, liabilities, and to policy makers anticipating future public demand. For both parties – and the managers that seek to identify and capture investment opportunities – the importance of labour unions to public policy debates as well as ongoing operations of many utilities is increasingly obvious.

In summary, as recognized by the UN PRI, ESG considerations are relevant to every asset class, but not necessarily in the same manner or consistently over time. The duty of the analyst should be to be familiar with responsible investment strategies, ESG factors, and related risks and opportunities but to apply this knowledge appropriately for the investments being considered or monitored.

Many of the points above were reflected in the “Freshfields Report”, the most influential recent review of fiduciary duty. This report was commissioned by the United Nations Environment Programme Finance Initiative (UNEP FI) Asset Management Working Group and completed by Freshfields Braukhaus Deringer, a London-based global law firm. The study focused on the largest capital markets in Australia, Canada, France, Germany, Italy, Japan, Spain, the United Kingdom and the United States and 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.”²³

The UNEP FI Asset Management Working Group has recently published a sequel to the earlier Freshfields Report in which the impetus for integration is given a major boost. The legal analysis reflects on developments since 2005 and argues, in the overview, that the financial services industry may have a positive obligation to facilitate a responsible investment approach to avoid, “a very real risk that they will be sued for negligence.”²⁴ The report is also notable for the emphasis it places on a proactive approach to RI for investment consultants and other advisors. Finally, it provides practical guidance to assist with the incorporation of RI strategies and monitoring in standard investment management contracts.

Finally, as a measure of the mainstream acceptance of RI insights the Chartered Financial Analyst (CFA) Institute -- the self-regulatory body for investment professionals – has recently published a guide outlining ESG issues, identifying materiality, and providing numerous case studies to guide analysts in the appropriate incorporation of ESG information.²⁵

²² See <http://www.privateequitycouncil.org/> for more information. PRI signatories can be viewed here: <http://www.unpri.org/signatories/>

²³ Freshfields Braukhaus Deringer, op. cit., page 13.

²⁴ Asset Management Working Group, op. cit., page 15.

²⁵ CFA Institute, *Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors*, 2008. Source: <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2008.n2.1>, retrieved on August 31, 2009.

The CFA report explains how ESG research fits within a “mainstream” approach to investment analysis. For example,

Traditional financial analysis already accounts for certain “intangibles” – such as goodwill – but up to this point has been less successful in integrating more dynamic, nonfinancial attributes. ESG factors represent a broad set of intrinsic concerns that may ultimately affect valuation of equity, fixed-income, real estate, and infrastructure investments²⁶.

The report goes on to argue that corporate governance factors have traditionally been predominate but that climate change, in particular, as well as a variety of environmental and social factors, in general, are increasingly followed closely by analysts. This is particularly true for long-term holdings where the potential materiality is even clearer.²⁷

Focus on Canada

As in most countries, there is very little jurisprudence to guide Canadian fiduciaries. Not surprisingly, legislative or regulatory frameworks in Canada do not either require or expressly sanction the consideration of ethical concerns with one exception.²⁸ Manitoba’s legislation governing trustees expressly allows them to consider non-financial criteria in the investment decision making process, within the “prudence” context set by broader trust law.

That being said, there appears to be no legal restriction on the incorporation of ESG information in the investment process. This is reinforced by the reality that some of the country’s largest pension funds pursue and promote responsible investment strategies with no evidence, to date, of any corresponding legal liability.

In 1990, the Government of Ontario passed legislation which specifically authorized pension fund divestment based on the consent of beneficiaries. Since 1990, there have been a variety of attempts to promote ESG integration in federal and provincial legislatures. Most recently (2009), Ontario Liberal MPP, Laurel Broten, moved a motion in the provincial legislature calling upon the Ontario Securities Commission (OSC) to investigate requirements for and actual corporate disclosure of ESG information and to report back to the Legislature with concrete recommendations for next steps. The motion passed with unanimous support from all parties. As noted above, the OSC has responded by holding hearings regarding materiality and disclosure related to certain ESG factors.²⁹

²⁶ Ibid., page 1.

²⁷ Ibid., page 3.

²⁸ The analysis of Canada in the Freshfields, Bruckhaus, Deringer report was based on research by McCarthy Tétrault, one of the largest corporate law firms in the country. It can be found on pages 49 through 55 of the 2005 paper, op. cit..

²⁹ These discussions were underway at the time of publication. For more information, please visit the Commission website at: <http://www.osc.gov.on.ca>

With regards to disclosure of responsible investment discussions and decisions at the pension board level, there have been a number of recommendations in recent years to codify a level of basic transparency between pension plans and their beneficiaries and wider public.

In 2001, a motion was introduced in the House of Commons requiring pension funds to disclose their active ownership and ESG analysis activities. In 2007, the National Roundtable on the Environment and the Economy (NRTEE) published a report calling for pension funds to make similar disclosures.³⁰ In Fall of 2008, Ontario's Expert Commission on the Future of DB Pensions, led by Professor Harry Arthurs, made a similar recommendation. To date and despite the precedent shown by the United Kingdom, Australia, France and Germany, no Canadian government has moved to make this requirement a reality.

Given recent developments, it may be time to consider moving beyond limited disclosure. One possible step would be to require additional information to explain the disclosed practices: institutions that do not incorporate ESG information in the investment decision-making process and ownership practices could be required to justify this decision and those that do incorporate ESG information could be required to disclose how they do so. This approach would be developed in consultation with the industry and with appropriate consideration given to mitigating factors such as level of internal versus external management, asset classes targeted, and absolute size of assets under management.

Finally, to echo the recommendations of many august bodies that have studied our capital markets, our mixture of provincial and federal regulation of finance – including pension funds – may complicate somewhat the pursuit of market efficiency, regulatory clarity and cost minimization. We note here as well that a consistent and informed approach to responsible investment would be more likely if all financial industry activity answered to a common regulatory standard. This is an area of potential leadership for the federal government in the future.

³⁰ NRTEE, "Capital Markets and Sustainability: Investing in a Sustainable Future," 2007. Source: <http://www.nrtee-trnee.com/eng/publications/capital-markets/NRTEE-capital-markets.pdf>, retrieved on August 31, 2009.

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Strategies for Improving RI Practices

This section of the report lists general recommendations of interest to regulators, legislators, and the broader financial services industry. The next section focuses on recommendations for pension plan trustees and administrators.³¹

1) That governments adopt, in their respective jurisdictions, regulations that require pension plans to disclose on a recurring basis, at a minimum annually:

- a) The extent to which environmental, social, and governance considerations are taken into account in the selection, retention, and realization of investments; and
- b) The extent to which environmental, social, and governance considerations are taken into account in proxy voting and corporate governance engagement activities; and
- c) The plan's proxy voting record; and
- d) Their approach to and experience with corporate engagement in general.

Regulators might consider setting different expectations for disclosure based on the size of the pension plan and its mix of external and internal investment management.

They should also begin a fulsome dialogue with pension funds to consider a stronger form of disclosure requirement: to disclose how pension funds incorporate ESG information and, if they do not, to explain why they do not incorporate this information.

It could also be helpful to consider stronger corporate disclosure requirements in dialogue with pension fund staff and external investment managers.³²

³¹ These recommendations build upon those found in similar, related reports including the June 2009 SIO report, "The Financial Crisis" and the NRTEE report, "Capital Markets and Sustainability", both of which are cited above.

2) That government regulators cooperate to:

- a) Introduce guidelines or, where appropriate, regulations to clarify that the fiduciary obligation of the trustee includes the consideration of ESG issues that are financially material to investment decisions; and
- b) Bring a test case to the Supreme Court of Canada to establish whether or not and under what circumstances pension plans, or their advisors, may face liabilities should they fail to properly incorporate, within their investment strategy, a framework to monitor and manage ESG factors.

3) That regulators work together with pension plans, legal and investment professionals, and other interested stakeholders to consider how best to incorporate long-term liabilities within current pension plan structures.

Questions that could be addressed include:

- ✓ Does or should fiduciary duty include an obligation to consider the purchasing power of future pension entitlements?
- ✓ Can future purchasing power be adequately addressed by inflation indexation or should scenarios for rapid and potentially negative social, environmental, and political change be considered as well?
- ✓ Are compensation structures in place for pension plan staff and related financial service professionals properly aligned with the interests of pension plan beneficiaries?

4) That the federal government lead by example and:

- a) Actively integrate ESG factors in federal funding of grants and projects related to capital markets; and
- b) Begin a dialogue on ESG integration with trustees appointed by the federal government.

5) That the SIO, working together with the Pension Investment Association of Canada (PIAC), survey the presence, quality and consistency of ESG-related educational materials used within existing training and education programs offered to pension trustees.

Furthermore the organizations should be encouraged to make recommendations for:

- a) The development of standard training courses (or course curricula) for trustees and that there be an expectation, or regulatory requirement, for trustees to complete basic training within a reasonable period following their appointment; and

32 A fulsome review of corporate disclosure requirements in Canada, and proposals for change, lies beyond the scope of this paper.

- b) The integration of responsible investment issues and themes into the education requirements of academic and professional institutions and programs including those granting business, commerce, MBA, or economics degrees; CFA accreditation and related accreditation programs; and director education courses and certification.
- 6) That institutional investors, money managers, and trustees engage companies on the potential materiality of ESG issues and encourage the development and adoption of methodologies to measure, and standardized reporting of, ESG impacts.
- 7) That pension funds with leading responsible investment programs be encouraged to assist and encourage other pension funds by working through industry groups such as the Pension Investment Association of Canada (PIAC) and the Canadian Pension Benefits Institute (CPBI).
- 8) That pension funds that have signed the UN PRI be encouraged to work through the SIO and PIAC to set goals for increased participation in this leading collaborative initiative, and to raise awareness within the broader pension community in order to meet these goals.

5

Strategies for Individual Pension Plans

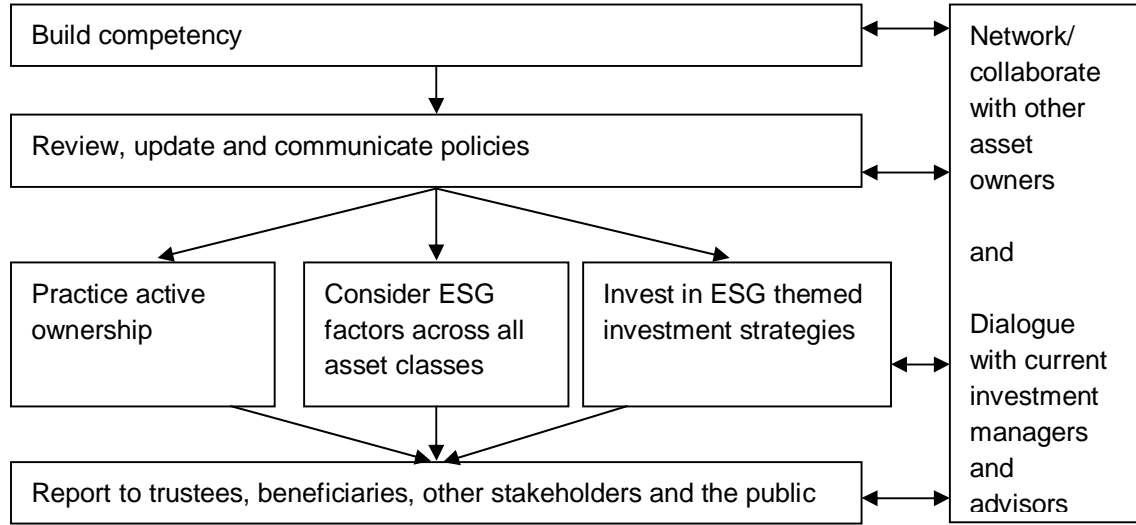
Developing and implementing an approach to RI does not have to be an overwhelming or resource intensive process. Pension fund trustees or plan sponsors can take some small steps – as simple as, for example, asking their existing investment managers to report on how they incorporate ESG factors – to initiate a responsible investment program upon which they can then build.

As the recent UN Environment Program Finance Initiative report highlights, the role of investment consultants and other advisors is critical to the advancement of responsible investment strategies.³³ And the level of understanding of and support for responsible investment among investment consultants is quite variable. For those consultants who are not familiar with the subject matter, there is sometimes a tendency to discourage their clients from exploring responsible investment. It is important that boards of trustees and pension staff are clear in their expectations of their investment advisors and are willing to seek qualified advice when and where necessary.

This section examines some standard milestones in the development of responsible investment programs by pension funds, based on our work with global clients.³⁴ As an overview, these steps are outlined in the chart on the next page.

³³ Asset Management Working Group, op. cit.

³⁴ Again, these steps are based on *Mercer's* experience working with pension funds to implement responsible investment strategies. There are a variety of other firms, both specialized RI providers and general investment consultants, that may recommend a different approach..



Build competency

In order to develop a robust and thoughtful approach to RI that will withstand scrutiny by stakeholders, decision makers and those who will implement the approach to RI must have sufficient information to make appropriate decisions. Actions that will help build the competency of trustees and staff include:

- Holding discussions with peer pension plans that have developed a RI strategy
- Identifying and attend RI-related seminars, training programs and conferences
- Reviewing relevant literature: socially responsible investment, corporate engagement, and the relationship between ESG issues and investment performance
- Reviewing collaborative initiatives (see next section)
- Reviewing RI activities of peer investors: policies, approach, resources, experience, etc.

Review, update and communicate policies

Policies provide critical links between the broader goals and objectives of organizations and investment program implementation.

Actions that will help enshrine a pension plan’s goals and objectives related to its approach to RI include:

- Including references to ESG issues and active ownership in Statement of Investment Policies and Procedures (SIP&P)
- Considering developing a stand-alone RI policy
- Considering incorporating basic responsible investment expectations in existing and new contracts between the plan and its external managers and other service providers
- Reviewing references to ESG issues and active ownership in policies annually
- Disclosing policies to external investment managers and any other relevant agents
- Disclosing policies publicly

Practice active ownership

Globally, the end-owners of assets are increasingly interested in being, and encouraged to behave as, active owners of the companies and assets in which they are invested. It might help to focus on key issues that are both material investment issues and of interest to the plan's beneficiaries.

Actions that will help pension plans practice active ownership include:

- Developing an active ownership policy that outlines expectations for companies and how active ownership responsibilities will be carried out
- Developing voting guidelines (ensure they cover ESG factors, cover all markets, are reviewed annually, and disclosed publicly)
- Ensuring voting rights are exercised (either in house or by agent)
- Monitoring portfolio companies for adherence to expectations
- Engaging with portfolio companies on ESG issues when they are not meeting expectations
- Evaluating and reporting on the success of voting and engagement activity to staff, trustees and beneficiaries
- Considering the impact of any stock lending activity on voting outcomes and potential conflicts with long-term value of holdings
- Engaging with regulators and other market participants to influence policies in order to improve capital market efficiency and strengthen plans' ability to meet the pension promise

Consider ESG factors across all asset classes

ESG factors may affect the performance (risk and/or return) of investment portfolios to varying degrees across companies, sectors, regions, asset classes and through time. Similarly, the relevance of ESG factors can be directly related to the holding period for a particular asset class or the asset class in question. For example, in real estate, the importance of tracking, managing, and maximizing energy efficiency has been largely accepted and incorporated as a best practice. For a more recent example, in infrastructure, the importance of labour unions, collective bargaining rights, and negotiated standards has very recently emerged as a key issue. This change has been driven as much by investment managers as by asset owners.

Actions that will help pension plans consider ESG factors across all asset classes include:

- Starting with one asset class (e.g. domestic equities) but plan to incorporate ESG factors into all investment decision making processes
- Evaluating active investment performance over long timeframes (3-5 years)
- Internal management: gather or purchase and analyse ESG factors; establish a continual improvement process; and ensure internal management staff are capable of integrating ESG factors into the investment process, as appropriate
- Regarding external investment management: consider capabilities of managers to gather and analyse ESG factors when retaining external investment managers
- Asking about the consideration of ESG factors in requests for proposals and consider the use of ESG criteria and reporting expectations in manager selection decisions and draft investment management contracts

Invest in ESG themed investment strategies

ESG-themed investments offer opportunities to focus on ESG factors and at the same time may improve diversification and perhaps the potential for returns (which will, as always, be dependent on the skill of the manager where actively managed). ESG-themed investments require specialized knowledge and are subject to issue specific risks such as renewable energy incentives for clean energy strategies and corporate governance legislation for activist funds, for example.

Possible thematic opportunities include:

- Listed equity focused on environmental companies, renewable energy, water or waste management
- Private equity focused on environmental companies, renewable energy, water or waste management
- Infrastructure investments focused on renewable energy
- Real estate investments focused on energy efficiency

Report to trustees, beneficiaries, other stakeholders and the public

Information sharing, networking, joint action, and transparency, in general, have been hallmarks of the responsible investment movement – in fact, they are arguably critical to its future success. Recognizing that pension funds face a variety of competing pressures and have different levels of available internal resources, best practices would encourage disclosure of responsible investment activities whenever possible.

The following items should be reported to and monitored by trustees and senior staff:

- Responsible investment policies, including proxy voting guidelines
- Past proxy voting records and voting intentions for upcoming proxies
- Corporate engagement including issues identified, companies contacted, and results
- Annual reporting of the above as well as general information about ESG integration by internal staff and external managers

Ideally, the information above would be disclosed publicly as well, although the ability of a given pension plan to do so depends in part on available resources and competing priorities.

Collaborate with other investors

Collaborative investor initiatives represent an excellent opportunity to mobilise change and undertake responsible investment activity with reduced effort, expense, and risk. Typically, investors' motivations for increased collaborative engagement are as follows:

- To gain information (about an issue, company or sector)
- To support investment decision-making
- To deliver a consistent message to corporations and stakeholders on various issues
- To leverage the combined ownership positions of like-minded peer organizations
- To share the costs and risks of responsible investment

Collaboration has emerged as a powerful tool in the promotion of active ownership and the integration of ESG factors into investment processes, with literally dozens of initiatives now in existence. There are a number of potential advantages for institutional investors in considering collaborating with others in the pursuit of these goals, rather than ‘going alone.’

First, economies of scale make collaboration between asset owners and asset managers a more cost effective and efficient way to implement change through pooling resources and sharing knowledge.

Second, there are benefits in terms of sharing the risks associated with introducing change and new innovations, or what some refer to as the ‘first mover risks’³⁵.

Third, in many situations coordinated efforts will be a more powerful and effective means of driving change and improvement than individual actions. Not only would a group of investment managers and asset owners have more power in terms of combined assets under management and representation at the industry level, but they would also be more likely to be perceived as a legitimate voice that carries more weight in influencing the behaviour of others than could be achieved individually.³⁶

Collaborative initiatives should not be viewed as a substitute for direct corporate engagement or individual plan efforts to develop and implement responsible investment strategies. Rather, collaboration is a complementary process, and one that can take many forms, between pension funds, investment managers, and service providers. In Canada, organizations like the SIO have organized and encouraged dialogue within the financial services industry – most recently, sponsoring an exploratory discussion at its 2009 Annual Conference between leading Canadian pension fund practitioners.

While much collaboration is *ad hoc* and can involve bilateral or multilateral discussions, there are a number of prominent, established initiatives worth exploring in greater detail. The next section of this paper examines some of the leading collaborative initiatives supported by pension funds with explicit responsible investment programs.

³⁵ Hoffman, A.J., Gillespie, J.J., Moore, D.A., Wade-Benzoni, K.A., Thompson, L.L. and Bazerman, M.H., “A Mixed-Motive Perspective on the Economics versus Environment Debate,” 1999, *American Behavioral Scientist*, Vol. 42(8), pp. 1254-1276.

³⁶ Guyatt, D. “Identifying and Mobilising Win-Win Opportunities for Collaboration between Pension Fund Institutions and their Agents”, 2008. A study sponsored by the Rotman International Centre for Pensions Management.

6

Key collaborative initiatives

The following initiatives represent some of the key collaborative groups in which institutional investors can participate:

- Canadian Coalition for Good Governance (CCGG)
- Carbon Disclosure Project (CDP)
- Council of Institutional Investors (CII)
- Extractive Industries Transparency Initiative (EITI)
- International Corporate Governance Network (ICGN)
- Investor Network on Climate Risk (INCR)
- Principles for Responsible Investment (UN PRI)

All of these initiatives are global in membership and focus with the exceptions of the CCGG, which concentrates on Canadian businesses, and the CII, representing American pension funds. This section provides a short overview of the first six initiatives before examining, in greater detail, the UN PRI. The UN PRI is generally recognized as the key collaborative initiative supporting a comprehensive, transparent, and accountable approach to responsible investment.

Canadian Coalition for Good Governance (CCGG)

The CCGG aims to represent Canadian institutional shareholders through the promotion of corporate governance best practices, and to align the interests of boards and management with those of their shareholders. Current members include 41 large Canadian institutional investors (fund managers, pension funds, and others) with total assets of C\$1.2 trillion. The Executive Director works with members to develop and maintain lists of governance opportunities across companies and public policy issues upon which the CCGG bases its action plan. Membership is available in two stages: a full membership with fees ranging from \$4,500 to \$31,000, and an associate membership for \$5,000.

One way that institutional investors take advantage of their membership in the CCGG is by participating in CCGG committees or sub-committees. For example, the Public Policy

Committee addresses matters that have a significant impact on aligning the interests of shareholders and management and attempts to create an environment for good governance. A sub-committee of the Public Policy Committee focusing on executive compensation and corporate boards recently developed its “Principles of Executive Compensation” to guide corporate boards in developing compensation plans that truly “pay for performance.”³⁷ Throughout 2009 and in 2010, the CCGG will actively encourage Canadian companies to implement the compensation principles³⁸.

Carbon Disclosure Project (CDP)

The Carbon Disclosure Project (CDP), launched by the Government of the United Kingdom in 2000, is a coordinating secretariat that lobbies companies for disclosure of investment-relevant information concerning their greenhouse gas (GHG) emissions. CDP is an effective mechanism for encouraging and achieving greater transparency about GHG emissions management. Due to its low resource requirement and broad support, CDP has received extensive investor support.

The coalition now has the world’s largest global database of corporate emissions. Using this data, supplemented by their own research, third-party service providers are creating tools to allow investors to track and monitor the carbon footprint of their own portfolios. Mercer’s investment consulting business recently concluded an arrangement with one such provider, Trucost, to provide this information to our clients at multiple levels: the overall portfolio, sectors within the portfolio, and individual holdings.

The 475 signatory investors to the Carbon Disclosure Project’s sixth request for information (CDP6) recognize the potential market impacts of unmanaged carbon- and carbon-related emission risks. Representing an unprecedented \$55 trillion in assets under management, this coalition of asset managers and asset owners are sending a clear signal to the world’s largest publicly traded companies by requesting corporate transparency on climate change–related risks and opportunities. There is no fee to participate in the CDP.

Council of Institutional Investors (CII)

The CII is a non-profit organisation of US public, labour and corporate pension funds, which seeks to address investment issues that affect the size or security of plan assets. Its objectives are to encourage member funds, as major shareholders, to take an active role in protecting plan assets and to help members increase return on their investments as part of their fiduciary obligations.

CII is recognized as a significant voice for institutional shareholder interests and is renowned for its efforts to improve corporate governance standards and to strengthen shareowner rights. Current members include over 130 pension fund members with

³⁷ CCGG Newsletter, Volume 6, Number 1. Edited by Paul Schneider, January 2009.

<http://www.ccg.ca/newsletter/>

³⁸ “2008-2009 Annual Report: Working to Improve Corporate Governance in Canada,” CCGG, June 2009.

<http://www.ccg.ca/>

assets exceeding US\$3 trillion, including most of the largest pension funds in the U.S. Membership fees range from US\$3,000 to US\$30,000, depending on the fund's assets under management.

CII members leverage their participation in this collaborative initiative by using their combined influence to help inform national policy. In May 2009, CII members joined together to send letters to the Securities Exchange Commission (SEC) and Financial Accounting Standards Board (FASB) concerning executive compensation; specially, about consultant independence and compensation structure, respectively³⁹. In March 2009, the CII sent a letter to then-SEC Chair Christopher Cox expressing concern that the commission had not acted on the New York Stock Exchange's proposal to eliminate uninstructed broker votes in director elections⁴⁰.

Extractive Industries Transparency Initiative (EITI)

Based in Oslo, the EITI focuses on improving governance standards in resource-rich, developing countries by boosting regulatory and legislative transparency and disclosure of revenues earned by governments from natural resource contracts. This initiative, launched in 2002, focuses on country-level regulatory and legal oversight and compliance.

The EITI acknowledges that companies with operations in countries with poor governance can often face risks that are outside their sphere of influence. Alongside governments, non-governmental organisations and companies – investors can support EITI by signing the 'Investors' Statement on Transparency in the Extractives Sector'. This is supported by 82 global institutional investors representing US\$14 trillion and there is no fee.

Given the low resource requirements and the benefits of increased disclosure, EITI is proving to be an effective mechanism for investors and may be of particular interest to Canadian funds with exposure to domestic extractive industries companies operating overseas.

International Corporate Governance Network (ICGN)

Established in 1995, ICGN is a non-profit organisation of individual members committed to the development of good corporate governance. Its objectives are to provide a network for the exchange of information about governance, to examine governance principles and practices, and to promote good governance. About 450 ICGN members come from organisations with AUM of approximately \$9.5 trillion. ICGN could be a valuable source of information to an institutional investor and the level of involvement could evolve over time to include involvement in specific committees to be determined as key areas of interest are identified, and available resources grow.

³⁹ "Executive Compensation," CII.

<http://www.cii.org/resourcesKeyGovernanceIssuesExecutiveCompensation>

⁴⁰ "Broker Voting," CII. <http://www.cii.org/resourcesKeyGovernanceIssuesBrokerVoting>

Institutional investors can leverage their membership by participating in ICGN Policy Committees, which bring together expertise and perspectives across borders in order to develop best practice guidance for continually raising standards in corporate governance. The latest ICGN best practice guidance outlines questions that investors can ask of company representatives about anti-corruption policies, procedures, enforcement, transparency and voluntary initiatives. The guidance, released in March 2009, is meant to help shareholders call on companies to improve measures to prevent corruption⁴¹.

Investor Network on Climate Risk (INCR)

The INCR, created in 2003 under the guidance of CERES, a coalition of investors and environmental groups working to promote sustainable economic growth, focuses on understanding the risks of climate change for institutional investors. Climate risk includes financial, fiduciary and liability risks ensuing from climate change. INCR encourages companies in which its members invest to address any material risks and opportunities to their businesses associated with climate change and, also, encourages a shift to a lower carbon economy. INCR's membership has grown from 10 investors managing \$600 billion in assets (in November 2003) to more than 70 investors managing more than \$7 trillion of assets today. Members include asset managers, state and city treasurers and comptrollers, public and labour pension funds, foundations, and other institutional investors. The fee for an investor with assets between US\$1 billion and US\$50 billion is US\$2,500.

Members can take advantage of their participation in the INCR by attending working groups and joining in collaborative efforts to inform national climate change policy. On June 12, 2009, a group of 41 members and affiliated investors sent a letter to the SEC requesting that the Commission address corporate disclosure of climate change and other material environmental, social and governance risks in securities filings.

⁴¹ <http://www.icgn.org/best-practice/>

7

Principles for Responsible Investment (PRI)

The PRI is an investor led-initiative in partnership with UNEP Finance Initiative and the UN Global Compact. The Principles were developed as a collaborative project, with individuals representing 20 institutional investors supported by a 70-person multi-stakeholder group of experts from the investment industry, intergovernmental and governmental organizations, civil society and academia. The PRI has grown to 550+ signatories, representing more than US\$18 trillion in assets under management.

The preamble to the Principles state:

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society.

The Principles address the integration of ESG issues into investment analysis and decision-making processes, active ownership policies and practices and corporate ESG disclosure practices. To date, there has been a voluntary fee structure. In 2010, this will move to a sliding but mandatory fee structure (capped at US\$10,000) with details to be finalized in the near future.

PRI signatories are required to report on their progress towards implementing the Principles at least every other year, and this process is facilitated through the provision of an annual, on-line Reporting and Assessment Tool. While this process requires some time, it also provides an off-the-shelf structure for managing and reporting on RI implementation. Signatories leverage their PRI membership by undergoing an annual peer benchmarking with regards to implementing the Principles; accessing the PRI Engagement Clearinghouse, which provides signatories with a forum to share engagement opportunities; and participating in the Implementation Blog, which shares learning experiences among signatories.

In July 2009, the PRI launched the PRI Enhanced Research Portal, an online platform to aggregate industry research that integrates ESG factors, allowing research providers to showcase their analysis and allowing signatories greater and easier access to these outputs. Members can also leverage their participation in the PRI by building on their signatory status to develop brand recognition and positive business connections.

From Commitment to Action

Becoming a signatory to the PRI requires a high-level commitment from organisations to apply the Principles throughout their approach to investment. However, it is also important to note that the Principles are voluntary and aspirational, and becoming a signatory is, for many, the first step towards incorporating ESG issues into mainstream investment decision-making and ownership practices. The initiative is non-prescriptive in nature, so signatories can each implement the PRI in the manner most suited to their investment approach, structure and available resources. Based on this non-prescriptive nature, signatories may allocate varying amounts of time and resources to implementing the Principles. In all cases, the resources available to signatories – the Engagement Clearinghouse, the Implementation Blog and the Enhanced Research Portal – facilitate the process of implementing the Principles.

Because PRI signatories are required to report annually on their progress towards implementing the Principles, they do need to allocate resources to collecting information/data and reporting on progress. Signatories, however, find this information useful for internal management of implementation and may wish to share it with investors or other stakeholders.

Developing an action plan based on the Principles

The PRI encompasses six overarching principles and a menu of possible actions for incorporating ESG issues into investment decision-making and ownership practices. Each of the possible actions and the activities listed earlier in this report can be assessed with regards to their resource implications as highlighted in the following chart. Resource implications can influence the prioritisation and scheduling of actions.

Range of resource implications

Resource implications	Time required	Cost	Complexity of implementation	Scope (asset classes, geography, etc.)	Required expertise
Low	Short and finite	Free/minimal	Straight-forward	Limited	Limited
Moderate	↕	↕	↕	↕	↕
High	Long and ongoing	Tens of thousands of dollars	Difficult	Potentially broad	Extensive

After resource implications have been assessed, an action plan can be developed based on both short term (one year) and long term (five year) goals. The plan of action should clarify milestones, resource implications and who is responsible for each action and hold them accountable by requiring the review of relevant information. The long term plan

should include different options and paths where they exist (i.e. corporate engagement could be carried out by staff or an external service provider).

Short and long term plans and policies may be subject to informal consultations, formal surveys, or even voting by beneficiaries either initially or on a regular basis, with provision for members to offer suggestions for modified or different approaches to RI.

Some of the lowest-resource actions for pension plans to explore include the following:

- Communicating ESG expectations to investment service providers
- Including RI-related requirements in requests for proposals
- Disclosing current policies
- Participating in collaborative initiatives, especially the PRI

8

Responsible Investment Glossary⁴²

Active ownership

The voting of company shares and/or the engaging of corporate managers and boards of directors in dialogue on environmental, social and corporate governance issues as well as on business strategy issues. This is increasingly pursued in an effort to reduce risk and enhance long-term shareholder value. See also *Collaborative engagement* and *Shareholder engagement*.

Avoidance

See also *Negative screening*.

Best-in-class

The focusing of investments in companies that have historically performed better than their peers within a particular industry or sector on measures of environmental, social and corporate governance issues. This typically involves positive or negative screening or portfolio tilting.

Cleantech

A range of products, services and processes that either directly reduce or eliminate ecological impacts or have the potential to provide performance at least matching that of traditional alternatives whilst requiring lower resource inputs, or a different mix of inputs.⁴³ Cleantech is an investment theme rather than an industrial sector as it may include investments in agriculture, energy, manufacturing, materials, technology, transportation, and water. In 2005, cleantech was North America's 5th largest venture capital investment category, attracting more than US\$1.6 billion.

⁴² This glossary is based on Mercer's "The language of responsible investment: an industry guide to key terms and organizations," (updated January 2008) and available at: <http://www.mercer.com/ridictionary>.

⁴³ Cleantech Venture Network. (2006). *Cleantech defined*. Retrieved 2006-11-23, from <http://cleantech.com/index.cfm?pageSRC=CleantechDefined>

Climate change

A change of climate which is attributed to natural or anthropogenic activity that alters the composition of the global atmosphere and changes weather patterns on a global scale. There is compelling evidence that increasing concentrations of greenhouse gases in the atmosphere are attributable to human activity and are increasing the greenhouse effect and causing climate change.

Climate risks

The risks stemming from climate change that have the potential to affect companies, industries and whole economies. There are five key areas of business risk associated with climate change: regulatory, physical, litigation, competitiveness and reputational.

Collaborative engagement

The engagement activities conducted collaboratively by multiple parties (for example, pension funds or fund managers) in order to gain leverage and minimize costs and risks.⁴⁴ Collaborative engagement forms a subset of collaborative initiatives. See also *Active ownership* and *Shareholder engagement*.

Collaborative initiatives

The initiatives conducted collaboratively by multiple parties (for example, pension funds and/or fund managers) in order to gain leverage and minimise costs and risks. The Principles for Responsible Investment, the Carbon Disclosure Project, and the national and regional social investment organisations are examples of collaborative initiatives.

Community investment

The capital from investors that is directed to communities underserved by traditional financial services. It provides access to credit, equity, capital and basic banking products that these communities would otherwise not have.⁴⁵

Corporate citizenship: See also *Corporate social responsibility*.

Corporate governance

The procedures and processes according to which an organisation (in this context, mainly a company) is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision making. There are both national and international best practice standards.⁴⁶

⁴⁴ Higgs, C. & Wildsmith, H. (2005). *Responsible investment trustee toolkit*. Retrieved 2006-11-08, from <http://www.uksif.org/J/Z/Z/lib/2005/files/04/jp-trtk/jp-trusteetoolkit-2005.pdf>

⁴⁵ Community Investing Program. (2005). *What is community investing?* Retrieved 2006-11-09, from <http://www.communityinvest.org/overview/what.cfm>

⁴⁶ OECD. (2004). OECD Principles of Corporate Governance. Retrieved 2006-11-10, from <http://www.oecd.org/dataoecd/32/18/31557724.pdf>

Corporate social responsibility (CSR)

The approach to business which takes into account economic, social, environmental and ethical impacts for a variety of reasons, including mitigating risk, decreasing costs, and improving brand image and competitiveness. This approach is sometimes implemented by means of a comprehensive set of policies and procedures integrated throughout a company. Often the policies and procedures encompass a wide range of practices related to all levels of business activity, including corporate governance, employee relations, supply chain relationships, customer relationships, environmental management, philanthropy and community involvement. Investors in companies, including institutional investors like pension funds, can use their leverage (through responsible investment) to encourage companies to adopt CSR practices. CSR practices have been linked to improved financial performance.

Divestment

The selling or disposing of shares or other assets. Changes in corporate behaviour or investment policies can lead investors to reduce or eliminate investments. Investors who practice active ownership often view divestment as the last resort. Divestment gained prominence during the boycott of companies doing business in South Africa, prior to the dismantling of apartheid. More recently, a campaign has begun to encourage divestment from companies doing business in Sudan.

Eco-efficiency

The ratio between goods produced or services rendered and the resources consumed or waste produced.

Economically targeted investment

An investment that aims to achieve a market rate of return while improving social conditions through, for example, investments that provide public housing or employment opportunities,

Emerging managers

See also *MFOE*.

Engagement

See also *Shareholder engagement*.

Engagement overlay service

A third-party service that engages investee companies on behalf of shareholder clients. Currently offered by a small number of investment fund managers and independent service providers.

ESG (environmental, social and corporate governance)

The term that has emerged globally to describe the environmental, social and corporate governance issues that investors are considering in the context of corporate behaviour.

No definitive list of ESG issues exists, but they typically display one or more of the following characteristics:⁴⁷

- Issues that have traditionally been considered non-financial or not material
- A medium- or long-term time horizon
- Qualitative objectives that are not readily quantifiable in monetary terms
- Externalities (costs borne by other firms or by society at large) not well captured by market mechanisms
- A changing regulatory or policy framework
- Patterns arising throughout a company's supply chain (and therefore susceptible to unknown risks)
- A public-concern focus

ESG integration

The active investment management processes that include an analysis of environmental, social, and corporate governance risks and opportunities.

ESG research provider

A firm that provides environmental, social, corporate governance or ethical research for use in investment decisions or shareholder engagement activities. Traditional sell-side researchers are increasingly offering environmental, social and corporate governance research.

Ethical investing

The investment philosophy guided by moral values, ethical codes or religious beliefs. Investment decisions include non-economic criteria. This practice has traditionally been associated with negative screening.

Exclusionary screening

See *Negative screening*.

Extra-financial factors

The factors that have the potential to have at least a long-term effect on financial performance but lie outside the usual span of variables that get integrated into investment decisions, irrespective of whether they are part of the research process. They include ESG factors (see above) but also traditional financial factors that are often ignored or under-utilised, at least in terms of the alignment of investments with the interests of beneficiaries.

Fiduciary duties

The duties imposed upon a person who exercises some discretionary power in the interests of another person in circumstances that give rise to a relationship of trust and confidence. Fiduciary duties are the key source of limits on the discretion of investment decision makers in common law jurisdictions. The most important fiduciary duties are the duty to act prudently and the duty to act in accordance with the purpose for which

⁴⁷ Enhanced Analytics Initiative. (2005). *What are extra-financial issues?* Retrieved 2006-11-10, from <http://www.enhancedanalytics.com/>

investment powers are granted (also known as the duty of loyalty).⁴⁸ See also *Prudent man rule*.

Greenhouse gases

The gases that contribute to the greenhouse effect and global warming. The gases are released into the atmosphere through the combustion of organic matter (including fossil fuels) and through natural processes. The Kyoto protocol deals with the following greenhouse gases: carbon dioxide, nitrous oxide, methane, sulphur hexafluoride, hydrofluorocarbons and perfluorocarbons. Focus of collaborative engagement initiatives such as the Carbon Disclosure Project.

Green investing

An investment philosophy that includes criteria relating to the environmental impact of the underlying investment.

Mission-based investing

The incorporation of an organisation's mission within its investment decision-making process.⁴⁹

Negative screening

An investment approach that excludes some companies or sectors from the investment universe based on criteria relating to their policies, actions, products or services. Investments that do not meet the minimum standards of the screen are not included in the investment portfolio. Criteria may include environmental, social, corporate governance or ethical issues. Common negative screens exclude investments in tobacco, alcohol and weapons manufacturers. Other negative screens aim to exclude companies that are considered poor executors in the areas of environmental and social management or corporate governance.

Portfolio tilt

The adoption of a particular view on a sector or issue by overweighting or underweighting the portfolio relative to the benchmark.

Positive screening

An investment approach that includes non-traditional criteria relating to the policies, actions, products or services of securities issuers. Portfolios are tilted towards stocks that rate well on the nominated criteria. The criteria could include environmental, social, corporate governance or ethical issues. Common positive screens include measures of energy efficiency, environmental management or employment standards. Increasingly, these factors are deemed desirable attributes for both financial and non-financial measures. In this case, see also *ESG integration*.

⁴⁸ Freshfields Bruckhaus Deringer. (2005). *A legal framework for the integration of environmental, social and governance issues into institutional investment*. Retrieved 2006-10-24, from http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

⁴⁹ Michael Jantzi Research Associates Ltd. (2003). *Investing in change: Mission-based investing for foundations, endowments, and NGOs*. Ottawa, ON: Canadian Council for International Co-operation.

Proxy voting

The delegation of voting rights from entitled voters who do not attend shareholders' meetings to delegates who vote on their behalf. Proxy voting allows shareholders to exercise their right to vote without committing the time involved in actually attending meetings.

Proxy voting policy

The written policy which articulates how proxy voting decisions are to be made and executed. Proxy voting policies can include specific guidance on environmental, social, corporate governance and ethical voting decisions.

Proxy voting advisory service provider

A third party who provides background information and advice in relation to proxy issues.

Prudent man rule

A common rule pertaining to fiduciary duty in Anglo-Saxon countries. The OECD states the rule in terms of the following broad principle: "A fiduciary should discharge his or her duties with the care, skill, prudence and diligence that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and aims."⁵⁰

Applications vary by country. In the United States, The Employee Retirement Income Security Act of 1974 (ERISA) outlines minimum standards for private pension plans that have since been adopted by many public pension plans. See also *Fiduciary duties*.

Responsible investment (RI)

The integration of environmental, social and corporate governance (ESG) considerations into investment management processes and ownership practices in the belief that these factors can have an impact on financial performance. Responsible investment can be practices across all asset classes.

Responsible investment policy statement

A general (usually public) statement on responsible investment adopted by boards of trustees or directors that directs investment staff practices and decisions. This can be included within a broader investment policy statement and/or developed as a standalone RI policy statement.

Responsible property investment

A property investment approach that includes the consideration of environmental, social and corporate governance issues. Energy and resource efficiency, both in construction and ongoing operations is a common consideration, as is social impact.

Restricted list

A list of securities that are not to be included in a portfolio by an investment manager. Typically facilitates implementation of negative screening.

⁵⁰ Galer, R. (n.d.). 'Prudent person rule' standard for the investment of pension fund assets. Retrieved 2006-11-09, from <http://www.oecd.org/dataoecd/51/0/2763540.pdf>

Screening

An investment approach that employs certain criteria (for example, environmental, social, corporate governance or ethical considerations) in investment decision making and portfolio construction. Only investments that meet certain criteria are included in investment portfolios. See also *Negative screening* and *Positive screening*.

SEE (social, ethical, and environmental)

The acronym that emerged in Europe to describe the social, ethical and environmental issues that responsible investors are considering in the context of corporate behaviour. No definitive list of SEE issues exists, but there is significant overlap with ESG issues.

Shareholder

An investor who holds preferred or common shares of a corporation.

Shareholder activism

A public or confrontational approach to shareholder engagement. In addition to shareholder engagement, pressure can be exerted on companies through strategic divestment or attempts to influence public opinion. See also *Active ownership*.

Shareholder engagement

The practice of monitoring corporate behaviour and seeking changes where appropriate through dialogue with companies or through the use of share ownership rights, such as filing shareholder resolutions. Shareholder engagement is often employed in attempts to improve a company's performance on environmental, social and corporate governance issues.

Shareholder proposal

A shareholder request that the company or its board of directors take particular action. Proposed by the shareholder, this request may be presented at a company's general shareholders' meeting and voted on by all shareholders. In some instances, shareholder proposals are withdrawn by shareholders or disallowed by regulators.

Shareholder resolution

See *Shareholder proposal*.

“Short-termism”

The bias some investors demonstrate for near- or immediate-term investment performance and share price appreciation instead of long-term investment performance. This bias may put pressure on corporate managers to make decisions that boost short-term accounting measures of profitability rather than long-term economic profitability.

“Sin stock”

The stock of a company that provides goods or services that the investor has deemed unethical. Common examples include the stocks of companies that are involved in the production or provision of tobacco, alcohol, pornography or gaming facilities.

Social investment policy statement

A general statement on social investment adopted by a board of trustees. See also *Responsible investment policy statement*.

Socially responsible investment (SRI)

An investment process that seeks to achieve social and environmental objectives alongside financial objectives.

Stakeholders

The individuals or organisations with an interest in the actions and impacts of an organisation. They may be customers, suppliers, shareholders, employees, communities, members of special interest groups, nongovernmental organisations, or regulators.

Sustainability

See *Sustainable development*.

Sustainability report

A report produced by an organisation to inform stakeholders about its policies, programs and performance regarding environmental, social and economic issues. Sustainability reports, also known as corporate citizenship reports or CSR reports, are usually voluntary and relatively few are independently audited or integrated into financial reports. Numerous corporations are now employing sustainability reports to expand public disclosure beyond financial metrics. The Global Reporting Initiative provides a framework for sustainability reporting.

Sustainable development

The concept of meeting present needs without compromising the ability of future generations to meet their needs.⁵¹ It encompasses social welfare, protection of the environment, efficient use of natural resources and economic well-being.

Thematic investment

The selected investment in companies with a commitment to chosen responsible business products and/or services, such as environmental technologies.⁵² See also *Cleantech* and *Community investment*.

Triple bottom line

A holistic approach to measuring a company's performance on environmental, social and economic issues. The triple bottom line focuses companies not just on the economic value they add, but also on the environmental and social value they add or destroy.

Universal owner

A large investor who holds a broad selection of investments in different public companies as well as other assets and who therefore is tied to the performance of markets or economies as a whole – not just to the performance of individual holdings. These investors have a vested interest in the long-term health of the economy, making public policy issues and cross-market ESG concerns particularly relevant.

⁵¹ Bruntland, G. (ed.). (1987). *Our common future: The World Commission on Environment and Development*. Oxford, UK: Oxford University Press.

⁵² Higgs, C. & Wildsmith, H. (2005). *Responsible investment trustee toolkit*. Retrieved 2006-11-08, from <http://www.uksif.org/J/Z/Z/lib/2005/files/04/jp-trtk/jp-trusteetoolkit-2005.pdf>

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MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

Mercer (Canada) Limited
161 Bay Street
P.O. Box 501
Toronto, Ontario M5J 2S5
416 868 2000