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*Note: Where this guidance note conflicts with the Financial Services Commission of Ontario Act, 1997, S.O. 1997, c. 28 (FSCO Act), Pension Benefits Act, R.S.O. 1990, c. P.8 (PBA) or Regulation 909, R.R.O. 1990 (Regulation), the FSCO Act, PBA or Regulation govern.*

*Note: The electronic version of this guidance note, including direct access to all linked references, is available on FSCO's website at [www.fSCO.gov.on.ca](http://www.fSCO.gov.on.ca). All pension policies and guidance notes can be accessed from the **Pensions** section of the website through the **Pension Policies** link.*

## 1. Purpose

This guidance note provides background information and guidelines on **environmental, social and governance (ESG) factors**, to assist pension plan administrators (administrator) in meeting the requirement of section 78(3) of Regulation 909 (Regulation) under the Pension Benefits Act (PBA), which comes into force on January 1, 2016. Under section 78(3), a plan's statement of investment policies and procedures (SIPP) is required to include information as to whether environmental, social, and governance (ESG) factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated.

## 2. Background on Relevant Legislation

### a. PBA Requirements for Prudent Investing (Section 22)

An administrator is responsible for investing the pension fund in accordance with the administrator's standard of care, in a prudent manner, and in the best interests of the pension plan's beneficiaries. Prudent investing entails understanding, monitoring and mitigating risk. It is the responsibility of the administrator to determine what prudence requires in the context of the plan and fund that it administers.

Accordingly, all investment decisions that are made by the administrator (or its delegates), including the decision as to whether or not to incorporate ESG factors, and, if so, how must be made in accordance with the administrator's fiduciary duties.

## **b. PBA Regulations**

Under section 78(1) of the Regulation, the administrator of a pension plan is required to establish a SIPP for the plan that meets the requirements of the federal investment regulations<sup>1</sup> as modified in sections 47.8 and 79 of the Regulation. A SIPP is a document that contains investment policies and procedures in respect of a plan's portfolio of investments and loans.

Section 78 of the Regulation has been amended, effective January 1, 2016, to add the following requirements concerning the SIPPs that are applicable to Ontario registered pension plans:

- Administrators will be required to file their SIPPs, and subsequent amendments to their SIPPs, with FSCO; and
- SIPPs must include information on whether or not ESG factors are incorporated into the plan's investment policies and procedures, and if so, include a description of how those factors are incorporated.

Under sections 40, 40.1, and 40.2 of the Regulation, effective July 1, 2016, administrators must include prescribed statements about the SIPP in annual statements to members, and in biennial statements to former and retired members.

The disclosure requirements set out in the Regulation are applicable to both defined benefit and defined contribution plans.

## **3. ESG Factors**

The term "ESG factors" is not defined in the PBA or the Regulation, and there is no standard definition of ESG factors that has been accepted among the investment community. Similarly, the approach to incorporating ESG factors into investment policies and procedures differs among investors.

One such approach involves integrating ESG factors into fundamental investment analysis to the extent that they are material to investment performance. This approach is driven by the belief that effective research, analysis and management of ESG factors can play a part in assessing the valuation and future performance of an investment over the short, medium and long term. It involves the assessment of a wider range of risks and opportunities that may influence the investment performance of the pension fund, by looking at factors beyond those included in traditional financial analysis. It also recognizes the long-term nature of ESG factors, and the impact they may have on the sustainability and profitability of individual entities in which the pension fund may invest. This approach sees ESG factors as among the many factors that may materially impact the investment performance of an asset; while all such factors should be taken into account as part of an administrator's duty to invest prudently, it is up to the

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<sup>1</sup> The federal investment regulations (FIR) are defined by section 66 of the Regulation as sections 6, 7, 7.1 and 7.2 and Schedule III to the *Pension Benefits Standards Regulations, 1985* (PBSR) made under the *Pension Benefits Standards Act, 1985* (Canada) as they may be amended from time to time. The FIR are incorporated by reference in sections 78 and 79 of the Regulation. The Regulation also modifies the application of the FIR with respect to Ontario plans.

administrator as fiduciary to evaluate which factors are material and how to take them into account.

Another approach is to incorporate ESG factors into the investment process from an ethical or moral perspective, instead of from a financial perspective. For example, an investor may screen investments on social and environmental factors, such as employing ethical screens targeting guns, tobacco, or nuclear power. An administrator should be cautious to ensure that its approach to incorporating ESG factors does not conflict with its fiduciary duties, as may be the case with the use of ethical screens. The best interests of plan beneficiaries has traditionally been defined by the courts in terms of the beneficiaries' financial interests, with the result that there is a potential conflict with investing with other goals in mind such as social causes. If the administrator is considering such an approach, the administrator is encouraged to consult with its legal counsel on this issue.

#### **4. ESG Disclosure in the SIPP**

In order to comply with the Regulation's ESG disclosure requirement, FSCO expects that by January 1, 2016, the administrator will have made a decision on whether or not to incorporate ESG factors into its investment policies and procedures, and will have documented its position in the plan's SIPP. Like all decisions of the administrator, this decision should be made with regard to its fiduciary duties. In making this decision, FSCO expects that the administrator will, after consultation, as appropriate in the context of the plan (such as with the plan's trustees, investment committee, and/or investment advisors):

- establish and document its own view or understanding on what is meant by ESG factors; and,
- consider whether or not it will incorporate ESG factors and document the basis for its decision.

An appropriate place for such documentation would be the minutes of the meeting(s) where the issue was discussed, or in an internal memorandum.

##### ESG Factors Not Incorporated

Where the administrator has decided not to incorporate ESG factors into its investment policies and procedures, a statement to that effect must be made in the SIPP. Administrators may also wish to include a brief explanation of their rationale in the SIPP itself, in the interest of transparency to members and beneficiaries.

##### ESG Factors Incorporated

Where the administrator has decided to incorporate ESG factors into its investment policies and procedures, then a statement to that effect must be made in the SIPP, as well as a description as to how those factors have been incorporated. The Regulation does not provide further details, however, FSCO expects the following information to be disclosed:

- Either a broad statement that the administrator incorporates all ESG factors, or an enumeration of ESG factors that are incorporated, such as a particular ESG category or categories (i.e., environmental, social, or governance) and/or specific factors within those categories (e.g., renewable energy, labour relations, shareholder rights) which form the focus of the program. Since the SIPP is an integral plan document and the

administrator is responsible for ensuring compliance with the SIPP, the policies and procedures, including those pertaining to ESG, must be clearly drafted. A general reference to incorporating ESG factors will be interpreted by FSCO as including the broadest range of ESG factors.

- A brief explanation of the methodology used by the plan to incorporate ESG factors. The administrator is not required to provide information that would disclose any proprietary information concerning the plan's investment strategy or practices.
- A description of the scope of the application of ESG factors. The disclosure should indicate if ESG factors are applied to the entire pension fund, or only certain portions of the pension fund (e.g., such as certain asset classes, or internally managed assets rather than externally managed assets).

The administrator is responsible for ensuring compliance with the SIPP, not only by itself, but by its delegates.<sup>2</sup> Accordingly, the language concerning the incorporation of ESG factors to be included in the SIPP should be drafted in such a way that it can be complied with by the administrator and, where applicable, external investment managers. In this regard, the administrator may want to engage with its external managers in preparing its ESG disclosure language for the SIPP.

## 5. Member Statements

Effective July 1, 2016, the annual statements to members will be required to include specific *statements* concerning SIPPs, as prescribed in section 40 of the Regulation. Among these prescribed statements is the following:

(v) a statement that the administrator of the pension plan must establish a statement of investment policies and procedures for the plan that contains,

(i) the investment policies and procedures in respect of the plan's portfolio of investments and loans, and

(ii) information about whether environmental, social and governance factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated.

Similar requirements have also been prescribed for biennial statements to former and retired members (see sections 40.1 and 40.2 of the Regulation).

As can be seen from the language above, the administrator is not required to make the same ESG disclosure as in the SIPP, but is only required to make reference that such disclosures can be found in the SIPP. Administrators are required to provide the SIPP to plan members, former members, retired members, and other stakeholders upon request<sup>3</sup>.

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<sup>2</sup> See section 22(7) of the PBA, and section 79(1) of the Regulation (as of January 1, 2016). In addition, agents of the administrator have a fiduciary standard of care (PBA, s. 22(8)) and every person engaged in selecting an investment must ensure that the investment is selected in accordance with the criteria set out in the PBA and Regulation (PBA, s.62).

<sup>3</sup> See PBA, s. 29 and Regulation, s. 45(1)13 and s. 45(2)7.

## **6. Expert Advice**

Where the administrator does not believe it has sufficient knowledge on the topic of ESG factors, it would be prudent for it to seek advice from an external advisor. As in the selection of all advisors, the administrator is responsible for selecting a suitable advisor, i.e. one with relevant knowledge and expertise.

## **7. SIPP Policy Review**

The SIPP is required to be reviewed on an annual basis. This will require the administrator to annually review the ESG disclosure contained in the SIPP.

Public consultation