Fiduciary Duties, Investment Screening and Economically Targeted Investing: A Flexible Approach for Changing Times

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1. Introduction

> *"...the investor, though a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of the funds in a manner detrimental to society."*[1]

The legal boundaries of pension plan investment practice continue to be the subject of much debate in Canada. This is particularly so in the context of applying non-financial criteria to the investment decision-making process where the absence of legislative or judicial guidance continues to leave uncertainties for pension trustees.

The integration of non-financial criteria into the traditional investment decision-making process is often referred to generically as socially responsible investing (SRI).[2] However, SRI captures a number of distinct investment practices: investment screening, shareholder action, community economic development, social venture capital and economically targeted investing.[3] From a legal perspective, discussions about the fiduciary implications of SRI is misleading – and the source of much confusion on the part of trustees -- because of the unique nature of each of the various practices. Therefore, it is important to consider the legal dimension of each practice separately. This paper focuses strictly on the fiduciary issues related to investment screening and economically targeted investing.

Investment screening typically takes three forms. Positive screens set inclusive criteria which investments must satisfy in order to be included in a portfolio. Examples include health and safety standards and environmental protection measures. Negative screens are criteria applied to exclude certain investments. Examples of this type of screen include production of tobacco, alcohol, nuclear power, or military equipment, and gambling. The third approach applies a patented "best of sector" approach to selecting investments that avoids eliminating entire sectors, but rather includes the best performers from each sector. Minimum criteria are established which any company must meet. Of those that satisfy this minimum threshold, those with the highest level of performance in each sector are selected for inclusion in the portfolio.

There are two primary motivations for the application of non-financial screens. From a financial perspective, investors are concerned that non-financial factors may adversely affect investment returns, as well as the health of capital markets and the economy as a whole with direct ramification for the individual pension plan. For example, an Investor Summit on Climate Risk at the United Nations in November 2003 has led to a commitment by eight large institutional investors to develop action plans to address risk associated with global warming.[4]

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[1] Professor Austin Wakeham Scott and William Franklin Fratcher, *The Law of Trusts* (4th ed.) (Boston: Little Brown, 1987) vol. III at 500-501.

[2] In the context of socially responsible investing, the screening criteria are non-financial, although it is important to recognize that all investment selection processes employ screening criteria.

[3] *See e.g.* Social Investment Organization, *Canadian Social Investment Review 2004* (Toronto: SIO, April 2005); Russell Sparkes, *Socially Responsible Investment: A Global Revolution* (UK Social Investment Forum, 2003).

[4] CalPERS and CalSTRS recently unveiled their action plan to invest a combined $1 billion of their $250 billion portfolio into environmentally screened funds through leading active public equity investment managers with proven track records, and to undertake comprehensive audits of their $16 billion real estate portfolios to identify areas for

Internationally, 143 institutional investors participating in the Carbon Disclosure Project have called on FT500 companies to disclose information on greenhouse gas emissions to assist investors in better assessing associated risk.[5]

Plan beneficiaries are also concerned that investments be consistent with their values, the interests of their communities, the rights of workers, and the environment. Since the campaign against Apartheid in the 1980s, pension funds and other institutional investors have employed various negative screens to exclude investments that do not comply with a particular value set.[6] More recently in Canada, there have been renewed calls for the Ontario Teachers' Pension Plan to divest itself of all holdings in tobacco[7] and for the Canada Pension Plan to divest itself of both tobacco and military investments[8]. The "values" based approach to investment screening has been the focus of legal debate on investment screening and is accordingly the focus of this paper.

In addition to investment screening, pension plans are exploring opportunities to target some of the $663.7 billion in trusteed retirement assets (as of the end of the third quarter 2004)[9] towards projects that provide market returns while also addressing some of the pressing economic and social concerns facing communities. Economically targeted investments" (ETIs) are investments "…designed to produce a competitive rate of return commensurate with risk as well as create collateral economic benefits for a targeted geographic area, group of people, or sector of the economy."[10] Examples include investments in real estate in Old Winnipeg by the $750-million

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greater energy efficiency to reduce long-term costs and increase long-term value: Press release, "In Follow-Up to Investor Summit on Climate Risk, California Treasurer Launches Environmental Disclosure and Investment Initiative" (February 3, 2004).

[5] See http://www.cdproject.net.

[6] Moira Hutchinson, *The Promotion of Active Shareholdership for Corporate Social Responsibility in Canada* (Toronto: Canadian Friends Service Committee, November, 1996) (unpublished on file with author).

[7] Adria Vasil, "What Teach is Smoking" (February 19-25, 2004) 23 (25) *NOW Magazine*.

[8] *See e.g*. Andre Picard & Steven Chase, "End CPP investment in tobacco, doctors demand" (August 18, 2004) *Globe & Mail*; Gordon Pape, "Cigarettes and the CPP" (August 23, 2004) *GlobeInvestorGOLD.com*; Tavia Grant, "The Canada Pension Plan should divest its tobacco holdings" (August 26, 2004) *GlobeInvestorGOLD.com*.

[9] Statistics Canada, "Employer pension plans (trusteed pension funds)" (March 29, 2005) *The Daily* available at www.statcan.ca/Daily/English/050329/d0503293.htm.

[10] Severyn Bruyn, The Field of Social Investment (Cambridge: Cambridge University Press, 1987) at 67 cited in Isla Carmichael, Union Pension Funds, Worker Control and Social Investment in Canada: Implications for Labour Education (Toronto: Ontario Institute for the Study of Education, 2000)(Ph.D. Thesis) at 140. Another accepted definition of ETI is "pension asset allocations [that] obtain both market-grade returns and economic or social benefits by addressing perceived financing gaps and under-investment.": Falconer, Kirk. Prudence Patience and Jobs. Ottawa: Canadian Labour Market and Productivity Centre, January 1999. The definition of economically targeted investments (ETI) is also the cause of much confusion. As with investment screening, ETI is often lumped into the general discussion about SRI. Confusion also arises because of the overlap between ETI and alternative investments. While both include investments in non-traditional sectors of the economy, the primary difference is that ETIs seek to attain collateral benefits in addition to market-grade rates of return through investments in such ventures as mortgage trusts, affordable housing, commercial building, regional development, small business, emerging technology sectors, real estate, and local community investment. For a broader discussion of ETIs, *see* Carmichael, *supra*; Michael Calabrese, "Building on Success: Labor-Friendly Investment Vehicles and the Power of Private Equity" in Archon Fung, Tessa Hebb, and Joel Rogers (eds.) *Working Capital: The Power of Labor's Pensions* (New York: Cornell University, 2001) at 93; Kirk Falconer, *Prudence, Patience and Jobs: Pension Investment in a Changing Canadian Economy* (Ottawa: Canadian Labour Market and Productivity Centre, 1999).

Workers Compensation Board Investment Fund and the $2.1-billion Teachers' Retirement Allowances Fund as part of their private equity portfolios,[11] the commitment of $300 million by the Ontario Municipal Employees Retirement System (OMERS) towards building 2,300 to 2,500 rental apartment units in the Toronto area,[12] and other significant private equity and venture capital commitments by pension funds across the country.[13]

More and more, pension plans (and other bodies that act in a fiduciary capacity managing investments on behalf of others) are confronting the dual aspect of value and values with respect to their investments.[14] The primary question in all instances is whether the application of non-financial screens or the investment in economically targeted investments (ETIs) is consistent with the pension trustee's fiduciary duties. This paper argues that the traditional interpretation of the law has been unnecessarily rigid and narrow, especially in light of the rapid pace of change in investment practice -- the establishment of modern portfolio theory as the framework for institutional portfolio management, the introduction of a plethora of new investment products and services, the growing awareness of the interrelationship of so-called externalities and market performance, and the rise of institutional investors as major players in capital markets.

A brief survey of representatives of the pension bar in Canada reveals differences of opinion on the precise position of the law on this point.[15] Much of the non-legal pension industry continues to instruct plan administrators narrowly that the application of non-financial criteria to the selection of investments is illegal. Comments made by Claude Lamoureux, President of the Ontario Teachers' Pension Plan, to the 2000 annual general meeting of plan members are typical:

> ...Our investment decisions are based on the law. Pension plans do not have the legal authority to restrict investments based on social, political or ethical criteria. This is the law...
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> ...To quote the Senate Committee on Banking, Trade and Commerce:
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> "The primary responsibility of pension funds should be to the beneficiaries of the fund. Social investment or any other form of investment must be subordinate to the long-term growth of the pension plan."…
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> … if all the teachers of Ontario want us to follow a social investment policy and are willing to take the risk of lower returns, then first agree on what is acceptable and what is not acceptable as an investment…

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[11] Martin Cash, "Crocus to direct fund for downtown" (July 22, 2004) *Winnipeg Free Press*.

[12] Paul Maloney, "Big kickstart for rental housing" (May 31, 2002) *Toronto Star*.

[13] Kirk Falconer, "Venturing Forth" (October 2000) *Benefits Canada* 57 at 60; Cash, *supra* note 11.

[14] According to the Social Investment Organization, Canadian institutional investors, including pension funds, religious and public institutions, and foundations (not including screened mutual funds), invested $21.22 billion through asset management companies in 2004 subject to social and environmental screens. An additional $25.44 billion in screened assets were managed primarily or wholly in-house. The amount of **ETI** investment by Canadian pension funds has not been documented to date, although there is a modest investment in community investments ($546 million), socially responsible lending ($1.29 billion), and sustainable venture capital ($52 million): Social Investment Organization, *Canadian Social Investment Review 2004* (Toronto: SIO, April 2005) available at www.socialinvestment.ca.

[15] Informal interviews conducted with by the author between June and August 2004 and review of confidential legal opinions of nine Canadian pension lawyers.

Then convince the Ontario government -- who is the other partner in the plan -- to change the law.[16]

This common response raises two separate issues. First, with respect to the use of non-financial *criteria*, whether the application of non-financial criteria by way of investment screens and economically targeted investing is compatible with the fiduciary obligations of pension trustees. Second, whether the *process* of integrating non-financial criteria either through a risk-based approach or a values-based approach is permissible?

There has been virtually no guidance from regulators or courts in Canada to clarify these issues.[17] Changes to policy in other countries have left Canada's regulatory framework increasingly out-of-step with international norms, and its pension trustees with inadequate guidance in an increasingly complex and ever-changing investment environment.[18]

The primary purpose of this paper is to consider these issues and attempt to arrive at some conclusions.[19] The paper begins by introducing the reader to the fiduciary duties of prudence and loyalty in section two. Section three provides a comparative analysis of the legal interpretation of these duties among different common law jurisdictions. Based on the above analysis, section four reexamines four commonly cited legal barriers to investment screening and economically targeted investing. This analysis leads to the conclusion that, subject to the terms of the trust, screening and ETI are legally permissible investment practices. Following from these conclusions, section five lays out seven procedural prerequisites that fiduciaries should follow when incorporating investment screening and ETI into a plan's investment strategy. Section six concludes with a restatement of the fiduciary duties of pension trustees in relation to investment screening and ETI.

2. The fiduciary obligations of pension trustees

The duties of pension trustees and other fiduciaries may be documented in various places, including the terms of the trust agreement, pension statute and regulation, and common law.

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[16] Ontario Teachers' Pension Plan Board, Presentation to the 8th Annual Meeting of Stakeholders (Toronto: April 7, 2000) at 12. Available at www.otpp.com/web/website.nsf/web/AnnualMtgSpeech2000/$FILE/AnnualMtgSpeech2000.PDF.

[17] British Columbia amended its pension legislation in 2002 to require that pension trustees act in the best financial interests of plan members: *Pension Benefits Standards Act,* R.S.B.C. 1996, c.352, s.44(1). Manitoba amended its pension legislation in April 2005 to permit consideration of non-financial investment criteria by pension trustees: *Pension Benefits Amendment Act* (Bill 10), S.M. 2005, c.2, s.28.1(2).

[18] A 1993 survey on ETIs conducted by the Institute for Fiduciary Education found that 37% of 119 public pension funds in the United States identified conflicts with fiduciary duties as the principle barrier to economically targeted investing. This survey was conducted prior to the Department of Labor's bulletin issued in 1994 clarifying its position on the prudence of ETIs as part of a pension fund's investment portfolio (DoL Bulletin, *infra* note 61). However, the results continue to reflect the concerns that pension trustees have in this area. *See* Institute for Fiduciary Education, *Economically Targeted Investments: A Reference for Public Pension Funds* (Sacramento, CA: IFE, 1993) cited in Jayne Elizabeth Zanglein, "Overcoming Institutional Barriers on the Economically Targeted Investment Superhighway" in Fung, Hebb and Rogers, *supra* note 10 at 181, 184.

[19] This article expands on the author's initial research completed in 2001 on the issue of the fiduciary duties of trustees and socially responsible institutional investing. *See* Gil Yaron, "The Responsible Pension Trustee: Re-Interpreting the Principles of Prudence and Loyalty in the Context of Socially Responsible Institutional Investing" (June 2001) 20(4) *Estates, Trusts & Pensions Journal* 305.

Where the trust agreement sets out legal duties, these supercede legislation and common law. Subject to the terms of the trust, most jurisdictions provide some statutory provision covering one or more aspects of the fiduciary obligations of pension trustees.[20] Where legislation is silent, the common law applies. Canadian courts have affirmed that the common law of trusts applies to pension plans.[21]

Virtually all consideration of these duties in the context of investment screening by foreign judiciary and international legal scholars[22] occurred in relation to the South African Anti-Apartheid divestment campaigns. Judicial consideration of fiduciary duties and ETI has been limited to American courts prior to 1990. Unfortunately, neither issue has received direct consideration by Canadian courts.[23]

2.1. The duty of prudence

The duty of prudence is generally understood to require pension trustees to exercise the care, skill and diligence of a prudent person in dealing with the property of another.[24] While a generally consistent statutory framework exists amongst Canadian jurisdictions, there is no consensus on the exact definition of the duty of prudence.[25] Three jurisdictions (Federal, British Columbia and Alberta) provide specific provisions articulating the duty with respect to the management of pension investments.[26] The remaining provinces (except for PEI which has yet to bring into force its pension legislation) provide a generic standard of care with respect to the administration of the pension plan.

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[20] *Ibid*.

[21] *Bathgate v. National Hockey League Pension Society* (1994), 16 O.R. (3d) 761 at 776; *Boe v. Alexander* (1987), 41 D.L.R. (4th) 520 at 526-527 (C.A.), aff'g (1985) 21 E.T.R. 246, leave to appeal to SCC refused 43 D.L.R. (4th) vii.

[22] For the perspective of those opposed *see* John H. Langbein and Richard A. Posner, "Market Funds and Trust-Investment Law" (1976), 1 *Amer. B. Foundation Res. J.* 1 at 3; John H. Langbein and Richard A. Posner, "Social Investing and the Law of Trusts" (1980), 79 *Mich. L. Rev.* 72 at 99-104. For the views of those in support *see* Austin Wakeham Scott and William Franklin Fratcher, *The Law of Trusts* (4th ed.) (Boston: Little Brown, 1987), vol. III, §2227.17; Dobris, "Arguments in Favor of Fiduciary Divestment of 'South African' Securities" (1986), 65 Neb. L. Rev. 209 at 232; Ravikoff and Curzan, "Social Responsibility in Investment Policy and The Prudent Man Rule" (1980), 68 *Cal. L. Rev*. 518 at 519; Troyer, Slocombe and Boisture, "Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions, and Pension Funds" (1985), 74 *Geo. L.J.* 127 at 156-157.

[23] Bevis Longstreth, *Modern Investment Management Theory and the Prudent Man Rule* (1986) at 35: "Pure prudence cases are hard to find." As Longstreth notes, cases don't look at the application of prudence in the context of day-to-day investment decisions, but rather "involve some clearly abusive self-dealing, resulting in a 'prohibited transaction' and/or gross negligence bordering on bad faith."

[24] The standard of care was originally articulated in *Whiteley v. Learoyd,* [1887] H.L. 727.

[25] There is no consensus amongst the various pension statutes in Canada on the precise definition of the duty. *See* Yaron, *supra* note 19 at 314-317.

[26] *Pension Benefits Standards Act,* R.S.B.C. 1996, c.352, s.44 as amended by S.B.C. 1999, c.41, s.32; *Employment Pension Plans Act,* S.A. 1986, c.E-10.05, s.41, as amended S.A. 1999, c.21, s.33; *Pension Benefits Standards Act, 1985,* R.S.C. 1985, c.32 (2nd Supp.), s.8(4.1), as amended S.C. 1998, c.12.

At common law, US courts have recognized that the duty of prudence is an evolving concept that requires flexibility in its interpretation and application in light of each pension plan's unique circumstances.[27] Academic commentators have also given a flexible interpretation to the duty of prudence in the context of socially responsible investing under ERISA: "Whether a particular social investment is permissible under this section [§404(a)(I)(B) of ERISA] depends not only on the nature of the investment, but also on the needs of the plan and the characteristics of the remainder of the plan's portfolio."[28] In Canada, the Manitoba Law Reform Commission, charged with reviewing the subject of ethical investing by trustees in 1993, interpreted the application of the standard in similar terms:

> "...the 'principle of prudence' is simply a legal abstraction which first requires trustees to conduct themselves reasonably in making investment decisions and then provides a tool for measuring the reasonableness of those decisions, not from the vantage point of hindsight, but as at the time they were made. This, in turn, can only be judged in light of the complete factual backdrop against which trustees formulate their investment policies. This backdrop necessarily encompasses the needs and characteristics of both the trust fund and its beneficiaries, the nature of a proposed investment, the socio-economic climate then prevailing, and the current of professional opinion respecting the quality of new and evolving investment vehicles."[29]

The evolving nature of the duty is reflected in its history.[30] At common law, a trustee's obligation was originally to act as an ordinary prudent person would in conducting his or her own affairs.[31] This was later modified to require the trustee to act as a prudent individual would in managing the assets of another.[32]

Until 1961, the common law duty of prudence for trustees was qualified by a legal list of permissible investments. The "legal list" prohibited trustees from investing in commercial stock based on the regulators view "that commercial and industrial stocks were essentially speculative in nature and therefore unsuitable as trustee investments."[33] Subsequently, the "legal list" was gradually relaxed due in large part to demands by pension funds seeking more control over growing array of investment options. New investment strategies -- such as indexation -- gained credence and became well accepted amongst institutional investors. According to one American commentator, "...indexing was a new approach in the mid-1970s, created by the confluence of a broadened scope of investment authority under ERISA and new financial models that sanctioned passive investing."[34] In 2002, British Columbia became the last jurisdiction in Canada to replace

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[27] *Donovan* v. *Cunningham*, 716 F.2d 1455 at 1467 (1983); *Donovan v. Walton*, 609 F.Supp. 1221 at 1228 (D.C.Fla. 1985).

[28] James D. Hutchinson and Charles G. Cole, "Legal Standards Governing Investment of Pension Assets for Social and Political Goals" (1980), 128 *U. Pa. L. Rev*. 1340 at 1353.

[29] Manitoba Law Reform Commission, *Ethical Investment by Trustees* (Manitoba: Law Reform Commission, January 1993) at 33 [hereinafter MLRC].

[30] For a complete history *see* MLRC, *ibid*. at 7-9. For the American story, *see* Susannah Blake Goodman, Jonas Kron & Tim Little, *The Environmental Fiduciary: The Case for Incorporating Environmental Factors into Investment Management Policies* (Oakland, CA: Rose Foundation, 2003) at 36.

[31] *Speight v. Gaunt,* (1822) 22 Ch. D. 739 (C.A.), aff'g 22 Ch.D. 727;

[32] *Whiteley v. Learoyd, supra* note 24.

[33] MLRC, *supra* note 29 at 8.

[34] Richard H. Koppes and Maureen L. Reilly, "An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor an Index Fund Through Relationship Investing" (Spring 1995) 20(3) *J. of Corp. L.* 413 at 414ff. The *Employee*

the legal list with a general duty of prudence, however, some jurisdictions continue to impose mandatory or voluntary criteria for assessing the prudence of any particular investment decision.[35] Most provinces continue to also place limits on investments by pension plans. Nine jurisdictions in Canada have adopted the federal regulations governing permissible investments, which set numerous parameters on the investments of registered pension plans, including limits on investments in individual companies.[36]

In addition to the standard of care, Canadian courts have articulated a number of corollary duties pertaining to investment performance standards, portfolio diversification, the duty not to delegate authority and the duty to monitor. The exact standard applied in each instance is discussed in the following section.

2.2. The duty of loyalty

The duty of loyalty requires that pension trustees act honestly, in good faith, and in the best interests of the beneficiaries, treating all beneficiaries with an even hand.[37] Only Saskatchewan and British Columbia have codified the duty, British Columbia being unique in requiring that plan investments and other financial decisions be made "in the *best financial interests* of plan members, former members and other plan beneficiaries."[38] The obligation also contains a number of corollary duties (discussed below) relevant to the discussion of investment screening and economically targeted investing, including the obligation to make decisions based on the interests of plan members and beneficiaries and not based on personal interests or other conflicting interests.[39] American courts have ruled that ERISA permits trustees to maintain dual loyalties to both plan beneficiaries; however, the priorities and interests of plan members must come first.[40]

Retirement Income Security Act of 1974 (ERISA) administered by the Department of Labor governs private pension plans in the United States. ERISA provisions are not binding in Canada, but its similarities to Canadian pension legislation provide an instructive guide to pension trustees in areas where Canadian law is silent.

[35] See Yaron, *supra* note 19 at 231.

[36] *Pension Benefits Standards Regulation* SOR/87-19, sch. III; *Employment Pension Plans Regulation* Alta. Reg. 35/2000, s.50(1); *Pension Benefits Standards Regulation*, B.C. Reg. 433/93, s.38(1); *Pension Benefits Regulation* Man. Reg. 188/87, s.16(3); *Pension Benefits Regulation*, R.R.O. 1990, Reg. 909 amended to O. Reg. 444/03, s.78(2); *Pension Benefits Regulations*, Sask. Reg. 1993, c.P-6.001, s.38(2).

[37] *Balls* v. *Strutt* (1841), 1 hare 146, 66 E.R. 984 at 985; *Boe* v. *Alexander* (1985), 21 E.T.R. 246 (BCSC), aff'd (1987), 41 D.L.R. (4th) 520, 28 E.T.R. 228, 15 B.C.L.R. (2d) 106 (C.A.), leave to appeal to S.C.C. refused 43 D.L.R. (4th) vii, 28 E.T.R. xxxvi, 22 B.C.L.R. (2d) xxx; *Bathgate* v. *National Hockey League Pension Society* (1994), 16 O.R. (3d) 761 at 776; *Gisborne v. Gisborne,* [1877] 2 A.C. 300 (H.L.); *Cowan v. Scargill,* [1985] 1 Ch. D. 270, [1984] 2 All E.R. 750.

[38] *Pension Benefits Standards Act,* R.S.B.C. 1996, c.352, s.44, as amended by S.B.C. 1999, c. 41, s.32; *Pension Benefits Act,* S.S. 1992, c.P-6.001, s.11(2)(c).

[39] The conflict of interest rule has been codified in most jurisdictions. *See e.g. Pension Benefits Standards Act,* R.S.B.C. 1996, c.352, s.8(9).

[40] *Herdrich v. Pegram,* 154 F.3d 362 at 373 (7th Cir. 1998).

With this understanding of the fiduciary duties of pension trustees, we now turn to consider whether investment screening and ETI are compatible with the fiduciary duties of pension trustees.

3. Are investment screening and ETI compatible with the fiduciary duties of pension trustees?

The broad question to address is whether the legal duties of pension trustees permit them to consider investment screening and ETI as part of the pension plan's investment policy and strategy.

The fundamental distinction is whether non-financial criteria are employed as part of a plan's financial risk analysis or based on general moral or ethical principles. The law does not prohibit pension trustees from considering non-financial criteria – which include not only social, environmental and ethical factors, but also corporate governance practices – as possible risk factors in setting investment policy and evaluating investments. There is no legal basis for arguing against the application of non-financial criteria in relation to risk analysis aside from remote arguments that associated analytical costs outweigh risk-reduction benefits to the plan. Nevertheless, opposition remains. As one commentator has observed, "...the prudent man ideology still retains its power with many trustees. Social or political investment strategies remain cast as moral views, or views lacking in an objectivity, that would otherwise be obtained through a purely financial strategy or process."[41] This is due in large part to the failure of current accounting practice to capture and quantify social and environmental costs. The externalization of such costs – ultimately borne by the public – means that they are not viewed as material considerations in assessing the financial performance of companies in which pension plans are invested. The problem is compounded when considering the long-term implications of such factors on the economy, which should be the focus of pension funds as long-term investors, but which are often considered too remote in evaluating the financial benefit to the individual pension plan.[42] Studies attempting to demonstrate the costs associated with certain harmful social and environmental practices provide mixed results.[43] However, the possibility of such a relationship argues that non-financial criteria should at least inform the investment analysis employed by pension plans.[44] On this basis, I argue that prudence *requires* that pension trustees

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[41] Carmichael, *supra* note 10 at 34.

[42] James P. Hawley & Andrew T. Williams, *The Rise of Fiduciary Capitalism* (Philadelphia: University of Pennsylvania Press, 2000).

[43] *See e.g*. UNEP Finance Initiative, *The Materiality of Social Environmental and Corporate Governance Issues to Equity Pricing* (Switzerland: UNEP, June 2004); CSR Europe, Deloitte & Euronext, *Investing in Responsible Business,* (CSR Europe, Deloitte and Euronext: 2003) at 3; Roger Cowe, *Risk Returns and Responsibility Report* (London, UK: Association of British Insurers, February 2004); Lipper study cited in Sandra Haurant, "Ethical investment 'gains momentum'", (June 2, 2004) *The Guardian*; CSR Europe and Euronext, *The European Survey on Socially Responsible Investment and the Financial Community* (2002) available at www.bitc.org.uk/resources/research/research_publications/csr_europe_sri.html. *But see* Jon Entine, "Capitalism's Trojan Horse: How the "Social Investment" Movement Undermines Stakeholder Relations and Emboldens the Anti-Free Market Activities of NGOs (Draft publication: American Enterprise Institute, June 11, 2003).

[44] It is interesting to observe the widespread acceptance of corporate governance indicators – another set of non-financial criteria -- as part of prudent risk-based financial analysis by investors of all stripes, despite the equally inconclusive evidence linking such practices to corporate financial performance.

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

The more contentious debate – and the focus of the following discussion – is whether the consideration of non-financial criteria, as part of a values-based approach to investment decision-making, is consistent with the duties of prudence and loyalty.

The starting point is the 1984 Chancery Division decision in *Cowan* v. *Scargill*.[45] This case continues to be cited as the leading decision on point in Canada. However, I argue that the decision should be given less weight in light of the particulars surrounding the case and because of changes to both law and practice in this area in the twenty years since the decision was rendered. The influence of these developments is discussed later in the paper.

In *Cowan* v. *Scargill,* the employer trustees of the jointly trusteed Mineworkers' Pension Scheme brought an action against the Scheme's union trustees. The employer trustees alleged that the defendant union trustees had breached their fiduciary duty by refusing to approve the scheme's investment policy unless it was amended to prohibit an increase in the percentage of current overseas investment, to require withdrawal from existing overseas investments at the most opportune time, and to prohibit investment in energies in direct competition with coal. Megarry V.C. held that the union trustees had breached their duty of loyalty by placing the interests of the union in promoting the British coal industry and its workers ahead of the interests of plan members and beneficiaries.

The decision made the following points that are central to the discussion at hand:

- "When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests."[46]
- "...Under a trust for the provision of financial benefits, the paramount duty of the trustees is to provide the greatest financial benefits for the present and future beneficiaries..."[47]
- Investments made for social or political reasons that are equally beneficial to plan beneficiaries from a financial perspective are acceptable.[48]
- The word "benefit" is to be interpreted broadly. Where beneficiaries share strong views on particular issues, trustees, in rare circumstances, may make decisions for the benefit of beneficiaries other than their financial benefit.[49]

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[45] *Cowan v. Scargill,* [1985] 1 Ch. D. 270, [1984] 2 All E.R. 750

[46] *Ibid*.at 287.

[47] *Ibid*. at 289.

[48] *Ibid*. at 287. *See also Harries and others* v. *Church Commissioners for England and other,* [1993] 2 All E.R. 300 at 305 (Ch. D.).

[49] *Cowan* v. *Scargill, supra* note 45 *at* 288 citing *Re Towler's Settlement Trusts* [1963] 3 All E.R. 759, [1964] Ch 158; *Re CL* [1968]1 All E.R. 1104, [1969] 1 Ch. 587. In the first case, a mother sought a variation of a trust on

In short, the duty of prudence requires that pension trustees must act exclusively in the best financial interests of plan members. The application of social or political criteria to the investment decision-making process is acceptable provided it does not adversely impact the financial performance of the plan's portfolio. The rare exception is where plan beneficiaries share a strongly held view on an issue that forms the basis of investment criteria.

These statements by Megarry V.C. continue to be cited as authority for the view that the application of non-financial criteria by pension trustees in the investment process constitutes a breach of their fiduciary duties of prudence and loyalty.

Statutory Authorities

As detailed previously, pensions were historically limited to a list of permissible investments. Governments gradually did away with such lists and adopted the prudent person rule to guide investment decisions. Little legislative guidance has been provided interpreting this rule with respect to the application of non-financial criteria. Rather, the determination of which investment practices are considered prudent has been left almost entirely to the courts.

In 1992, the Financial Services Commission of Ontario issued a bulletin using a simple question-and-answer format that affirmed the legality of "ethical" investments.[50] The question asked: "Is it imprudent for a pension fund to take the position that it will make only "ethical" investments?" The brief response stated, "No. 'Ethical' investing is permitted, but the SIP&G must state this position and set out the criteria for investments. The members of the plan should be notified of this position." The bulletin does not define "ethical investing", however, the term is commonly understood to be synonymous with socially responsible investing.[51] With Ontario's adoption of the federal investment guidelines in 2000, the position detailed in the bulletin was declared "inactive".[52] Although inactive, the policy remains posted on the Financial Services Commission of Ontario website[53] and its substance was recently affirmed by a Financial Services Commission of Ontario representative who stated that subject to the requirement that investment returns not be impaired, "if plan members want it, they would have to talk to their plan administrators and change their statement of investment policies and procedures."[54] Another senior pension lawyer has also opined, "...the statement is a strong indication that the Commission does not view ethical investing as imprudent in and of itself."[55] These statements would seem to qualify views cited earlier in this paper such as those articulated by the Ontario

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behalf of her infant daughter. In interpreting the provisions of the *Variation of Trusts Act, 1958,* Wilberforce J. opined that "'benefit' is a word of wide meaning: it is not restricted to material benefit."

[50] Financial Services Commission of Ontario, *Ethical Investments* (February 1992) Bulletin 2/4, Index No. I400-350.

[51] *See* discussion of SRI, *supra*.

[52] *See* FSCO's website at www.fsco.gov.on.ca.

[53] www.fsco.gov.on.ca/Pensions/PensionP.nsf/14099b9d2ad0e3a3852568c0005337a0/acd095499b92a2638525688c0005a2d8/$FILE/i400-350.pdf

[54] Adria Vasil, "What Teach Is Smoking: Greenpeace Questions Ethics of Teachers' Pension Stake in Big Tobacco" (February 19-25, 2004) 23(25) *NOW Magazine*.

[55] Murray Gold, *Socially Responsible Investment: The Legal Perspective* (2003)(unpublished, on file with author).

Teachers' Pension Fund.[56] While it is important to note that policy statements are not law, courts are inclined to find them highly persuasive in the absence of legislative or judicial authority.

In 1988, Ontario passed legislation permitting a trustee to divest or refuse to acquire investments in companies doing business in South Africa. Repealed in 1997, the *South African Trust Investments Act* was enacted by a Liberal government, with the support of all political parties, to address the legal barrier to investment resulting from the fiduciary obligations imposed by trust law.[57] The legislation allowed fiduciaries of trusts, charities and pension funds, subject to approval by a majority of beneficiaries, the discretion to divest themselves of such investments even where such action could impair investment performance.

On April 19, 2005, Manitoba became the first Canadian jurisdiction to adopt legislation clarifying the duty of pension trustees on the use of non-financial investment criteria. Section 28.1(2.2) of Bill 10 (*The Pension Benefits Amendment Act*) states:

> "Unless a pension plan otherwise provides, an administrator who uses a non-financial criterion to formulate an investment policy or to make an investment decision does not thereby commit a breach of trust or contravene this Act if, in formulating the policy or making the decision, he or she has complied with subsections (2) and (2.1)."

Subsection 28.1(2) articulates the general applicable standard of care[58] and subsection 28.1(2.1) articulates the duty of prudence specifically with respect to investments.[59]

The United States and a number of OECD countries have also recognized the consideration of non-financial criteria by pension trustees. Numerous OECD countries, led by Britain in 2000, adopted regulations that require pension funds to disclose "(a) the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments..."[60] This disclosure obligation is important for several reasons.

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[56] *Supra* note 16.

[57] *South African Trust Investments Act*, R.S.O. 1990, c.S.16 repealed by *An Act to simplify processes and to improve efficiency in the Ministry of the Attorney General*, S.O. 1997, c.23, s.12 (November 28, 1997); Ontario Hansard Debates, L121 (Dec. 14, 1988).

[58] Section 28.1(2) provides "the administrator of a pension plan shall exercise the care, diligence and skill in the administration of the plan and in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person."

[59] Section 28.1(2.1) provides "the administrator of a pension plan shall invest the assets of the pension fund, and manage those investments, in accordance with the regulations and in a manner that a reasonable and prudent person would apply in investing and managing a portfolio of investments of a pension fund."

[60] As of January 2001, Sweden requires the five largest state-controlled pension funds to include environment and ethics in their investment policy and report to the government annually with respect to how they are fulfilling this policy. France's *Code monétaire et financier* was amended in February 2001 to provide "…that investment managers may consider social, environmental or ethical factors in the processes by which they buy and sell securities, and that this consideration shall further be extended to the voting of proxies for these securities. " In January 2001, Belgium's Parliament ratified a complete revision of the country's legislation on supplementary retirement schemes to give greater transparency and "democracy" to the management of pension funds, including a requirement that private-sector pension fund managers issue a publicly available annual report that includes "investment strategies for the long and the short term and how social, ethical and environmental aspects are being taken into account." In May 2001, Germany enacted amendments requiring each pension fund manager to disclose "if and how he takes ethical, social and ecological criteria into consideration for the use of the investment pension payments." And in June 2001, Australia enacted the *Financial Services Reform Bill 2001* requiring all financial

First, it implies that these governments view the application of non-financial screens to the investment process to be *prima facie* acceptable. If governments expect pension funds to make disclosures regarding such practice, it is presumed that the practice itself is considered to be legal by the respective government.

Second, and more importantly, Britain's adoption of the requirement creates a tension with the ruling in *Cowan v. Scargill*. That case stands for the proposition that the interests of plan members are generally their financial interests and that the application of non-financial criteria adversely impacts the financial performance of plan investments. Application of non-financial criteria on moral grounds will only be acceptable in rare circumstances where all plan members share a common view. In contrast, Britain's adoption of the disclosure requirement suggests that the government recognizes the need for greater accountability of pension funds to the interests of their beneficiaries and that these interests may extend beyond the financial.

With specific reference to ETI, the U.S. Department of Labor, which administers the *Employee Retirement Income Security Act* (ERISA), issued a 1994 interpretative bulletin on the fiduciary standards of prudence and loyalty under ERISA which permits investment in ETI:

> "The fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally. Therefore, if the above requirements are met [diversification of plan investments to minimize risk of large losses, prohibition on subordinating the interests of members and beneficiaries to unrelated objectives, providing appropriate consideration and acting according to relevant facts and circumstances, giving consideration to the role of each investment in the portfolio, and consideration of expected returns on alternative investments with similar risks], the selection of an ETI, or the engaging in an investment course of action intended to result in the selection of ETIs, will not violate section 404(a)(1)(A) and (B) [duties of prudence and loyalty] and the exclusive purpose requirements of section 403."[61]

While the interpretative bulletin makes specific reference to ETI, it also clearly states that the principles and standards articulated above are intended to apply to all investment practices, including investment screening. As with the Financial Services Commission of Ontario policy, the U.S. Department of Labor's interpretative bulletin is merely persuasive and not binding on courts.

The New Zealand Superannuation Act, a national pension fund for all New Zealanders created pursuant *New Zealand Superannuation Act, 2001*, provides unique limits on acceptable pension investments. Section 58 of the Act provides that:

> "The Guardians must invest the Fund on a prudent, commercial basis and, in doing so, must manage and administer the Fund in a manner consistent with –

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service providers to disclose the extent to which they took into consideration labour rights, social, environmental and ethical considerations when making investment choices. These provisions infer that governments of those nations recognize the legality of considering non-financial criteria as part of a pension plan's investment policy. Similar provisions are reportedly under consideration in Austria, Spain, Denmark, Switzerland, and Italy.

[61] 29 CFR 2509.94-1 (Interpretative bulletin relating to the fiduciary standard under ERISA in considering economically targeted investments.) Section 404(a)(1) of ERISA provides in part that "...a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and – (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan; (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims..."

(a) best-practice portfolio management; and

(b) maximizing return without undue risk to the Fund as a whole; and

(c) avoiding prejudice to New Zealand's reputation as a responsible member of the world community.[62]

The Fund's investment policy expands on what constitutes investment activity prejudicial to the country's reputation:

> "It shall be a breach of the policy...if a sovereign or corporate issuer of securities is widely regarded internationally as having participated in gross abuses of fundamental human rights; or serious infringements of labour and employment standards; or serious infringements of environmental standards; or promoting transnational organized crime or terrorism; or other conduct which is so reprehensible that it may prejudice New Zealand's reputation as a responsible member of the world community or its reputation as a responsible global investor in sovereign or corporate securities."[63]

It is arguable that the Anti-apartheid legislation in Ontario, Manitoba's amendments to its pension legislation, and legislation governing New Zealand's Superannuation scheme are recognition that the application of non-financial criteria to the investment decision-making process is prohibited where legislation does not authorize such activity. In response, I submit that these legislative and policy provisions merely seek to provide clarification to the confused and conflicting state of the common law.

Common Law

For Canadian pension fiduciaries, *Cowan* v. *Scargill* remains the most oft-cited decision on point. However, American and British courts have rendered other decisions which challenge the findings in *Cowan* v. *Scargill*. The decision itself must also be considered in light of a number of substantive and procedural weaknesses that undermine its authority.[64]

First, it is a well-established principle in trust law that trustees must act within the purpose and terms authorized by the trust.[65] In its findings, the court failed to acknowledge that the pension scheme in question was an extraordinary trust set up under a scheme for nationalization, the object of which was to develop the industry in the national interest and safeguard the welfare of employees.[66] Read broadly, this purpose would appear to be consistent with the types of investment screens introduced by the union trustees.

Second, the court provided no authority in support of its position that trust law applies to pension schemes. While the courts have subsequently affirmed the views expressed by Megarry V.C. in *Cowan* v. *Scargill* on the application of trust principles to pension plans[67], Megarry V.C. did not

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[62] *New Zealand Superannuation Act, 2001* (2001) No. 84, s.58. Available at http://www.treasury.govt.nz/release/super/assent84.pdf.

[63] Guardians of New Zealand Superannuation, *Statement of Investment Policies, Standards and Procedures* (28 June 2004) at 25. Available at http://www.nzsuperfund.co.nz/files/SIPSP.pdf.

[64] P. Pearce and A. Samuels, "Trustees and Beneficiaries and Investment Policies" [1985] *Conv*. 52; J.H. Farrar and J.K. Maxton, "Social Investment and Pension Scheme Trusts" (1986) 102 *L.Q. Rev*. 32 (case comment); H. Rajak, *The Haldane Journal: A Journal of Law and Socialism* (1985) vol.1 at 39-46.

[65] *Balls v. Strutt* (1841), 66 E.R. 984; 1 HARE 148.

[66] Farrar et al., *supra* note 64 at 33.

[67] *Bathgate* v. *NHL Pension Society* (1994), 16 O.R. (3d) 761 at 776 (C.A.) and *Boe* v. *Alexander* (1987), 41 D.L.R. (4th) 520 at 526-527, 15 B.C.L.R. (2d) 106 (C.A.) both affirming *Cowan* v. *Scargill, supra* note 45.

consider some of the unique aspects of pension schemes in drawing his conclusion. Pension schemes are considered a form of deferred remuneration with employee contributions in many instances, whereas trusts are established by way of a gift. Furthermore, as one commentator notes, the application of law to private trusts can be prejudicial to plan members in that "the strict operation of private trust principles can limit [employee] rights of participation and control" where employees make mandatory or voluntary contributions to the plan.[68] These distinctions are important when considering the role that plan members and beneficiaries have in directing the investment policy of a plan, a point discussed further in section 4.3.2 of this paper.

Second, the case was argued by the defendant who, in addition to lacking the skills of a professional litigator, had his credibility called into question because of untrue statements made by him about the content of a legal memorandum. As Megarry V.C. later commented in reflecting on the case, "one cannot say what would have emerged had the defendant's case been presented by a Chancery silk, particularly in the bound and rebound of ideas between Bench and Bar."[69] Commentators have also expressed the view that the "lack of balanced legal argument undermines the authority of the decision and has led Sir Robert Megarry V.C. to formulate principles which are unduly narrow and arguably incomplete."[70]

Third, the judgment was based on a poor set of facts and entirely ignored the highly charged political context at the time between the Thatcher government and the miner's union.[71] In specific, the requirement by the union trustees for an absolute prohibition on the named investments presented a significant barrier to the court. Megarry V.C. both in his decision and subsequent commentary emphasized that the proposed amendments calling for exclusions of entire sectors of the economy provided no discretion to the trustees to amend the policy if it proved to be disadvantageous to plan members.[72] This contrasts sharply with the situation in *Board of Trustees v. City of Baltimore* (discussed *infra*) where the municipal ordinances calling for divestment by the City's pension plans allowed the trustees to deviate from the requirements under certain circumstances.

Fourth, the Megarry decision is nearly twenty years old and was decided prior to the conflicting judgment in *Board of Trustees v. City of Baltimore* (discussed *infra*).[73] According to one

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[68] Farrar et al., *supra* note 64 at 33-34. *See also* MLRC, *supra* note 29 at 6; Richard Nobles, "Investment policies and trustees' duties" (Sept. 1984) 13(3) *Industrial L.J.* 167 at 169-171 9Case comment); *Mason and others* v. *Farbrother and others,* [1983] 2 All. E.R. 1078 at 1087.

[69] Right Honourable Sir Robert Megarry, "Investing Pension Funds: The Mineworkers Case" in *Equity, Fiduciaries and Trusts* (Toronto: Carswell, 1989) 149 at 152.

[70] Farrar et al., *supra* note 64 at 32.

[71] Andrew J. Richards, *Miners on Strike: Class Solidarity and Division in Britain* (London: Berg Publishers, 1997); *Civil War without Guns, A: 20 Years on - The Lessons of the 1984-85 Miners' Strike* (2004); Arthur Wakefield, *The Miners Strike Day by Day: The Illustrated 1984/85 Diary of Yorkshire Miner Arthur Wakefield* (London: Wharncliffe Books, April 2002); Jeremy Deller, *The English Civil War Part II: Personal Accounts of the 1984-85 Miners' Strike* (London: Artangel, 2002); Seumas Milne, *The Enemy Within: Thatcher's Secret War Against the Miners* (London: Verso Books, 2002).

[72] *Cowan* v. *Scargill*, *supra* note 45 at 296; Megarry, *supra* note 69 at 152-153, 157-158. Contrast this with the decision in *Board of Trustees v. City of Baltimore,* 562. A.2d 720 (Md. 1989) where discretion was retained.

[73] *Board of Trustees v. City of Baltimore, ibid*.

commentator, Megarry V.C.'s treatment of the three authorities referenced in his decision and discussed later in this paper was "somewhat cavalier".[74] In his judgment, he distinguishes *Evans v. London Co-operative Society Ltd.* (discussed *infra*) on the grounds that it focused on the interpretation of a specific provision of a plan's investment policy while ignoring the decision's more general statements with respect to the common law. The court also took a very narrow interpretation of *Blankenship v. Boyle* (discussed *infra*), whereas critics argue a proper reading of the facts demonstrates "that due consideration of the beneficiaries' interests cannot exclude the industry's ability to fund pensions."[75] Similarly, Megarry V.C. approved narrowly on its facts the actions of the trustees in *Withers v. Teachers' Retirement System of the City of New York* (discussed *infra*) which recognized the need to deviate from standards of prudence in certain instances.

Fifth, the changes to investment policy and practice over the past two decades, including the wide acceptance of portfolio theory[76], challenge many of assumptions underlying the court's reasoning (see discussion under section 4.1 below). The removal of the legal list of permissible pension investments means that trustees now have much more latitude in the nature of investments they may consider. Pension funds are now invested in a variety of higher risk vehicles, including real estate and hedge funds, as part of a balanced risk portfolio, investments which would previously have been considered imprudent. The introduction of these classes of investments means that pension funds have the opportunity to achieve even greater diversification, thereby reducing the potential implications of either screening out part of the investment universe or investing a portion of the plan's portfolio in any one particular type of investment.

On the basis of these criticisms and observations, the lack of binding authority of the decision of a lower British court on Canadian courts, and the other authorities discussed below, I argue that *Cowan* v. *Scargill* should be limited to the facts in that case. Furthermore, any principles emanating from the decision should be considered and interpreted in light of the current understanding about investment screening and ETI.

Harries v. Church Commissioners for England

Harries v. *Church Commissioners for England* involved the investment policy of a charitable trust. Yet, its findings may be extended to the pension fund context to some degree. In this 1991 decision, representatives of the Church, including a commissioner, sought a declaration requiring the Church Commissioners of England, a large charitable trust, to exercise its office to pr event the investing of assets in a manner incompatible with the object of promoting the Christian faith through the established Church of England. In denying the declaration, the court upheld the position in *Cowan* v. *Scargill* regarding the duties of trustees to maximize returns on investment:

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[74] Nobles, *supra* note 68 at 169.

[75] *Ibid*.at 170.

[76] For an explanation of modern portfolio theory, *see* Harry Markowitz, "Portfolio Selection" (March 1952) Vol.7(1) *J. of Finance* 77.

> "...prima facie the purposes of the trust will be best served by the trustees seeking to obtain therefrom the maximum return, whether by way of income or capital growth, which is consistent with commercial prudence."[77]

Aside from articulating this standard and its associated problems (see discussion in section 4.1 below), the court identified a non-comprehensive list of four instances where trustees should take non-financial criteria into consideration:

(1) Where the trust deed requires consideration of non-financial criteria.[78]

(2) The rare circumstance where the practices of a company in which the trust invested might conflict with the objects of the charity. In such instances, trustees should not invest even if it resulted in significant financial detriment to the charity, although the court notes that this outcome would be unlikely given the range of available alternative investments.[79] Examples cited include investment of cancer research charities in tobacco companies, temperance charities in brewery and distillery shares, and the Society of Friends in companies involved with production of armaments.[80]

(3) Where those who support or benefit from the charitable trust feel that a particular investment would conflict with the objects of the charity, so long as the trustees are satisfied that course would not involve a risk of significant financial detriment.[81]

(4) Where investments by a charity have the result of deterring donations to the charity or making potential recipients of aid unwilling to be helped because of the source of the funds, trustees have the responsibility of balancing the potential financial losses against the risk of financial detriment resulting from excluding the investments.[82]

The court reviewed the commissioners' existing investment policy, with exclusions from investment in companies whose main business is armaments, gambling, alcohol, tobacco, newspapers, or companies that have more than a small amount of business in South Africa, and found, not surprisingly, that an 'ethical' investment policy already existed. The policy also stipulated that the commissioners' "ensure that environmental considerations are properly taken into account" when considering development opportunities.[83] It is not clear whether the application of these non-financial criteria fall under the second or third instance described by Sir Donald Nicholls V.C. in his decision. Nevertheless, the important aspect of the decision to note is that his Honour stated he could see nothing in the Church's existing ethical policy that was inconsistent with general fiduciary principles.[84]

Board of Trustees v. City of Baltimore

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[77] *Harries and others* v. *Church Commissioners for England and other,* [1993] 2 All E.R. 300 at 304 (Ch. D.).

[78] *Ibid*. at 305.

[79] *Ibid*. at 304.

[80] *Ibid*..

[81] *Ibid*.at 305

[82] *Ibid*.at 305.

[83] *Ibid*. at 307.

[84] *Ibid*.

The 1989 decision of the Maryland Court of Appeal in *Board of Trustees v. City of Baltimore* stands in sharp contrast to the findings in *Cowan v. Scargill*.[85] In that case, the Trustees of three municipal pension funds sought a declaration declaring invalid a number of city ordinances that mandated the funds to divest their holdings in "...banks or financial institutions that make loans to South Africa or Namibia or companies 'doing business in or with' those countries."[86] The ordinances permitted trustees to suspend divestiture for up to 90 days if the rate of return on the funds was substantially lower than the average of the annual earnings on the funds over the past five years, inconsistent with generally accepted investment standards for conservators of pension funds, or would otherwise cause financial losses to the funds.

The boards of trustees challenged the Ordinances on a number of grounds. For the purposes of this paper the main argument was that the Ordinances violated the contractual rights of plan beneficiaries by altering the common law duties of prudence and loyalty owed to them by the funds and were therefore unconstitutional. The Court of Appeal, upholding the trial court's decision, drew several conclusions in dismissing the claim.

First, the court found that consideration of non-financial criteria in making investment decisions does not *per se* violate a trustee's duty of prudence and loyalty. Investment screens may be applied to a pension plan's portfolio subject to the availability of alternative investments with comparable risk and returns. The court cited with approval Professor Austin Wakeman Scott, an American authority on trusts, whose view was based on an analogy to corporate directors making charitable contributions:

> "Trustees in deciding whether to invest in, or to retain, the securities of a corporation may properly consider the social performance of the corporation. They may decline to invest in, or to retain, the securities of corporations whose activities or some of them are contrary to fundamental and generally accepted ethical principles. They may consider such matters as pollution, race discrimination, fair employment, and consumer responsibility."[87]

As a corollary, the court ruled that collateral benefits may be taken into consideration when making investment decisions provided they do not compromise the interests of plan members and beneficiaries. Citing Professor Scott, the court found that pension trustees, as with corporate directors, "may well believe that a corporation that has a proper sense of social obligation is more likely to be successful in the long run than those that are bent on obtaining the maximum amount of profits. But even if this were not so, the investor, though a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of funds in a manner detrimental to society."[88]

Second, the court articulated a different standard of prudence from the British decisions in *Cowan* and *Harries*. According to the court, "a trustee's duty is not necessarily to maximize the return on investments but rather to secure a "just" or "reasonable" return while avoiding undue risk."[89] In the specific instance, the court found that notwithstanding the effect of the Ordinances

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[85] *Board of Trustees v. City of Baltimore,* 562. A.2d 720 (Md. 1989).

[86] *Ibid*. at 724.

[87] *Ibid*. at 736.

[88] *Ibid*. at 736-737.

[89] *Ibid*. at 737 citing *King v. Talbot,* 40 N.Y. 76, 86 (1869); *Withers v. Teachers' Retirement System, infra* note 90; III *Scott on Trusts* §227.3 (W. Fratcher 4th ed. 1988); Restatement (Second) of Trusts §227 comment (e) (1957); Dobris, "Arguments in Favor of Fiduciary Divestment of "South African" Securities" (1986) 65 *Neb. L.R.* 209, 232;

on the plan's portfolio – barring investment in 120 of the S&P500 companies representing approximately 40% of the index's market capitalization and resulting in a portfolio of relatively smaller companies with more share price volatility – they did not imprudently increase risk or decrease income. The court found that alternative investments were available and a shift to passive management could duplicate the performance of the benchmark index. Concerns regarding the impact of screening on the funds' active managers were dismissed where the court found that no contractual right existed to a particular management style.

In addition, the trustees argued that the Ordinances would compromise the plan's portfolio by requiring investment managers to reject their first choice of investments. In response, the court found that it did not follow that the second choice was necessarily inferior to the first. The court noted that managers ordinarily invest in a limited universe of companies and the restrictions would only require the managers to do additional research which had the added possibility of benefiting the plan.

Third, the Court of Appeal held that minimal costs in relation to the plan's total assets accrued in applying social considerations does not violate a trustee's duty of prudence. In that instance, the trial court determined the initial and ongoing costs of divestiture to be $1/16^{th}$ and $1/10^{th}$ of 1% respectively of the funds' total value.

Fourth – and an important difference from the facts in *Cowan* v. *Scargill* –the court looked favourably upon the inclusion of the escape provision in the Ordinance permitting the trustees to suspend divestiture.[90] The judgment acknowledged the presence of numerous safeguards in the Ordinances, including the suspension provision, which guaranteed that divestiture could not occur unless consistent with the trustees' duty of prudence. These judicial observations lead to the inference that the inclusion of a provision permitting trustees the discretion to alter an investment policy where implementation of a provision adversely affects the interests of plan members is an indicia of a prudent investment strategy.

Withers v. Teachers' Retirement System

In an earlier 1978 American decision, the Teachers Retirement System (TRS) of the City of New York agreed to purchase City bonds in the amount of $860 million as a part of a financial plan to stave off the City's bankruptcy.[91] According to the court, the trustees' primary concern was to prevent the depletion of the City's funding to the TRS, which was its principal source of contributions. Evidence indicated that the plan had a funding deficit and that existing assets would be exhausted in meeting the benefits owed to retired beneficiaries to the exclusion of active members if the City went bankrupt. The court noted that in making the decision to purchase the City bonds, the trustees went to great lengths to satisfy themselves that the City could not obtain financing from other sources, and sought the fullest possible protection for their beneficiaries with respect to the investment. Based on the facts, where the survival of the fund as an entity was dependent on the solvency of the City, the court held that the trustees had not

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Ravikoff & Curzan, "Social Responsibility in Investment Policy and The Prudent Man Rule" (1980) 68 *Cal. L.R.* 518 at 519; *Cf.* Troyer, Slocombe & Boisture, "Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions, and Pension Funds" (1985) 74 *Geo. L.J.* 127 at 156-157.

[90] It is assumed that this approach would extend to a pension plan's investment policy.

[91] *Withers v. Teachers' Retirement System,* 447 F.Supp. 1248 (1978)(N.Y.D.C.).

breached their duty by authorizing the investment. In its reasons, the court distinguished *Blankenship* v. *Boyle* (discussed *infra*) because, unlike that case where union trustees held pension assets in a union-owned bank in liquid form for the benefit of the bank, there was no evidence of union involvement in the decision taken by the TRS.

Critics have distinguished this case based on its unique facts.[92] They argue that the situation where the plan's survival was dependent on the solvency of the municipality was an extreme situation that cannot be compared with other contexts in which non-financial criteria are normally considered. However, the recent rash of corporate insolvencies in Canada and the decisions that pension plans have had to take in order to resuscitate their corporate plan sponsors suggests that the *Withers* scenario is not one of a kind. At a minimum, the case supports the proposition in *City of Baltimore* that pension trustees may take collateral issues into consideration when determining the long-term best interests of plan beneficiaries. In drawing this conclusion, I am not asserting that pension trustees may make investments with unacceptable levels of risk in order to address collateral concerns, but rather to demonstrate that the American courts take a broad view of what constitutes prudence and the best interests of plan members when it comes to investing pension assets.

Martin v. City of Edinburgh District Council

The facts in *Martin* v. *City of Edinburgh District Council* are reminiscent of those in the *City of Baltimore* decision, although the case focused on the merits of the investment policy while the *City of Baltimore* decision addressed the process employed by the trustees. Resolutions adopted by members of the Labour Party of Edinburgh City Council authorized the withdrawl from 58 trusts of investments in companies operating in South Africa valued at more than £2.25 million. At issue was whether the council had given proper consideration to what was in the best interests of the beneficiaries, and whether it had sought or obtained proper professional advice in considering the best interests of the beneficiaries.[93]

The court's judgment is informative on a number of points. First, the court held that Council had breached its duty by failing to obtain any professional advice prior to authorizing the resolution to divest and for neglecting to put their minds to whether the divestments were in the best interests of plan members.[94] Furthermore, the court upheld the fiduciary principles in *Cowan* v. *Scargill* requiring trustees to not allow extraneous factors to fetter their investment decisions and to not permit complete delegation of authority for making investment decisions to others.

However, the court disagreed with Megarry V.C. on two grounds. First, the court rejected the requirement that trustees must invest trust funds in the most profitable investment on the grounds that it effectively substituted the discretion of money managers for the discretion of trustees.[95] Second, Lord Murray took a practical approach in interpreting the conflict of interest standard for pension trustees:

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[92] *See e.g*. Hutchinson and Cole, *supra* note 28 at 1363; Langbein and Posner, *supra* note 22 at 24.

[93] *Martin* v. *City of Edinburgh District Council,* (1988) S.L.T. 329 at 332 (Outer House).

[94] *Ibid*. at 334.

[95] *Ibid*.

> "If [the proposition that trustees have a duty not to fetter their investment discretion for reasons extraneous to the trust purposes] means that each individual trustee in genuinely applying his mind and judgment to a trust decision, must divest himself of all personal preferences, of all political beliefs, and of all moral, religious or other conscientiously held principles, then I do not think that this proposition is either reasonable or practicable. What he must do, I think, is to recognize that he has those preferences, commitments or principles but nonetheless do his best to exercise fair and impartial judgment on the merits of the issue before him. If he realizes that he cannot do that, then he should abstain from participating in deciding the issue...or, in the extreme case, resign as a trustee."[96]

This articulation of the conflict of interest standard recognizes the reality that all pension trustees – whether employer or employee representatives – come to the table with personal values and interests that reflect the entity they represent. These perspectives should be recognized (not artificially ignored) in the process of determining what is in the best interests of plan participants.

Donovan v. Walton

Donovan v. Walton considered the duties of prudence and loyalty in the context of an ETI-type investment. In that case, the US Department of Labor alleged that the trustees of the Operating Engineers Local 675 Pension Trust Fund had breached their fiduciary duties by constructing and financing an administration building on property owned by the Fund and leasing space to its Union. Trustees representing labour and management jointly administered the Fund.

The factual findings detailed by the court were that the Fund decided to purchase land and construct an administration building "based on deliberative research and analysis by both the trustees and independent consultants…"[97] A committee established by the trustees to review real property investments identified a property, which in their view, "would satisfy the Fund's need to diversify its portfolio while providing the dual benefits of prudent returns and employment opportunities for Fund participants."[98] The Fund decided to self-finance the project due to then-prevailing unprecedented high interest rates. The Building's design and construction were open to competitive bidding and the project was assessed on an ongoing basis with the successful contractor using union labor "which added to the overall cost". One of the member unions – the International Union of Operating Engineers Local 675 – was identified as the principal tenant. That union's business manager and CEO was also a trustee of the Fund and chair of the committee advising the Fund on the development.

The court found that the decision to purchase the real estate was not a breach of the trustees' fiduciary duties. Despite cost overruns, the court affirmed that the trustees' decision should be judged based on the process followed in evaluating the investment, not the investment's actual performance.[99] In this case, the trustees had retained numerous expert advisors, conducted thorough, ongoing research, and based on new information and financial considerations made necessary modifications as the project proceeded.[100] All evidence suggested that the investment

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[96] *Ibid*.

[97] *Donovan* v. *Walton,* 609 F.Supp. 1221 at 1226 (D.C.Fla. 1985).

[98] *Ibid*. at 1232.

[99] *Ibid*. at 1238 citing *American Communications Association v. Retirement Plan,* 488 F.Supp. 479, 483 (S.D.N.Y.) *aff'd,* 646 F.2d 559 (2d Cir. 1980).

[100] *Ibid*. at 1240.

appeared to be prudent at the time of consideration by the trustees. The fund's decision to use its own assets to finance the project was under the circumstances also deemed to be prudent.[101]

In related proceedings based on the same facts, the US Department of Labor alleged that the Fund's trustees had breached their fiduciary duties by offering mortgages at below market rates of interest to plan members through a mortgage loan program.[102] At issue was whether the requirement that ERISA trustees charge a "reasonable rate of interest" on loans meant that they must charge "the prevailing or market rate of interest." The program gave Fund members first mortgage loans on residential property under specified conditions at a rate of interest 2 1/8 percentage points below the "prevailing rates in the community".[103] The Court of Appeal affirmed the district court's decision that the two terms are not synonymous. In other words, a reasonable rate of interest may be below the prevailing market rate. This is important in the context of understanding the fiduciary obligation of pension trustees to obtain a reasonable rate of return for the pension plan (see discussion *infra* section 4.1). The court noted that rates could be so far below market rates to not be justified; however, such was not the case in this instance. Furthermore, this was not a case involving self-dealing or preferential loans.

Evans v. London Cooperative Society

The 1976 decision of *Evans* v. *London Cooperative Society*[104] involved a pension scheme established for the benefit of the defendant Society's employees. The Society was the plan sponsor and trustee, with the administration of the plan vested in a pension committee chaired by the president of the Society. The case centred on a rule (presumably part of the plan's trust agreement) that gave the trustees discretion to loan excess plan assets to the Society at any rate above a prescribed minimum. On the advice of the plan's consultant and chair, the trustees had interpreted the rule to be mandatory and continued to make loans to the Society on that basis at below market rates. While the court recognized that the plan had the discretion to establish a rule that allowed for loans at below market value, the court found the pension committee had breached its duty by failing to exercise its discretion when loaning assets to the Society. The Society was also found to have breached its fiduciary duty "because its Board knew precisely what was happening."[105] The case is significant because it recognizes that trustees have the discretion to accept rates of return below market value provided the decision is made by the trustees in a prudent manner.

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[101] *Ibid*. at 1241.

[102] *Brock v. Walton,* 794 F.2d 589 (11th Cir. 1986).

[103] *Brock v. Walton, ibid*. at 587. The specified conditions included: (1) borrowers had to prove creditworthiness and financial stability, (2) each loan was secured by a first mortgage on the principal residence of the mortgagor, (3) title to every property was marketable and insurable, (4) no loan was assumable unless specifically permitted by the Trustees, (5) no loan exceed ninety-five percent of the appraised value of the property, (6) borrowers had to secure mortgage insurance if the down payment was less than 20% of the appraised value, and (7) a mortgagor-borrower had to assign his accrued pension benefits to the Plan as additional loan security.

[104] *Evans* v. *London Co-operative Society Ltd.,* [1976] C.L.Y. 2059 (Ch. D.), unofficially reported in R. Ellison, *private occupational Pension Schemes* (London: Oyez, 1979), vol. 1, App. III, at 356.

[105] *Ibid*..

Clearly, the cases cited above beginning with *Cowan* v. *Scargill* conflict in many respects. The highly fact-dependent nature of the respective judgments make them difficult to reconcile. While the courts maintain an objective tone in their reasons, many of the cases were set in a highly charged social and political context. Despite the challenges this presents for those seeking to rationalize the findings, some general observations can be made.

A review of both statutory and common law indicates that the law does not prohibit the use of investment screening and ETI as part of a pension plan's investment policy. Pension trustees may incorporate investment screening and ETI into a fund's investment strategy provided that it is articulated in the fund's investment policy, that it is communicated to plan members, and that it does not impair the risk and return profile of the fund's portfolio.[106] Furthermore, a close reading of American and British cases indicates that, in principle, pension trustees may take non-financial criteria into consideration for non-financial reasons when making investment decisions pursuant to the same conditions.

However, uncertainty persists regarding the appropriate standards of prudence and loyalty and their corollary duties that pension trustees must consider when setting investment policy in these areas. This remains the primary barrier for pension trustees.

4. Legal barriers to investment screening and ETI

While the law does not prohibit investment screening and ETI by pension plans, the issue is what are the appropriate circumstances under which pension trustees may elect to employ these practices in each case. The following section considers four questions commonly raised regarding the fiduciary duties of pension trustees in relation to screening and ETI. First, what is the requisite rate of return for a pension plan and does investment screening and ETI comply with that fiduciary standard? Second, does screening investments infringe on the duty to achieve maximum portfolio diversification? Third, what are the best interests of plan members and beneficiaries and do these practices conform with those interests? Finally, does the requirement to treat all beneficiaries with an even hand prohibit the consideration of non-financial interests or investment objectives?

4.1. What is the requisite rate of return?

The duty of loyalty requires that pension trustees act in the best interests of plan members and beneficiaries. British decisions, including *Cowan* v. *Scargill* and *Harries* v. *Church Commissioners of England,* have held the best interests of plan members and beneficiaries to be their financial interests, a position that has since been codified in British Columbia.[107] The British courts noted above along with some commentators have read "best financial interests" to

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[106] *Supra* note 15.

[107] In *Cowan v. Scargill, supra* note 45 at 760 the court does not actually speak of "maximizing" returns except in referring favourably to statements made by counsel to the effect that "'the trustees' only concern is to ensure that the return is the maximum possible consistent with security." The court alludes to such a standard when it states "the paramount duty of the trustees is to provide the greatest financial benefits for the present and future beneficiaries." (at p.762) "Where property is so held, prima facie the purposes of the trust will be best served by the trustees seeking to obtain therefrom the maximum return...": *Harries and others* v. *Church Commissioners for England and other,* [1993] 2 All E.R. 300 at 304 (Ch. D.).

mean that pension trustees must obtain the maximum possible return on investments within accepted levels of risk.[108]

The alternative view holds that pension trustees have a responsibility to set policy that aims at achieving a reasonable rate of return across the portfolio consistent with a plan's funding requirements and risk tolerance. Prior to Ontario's adoption of the federal investment guidelines in 2000, section 67(2) of Ontario's PBA Regulations stated that: "In the establishment and application of the written Statement of Investment Policies and Goals, the selecting of investments shall be made with consideration given to the overall context of the investment portfolio without undue risk of loss or impairment and with a *reasonable expectation of fair return or appreciation* given the nature of the investment"[109] (emphasis added). Legislated standards in other Canadian jurisdictions[110], legal scholars[111], the *Restatement (Third) of Trusts*, several law reform commissions reviewing the standard in the context of trust legislation[112], and American common law[113] also affirm this alternative standard.

To some extent the conflicts between law and practice may be due to an imperfect understanding of investment practices and blind restatements of the law that do not fully appreciate the manner in which pension investments are managed. In any event, the maximization doctrine cannot be said to be the accepted standard at common law.

Possibly, the standard exists as a remnant of the period when the prudential value of investments was determined on an individual basis. In that context, the notion of maximizing returns makes

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[108] *See e.g.* John H. Langbein and Richard A. Posner, "Social Investing and the Law of Trusts" (1980), 79 *Mich. L. Rev.* 72 at 99-104; Olev Edur, "Lead us not... Will taking the moral high ground produce heavenly returns?" (1999), 23 *Benefits Canada* 29.

[109] R.R.O. 1990, Reg. 909, ss.67(2), revoked by O. Reg. 144/00, s. 29.

[110] *Pension Benefits Standards Act,* R.S.B.C. 1996, c.352, s.44(2): "Pension plan assets must be invested in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments made on behalf of another person to whom there is owed a fiduciary duty to make investments without undue risk of loss and with a reasonable expectation of a return on the investments commensurate with the risk."

[111] Ravikoff and Curzan, *supra* note 22; Fung et al., *supra* note 10. According to one author, by virtue of the adoption of this standard, trustees are permitted to seek economic benefits for beneficiaries beyond income or appreciation: Robert T. Willis, Jr., "Prudent Investor Rule Gives Trustees New Guidelines" (1992), 19 Est. Plan. 338 at 341.

[112] MLRC, *supra* note 29 at 32 ("Generally speaking then, at a minimum, the principle of prudence requires trustees to invest the funds under their control so as to both attain an adequate or reasonable return and preserve the trust capital."; Alberta Law Reform Institute at xv. ("Trustees should be directed to invest trust property with a view to obtaining a reasonable return while avoiding undue risk in the context of the overall trust portfolio.")

[113] *Withers' v. Teachers Retirement System of the City of New York, supra* note 91 at 1254 ("In the area of investment decisions, the obligation to exercise prudence is essentially an obligation to give primacy to the preservation of the trust estate and the procurement of a reasonable income while avoiding undue investment risks...and to make independent inquiry into the merits of particular investments rather than to rely wholly upon the advice of others."); *Foltz v. U.S. News & World Report Inc.*, 865 F.2d 364 at 373 (D.C.Cir. 1989), cert. Denied 490 U.S. 1108 (1989) ("section 404 [of ERISA] creates no exclusive duty of maximizing pecuniary benefits"); *Anderson v. Mortell,* 722 F. Supp. 462 at 470 (N.D. Ill. 1989) ("a fiduciary has no duty to "achieve the highest possible price" on the sale of securities); *Ershick v. United Missouri Bank,* 12 *Employee Benefits Cas. (BNA)* 1848 (10th Cir. 1991); *Donovan* v. *Walton, supra* note 27*; Evans v. London Co-operative Society Ltd., supra* note 104; *Brock* v. *Walton, supra* note 102.

sense. However, that approach to pension investment has been abandoned both in law and practice in favour of a portfolio-based approach. As one commentator notes, the standard of care to be observed by trustees is "capable of adaption [sic] to current economic conditions and contemporary understanding of markets and investments...Modern trustees active within their investment powers are entitled to be judged by the standards of current portfolio theory, which emphasizes the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation."

The more likely origin of the maximization standard is the British courts' adoption of the mathematical language of modern portfolio theory. First introduced by Harry Markowitz in his seminal 1952 paper "Portfolio Selection"[114], modern portfolio theory looks at investment performance in a mathematical context based on averages and probabilities:

> ...An efficient portfolio offers the maximum return for a given average level of risk. This is expressed in the capital asset pricing model, where the portfolio return is calculated as the average expected return for all the assets. The risk is the variance of an asset's expected return around a norm in comparison to a low-risk benchmark like cash or treasury bills.[115]

In a mathematical context, the notion of maximizing returns makes sense. However, in a legal context the idea is problematic. Portfolio theory -- which offers the best average return within an accepted level of risk -- may generate the maximum return possible within that risk parameter as a mathematical average, but it does not mean that it will generate the maximum possible return from actual available investments. A portfolio's performance depends on a myriad of factors including the specific investments selected and how those assets are allocated. Consequently, each portfolio will perform differently.

From a real perspective, as an average of individual investment returns, the portfolio approach cannot maximize returns, it can merely optimize them. For pension plans that follow a portfolio-based approach, it is recognized that all investments will not perform to maximize returns at the same time. Each will respond differently over time. Therefore, a pension plan will seek to include investments with varying expected rates of return and risk as part of its diversification strategy thereby achieving an optimal average rate of return over a prescribed period of time.

This understanding of portfolio theory undermines the pronouncements made in *Cowan* v. *Scargill* and other British decisions applying the maximization doctrine. In *Cowan* v. *Scargill*, Megarry V.C. asserts that where alternative investments are made that are equally financially beneficial to beneficiaries, trustees will not be criticized.[116] Conversely, investments that are less financially beneficial may leave trustees open to criticism.[117] This perspective is problematic in the context of portfolio theory because a portfolio-based approach is based on the assumption that not all investments will perform well all the time and that a portfolio must include a

[114] Harry Markowitz, "Portfolio Selection," (1952) 7(1) *J. of Finance* 77.

[115] Carmichael, supra note 10 at 39 citing Edwin Elton, *Modern Portfolio Theory and Investment Analysis* (2nd ed.) (New York: John Wiley, 1981); Diane Harrington, *Modern Portfolio Theory, The Capital Asset Pricing model and Arbitrage Pricing Theory: A User's Guide* (2nd ed.) (New Jersey: Prentice Hall Inc., 1987).

[116] *Cowan* v. *Scargill, supra* note 45 at 761.

[117] *Ibid*.

diversity of investments with different risk and return characteristics in order to achieve the target rate of return in the plan's investment policy.

In this context, screened investments and ETI are not only acceptable but may make sense as a means of achieving optimal diversification within a balanced portfolio. For example, the General Board of Pension and Health Benefits of the United Methodist Church (US$10B) in the United States found that investments in affordable housing helped offset the poor performance of equities. "When equities overall were declining, the General Board's $1 billion in affordable housing brought in 16.8 percent in 2000, 81 percent in 2001, and 12.8 percent through September 2002...."[118] Similarly, the California Public Employees' Retirement System reports that "over the past ten years, CalPERS' highest returning investment category has been its mission-related Single Family Housing Program – which has earned more than 20 percent annually. The portfolio has also brought great social returns, leading to the building of 32,000 homes in 200 California communities."[119] Such investments may also perform poorly. It is therefore the role of the pension trustee to monitor such investments to ensure that their inclusion benefits the pension plan over the long-term.

The position in favour of maximizing returns is also at odds with the long-term investment orientation of pension plans. Pension plans are by definition long-term investors. They are (or ought to be) concerned with ensuring that contributions and investment returns are sufficient to meet the pension promise by matching assets and liabilities, not with beating the market. The preoccupation of money managers on short-term performance should not divert the trustee's focus on meeting the long-term funding requirements for the pension plan. The facts in several cases demonstrate that a long-term orientation to plan investment is not always necessarily consistent with maximizing returns in the short-term. In *Blankenship* v. *Boyle,* the court stated "...while the beneficiaries have suffered as a result of the Fund's loss of investment income, they have benefited to some extent from the Union's activities over the past twenty years. In the longer view of matters, the Union's strength protects the interests of the beneficiaries, past and prospective..."[120] And in *Withers,* where funds were invested in city bonds, it was held that "their obligation, plainly, was to manage the fund so as to enable it to meet its obligations not only to current retirees, but also to those scheduled to retire in the future, whose pension and annuity rights would have been similarly earned over their years of active service and to whom the fund therefore had a legal responsibility."[121]

Finally, there is a fundamental problem with applying a standard that considers outcomes when the common law clearly articulates that pension trustees are to be evaluated based on process, not performance.[122] This point is eloquently stated by the Manitoba Law Reform Commission in its consideration of ethical investment by pension trustees:

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[118] Mark Thomsen & Doug Wheat, "The New Fiduciary Duty" (Spring 2003) *Business Ethics* 12 at 12.

[119] *Ibid*. at 13.

[120] *Blankenship* v. *Boyle*, 329 F. Supp. 1089 at 1112 (1979).

[121] Withers' v. Teachers Retirement System of the City of New York, *supra* note 91 at 1257-1258.

[122] *DeBruyne v. Equitable Life Assur. Soc. Of the U.S.*, 920 F.2d 457 (C.A. 7th Cir. 1990), aff'g 720 F.Supp. 1349 ("The fiduciary duty of care requires prudence, not prescience"); *Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan,* 507 F.Supp. 378, 384 (D.Haw. 1980); *Donovan v. Walton, supra* note 27*; Leigh* v.

> On the one hand, it seems clear that, subject to express terms to the contrary, the maximization of financial returns must be the trustee's paramount objective. At the same time, the *Harries* case seems to recognize that ethical criteria, at least to some unstated extent, may be considered. It would seem that these two positions can be bridged only by the proviso that the consideration of ethical criteria may not result in a lowered financial return. Yet such a proviso is surely incompatible with the basic principle of trust law that the prudence of a trustee's actions is to be determined as of the time they were taken, and not with the benefit of hindsight.[123]

If pension trustees are not expected to have foreknowledge of how an investment will perform, how could it be that they are expected to maximize investment returns? At most, it can be argued that trustees have a duty to make investment choices that they believe would result in the maximum overall return across the entire portfolio given the possible available investments, the plan's risk tolerance and any other relevant considerations.

To summarize, the better view is that Canadian pension trustees do not have a fiduciary obligation to maximize returns in the short-term, but rather to set investment policy with a reasonable expectation that the portfolio will achieve a reasonable rate of return over the long-term that satisfies the individual pension plan's funding requirements while minimizing risk through a portfolio-based investment approach.

Replacing the maximization doctrine with a reasonable return standard has significant implications for pension plans that seek to incorporate investment screening and ETI into their investment policies. In that context, screened investments and ETI – which by definition are intended to provide a market-grade return – may form part of a balanced portfolio.[124] This is consistent with the US Department of Labor's bulletin on ETI, which authorizes such investments provided that they aim to provide "a risk-adjusted, market-grade return that is equal or superior to a comparable investment of comparable risk and otherwise supports a plan's fiduciary imperatives."[125]

Engle, 727 F.2d 113, 124 (7th Cir. 1984); *American Com. Ass'n v. Retirement Plan,* 488 F.Supp. 479 at 483 (1980) citing *Matter of Clark,* 257 N.Y. 132, 177 N.E. 397 (1931); *In re Morgan Guaranty Trust Co. of New York,* 89 Misc.2d 1088, 396 N.Y.S.2d 781, 784 (Sur.1977).

[123] MLRC, *supra* note 29 at 38.

[124] This discussion does not speculate on the actual performance of screened investments or ETIs, but merely considers the appropriate standard to apply in evaluating whether such investments will be deemed prudent. A discussion about the risk/return profiles of such investments is beyond the scope of this paper.

[125] 29CFR 2509.94.1 (revised July 1, 2002). Previously, a 1994 bulletin issued by the Department of Labor stated "that ETIs are not incompatible with ERISA's fiduciary obligations." The bulletin provides that a plan may consider collateral benefits derived from an investment, including its social desirability, as long as the investment earns a competitive return: Department of Labor, Interpretative Bulletin 94-1 (June 23, 1994). According to Virginia L. Gibson, Bonnie K. Levitt & Karine H. Cargo, *Overview of Social Investments and Fiduciary Responsibility of County Employee Retirement System Board Members in California* (San Francisco: Baker & McKenzie, 2000) at 8 citing Jt. Economic Comm., "Putting People First: A National Economic Strategy" (1992) at 6, the DOL statements were in response to an plan by President Bill Clinton for an $80 billion dollar federal investment in a variety of infrastructure developments leveraged with public and private pension funds.

4.2. Does the duty of diversification permit consideration of investment screens and ETI?

In the context of portfolio theory, pension trustees have a fiduciary duty to ensure that the plan's investment portfolio is diversified as a recognized means of mitigating market risk. Through a strategy of diversification, pension plans seek to minimize market risk by holding a range of asset classes and investments within each class that have differing risk/return characteristics. Canadian law imposes no standard for diversification, although federal investment regulations implicitly recognize the importance of portfolio diversification by imposing limits on specific classes and types of investments.[126] In the United States, s.1104(a)(1)(C) of ERISA requires the fiduciary to "diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it was clearly prudent not to do so." Specific percentages are not specified.

Critics of socially responsible investment argue that applying non-financial screens violates the duty to diversify the plan's portfolio because it reduces the universe of possible investments and increases the risk to the plan's portfolio.[127] With respect to ETI, the argument is that allocating assets to such investments means fewer assets are available to be invested in other asset classes with lower risk profiles.

At issue is what level of diversification is required by pension plans, and what impact do screening and ETI have on portfolio diversification. Again, judicial statements emanating from the *Cowan v. Scargill* decision imply a maximization standard. Megarry V.C. stated "it is the duty of trustees... to take advantage of the full range of investments authorised by the terms of the trust, instead of resolving to narrow that range."[128] He later opined "I find it impossible to see how it will assist trustees to do the best they can for their beneficiaries by prohibiting a wide range of investments that are authorised by the terms of the trust."[129] However, a reading of the entire body of jurisprudence on point provides a more nuanced understanding of the issue.

It is well-established that the level of diversification required is plan-specific and fact-dependent.[130] Furthermore, portfolio diversification is determined and influenced by a myriad of

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[126] *Pension Benefits Standards Act, 1985,* R.S.C. 1985, c.32 (2nd Supp.), Schedule III.

[127] *Langbein & Posner, supra* note 22.

[128] *Cowan* v. *Scargill, supra* note 45 at 289,295.

[129] Megarry, *supra* note 69 at 766.

[130] *Cowan* v. *Scargill, supra* note 45 at 762; *Board of Trustees v. City of Baltimore, supra* note 85 (application of a screen eliminating approximately 40% of the index did not limit diversification based on the availability of alternative investments and evidence supporting the view that passive investment strategies could compensate for the impact the screens would have on the active investment approach of the funds' managers); *Harries v. Church Commissioners of England, supra* note 87; *Brock v. Citizens Bank of Clovis,* 841 F.2d 344 (10th Cir. 1988) (investment of more than 65% of bank pension plan's assets in commercial real estate first mortgages violated diversification requirements of ERISA); *Lanka* v. *O'Higgins* 810 F. Supp. 379 (N.D.N.Y. 1992)(investment manager's investment in three stock where plan trustees were aware of manager's philosophy and risks and selected him based upon his history of success); *Withers* v. *Teachers' Retirement System of the City of New York,* 447 F. Supp. 1248 at 1254 (S.D.N.Y. 1978), aff'd 595 F.2d 1210 (2d Cir. 1979); *Marshall* v. *Glass/Metal Ass'n & Glaziers,* 507 F.Supp. 378 at 383(1980)(investment of 23% of total plan assets in a single real estate loan violated the duty to diversify).

factors, some or all of which have the potential to affect the level of diversity. First, investment styles – are highly selective. For example, active managers select a subset of equities based on the manager's particular investment philosophy. Some pension plans have also adopted "immunization strategies" which invests all plan assets in bonds on the basis that long-term bonds most closely match the liabilities of a pension plan. Despite the pronouncements by some courts, the law recognizes that an investment strategy involves the selection of certain investments to the exclusion of others. According to the *Restatement of Trusts*:

> "[L]iberated portfolio concepts also allow for the introduction of active management strategies. These efforts may involve searching for advantageous segments of a market, or for individual bargains within the highly efficient markets as well as the less efficient ones."[131]

The court in *Board of Trustees v. City of Baltimore* observed correctly that investment managers normally carry a small range of investments in their portfolios which they have selected based on various criteria used as a means of differentiating themselves from the rest of the market and beating the standard benchmark for their asset class.[132] The range of investments within a pension plan's portfolio will therefore vary depending on the mix of managers selected.

The application of non-financial screens mirrors the philosophical approach of active managers by applying criteria in the selection of investments that offset the risk associated with a smaller universe through gains achieved from the remaining superior quality investments:

> "any loss of portfolio efficiency due to a smaller investment universe is more than offset by the more attractive investment characteristics of the remaining companies... The disciplined application...investment principles [by mainstream investment managers], just like the application of SRI principles, reduces the size of the investible universe for the fund manager. And just like socially responsible investors, mainstream investment managers justify this exclusionary process as a means to identify superior investment opportunities... Style adherence, a cornerstone of modern portfolio management, equates to a smaller investment universe."[133]

The application of investment screens may also have the benefit of identifying additional investment opportunities that were previously not in the universe of a plan's portfolio. As the Manitoba Law Reform Commission observed in its consideration of ethical investment by trustees, "a policy of diversification might just as easily encourage investment of a percentage of assets in socially or ethically desirable investments whose characteristics differ from the other securities in a portfolio..."[134]

Second, most small- and medium-size pension plans limit diversification by not investing in non-traditional asset classes, such as hedge funds. Trustees have an obligation to understand the nature of investments in the plan's portfolio as well as associated risks, and to monitor such investments. Oftentimes, trustees in smaller plans do not have the requisite skill and expertise fulfill this responsibility. Consequently, the majority of pension funds continue to limit diversification by investing solely in traditional asset classes (i.e. stocks, bonds), despite the

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[131] *Restatement (Third) of Trusts,* §227 rptr's. notes to cmt. M (1992).

[132] *City of Baltimore, supra* note 85 at 726.

[133] Brent A. Sutton, "Socially Responsible Investing and its Critics: The Emperor has no Clothes!" (Presentation to the Canadian Social Investment Conference by a Vice President of Phillips, Hagar & North Investment Management Ltd., Vancouver: June 3, 2003) at 4 (unpublished draft on file with author).

[134] MLRC, *supra* 29 at 35.

availability of a wide range of alternative investment vehicles.[135] Similar arguments extend to the consideration of foreign investments by pension plans, especially in light of the federal government's anticipated removal of the cap.

Based on the above considerations and without legislative or judicial guidance in Canada, most leading pension lawyers consulted for the purpose of this paper consider that pension trustees have a fiduciary obligation to maintain *adequate* or *optimal* diversification.[136] That is, to ensure that the portfolio is sufficiently diversified to meet the plan's particular risk profile. This standard provides pension plans with discretion to consider investment screens and ETI provided that the overall desired risk/return profile is maintained.

One U.S. decision identified seven criteria to consider in determining the degree of concentration that would violate the diversification requirement:

1) The purpose of the plan;
2) The amount of plan assets;
3) Financial and industrial conditions;
4) The type of investment, whether mortgages, bonds or shares of stock or otherwise;
5) Distribution as to geographical location;
6) Distribution as to industries; and
7) The dates of maturity.[137]

Canadian pension trustees are not required to consider these criteria; however, they may provide some guidance to fiduciaries on this point.

4.3. Best interests

The duty of loyalty requires that pension trustees act in the best interests of plan members and beneficiaries.[138] Most Canadian jurisdictions have codified this duty in statute. British Columbia's legislation is unique in this regard; explicitly referring to the best *financial* interests of plan members and beneficiaries.[139]

Critics of socially responsible investment raise three common arguments when considering the best interests of plan participants in relation to investment screening and ETI. First, they argue that the best interests of plan beneficiaries are limited to their financial interests. Is this the case

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[135] Eighty-seven per cent of assets of Canadian pension funds are invested in bonds and equities (domestic and foreign. The remainder is held in real estate (4%), as cash (2%), in alternative investments (2%) and other investments (5%): Watson Wyatt, *Pension Fund Investment: The Canadian Climate* (March 2004) available at www.watsonwyatt.com. *See also* Statistics Canada, *Quarterly estimates of trusteed pension funds* (2002) vol.30(1).

[136] *Supra* note 15.

[137] *Lanka* v. *O'Higgins,* supra note 130 at 386.

[138] *Cowan* v. *Scargill, supra* note 45 at 760; *Duke of Portland v Topham* (1864) 11 HL Cas 32, [1861-73] All ER Rep 980.

[139] *Pensions Benefits Standards Act,* R.S.B.C. 196, C.352, s.8(5).

or does the law recognize a broader understanding that incorporates other possible interests? Second, they submit that any other interests shared by plan members and beneficiaries require unanimity. How is a legal determination of the best interests of plan members and beneficiaries arrived at? Does the law require unanimity or is some other standard applied? And third, they contend that pension trustees are required to consider the interests of plan members and beneficiaries exclusively. This section considers each of these arguments.

4.3.1. What are the best interests of plan members and beneficiaries?

Absent provision in the trust agreement, the duty of trustees to act in the best interests of plan members has commonly been interpreted to mean their financial interests.[140] In *Cowan* v. *Scargill,* the court stated:

> When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question; and the prospects of the yield of income and capital appreciation both have to be considered in judging the return from the investment.[141]

Clearly, the financial interests of plan members are the paramount concern of plan trustees. Plan members and beneficiaries look to their pension plan to provide them with financial security in their retirement. Accordingly, trustees must be concerned with ensuring that the plan provides the returns needed to adequately fund the plan and provide the pension promised. However, a larger policy consideration argues for a more expansive reading of best interests that pension funds depend on a strong economy and healthy society in order to sustain returns.[142]

For defined benefit pension plans, the primary interest of all plan members and beneficiaries is to receive the retirement benefit promised. Theoretically, funded defined benefit pension plans apply current contributions towards payment of future liabilities. Consequently, current plan members and their beneficiaries have a long-term interest in the performance of the pension plan's investments. While this relates directly to their financial interests, it requires a broader consideration of the macroeconomic context in which those investments are made. As Sean Harrigan, past-President of CalPERS and Vice-Chair of the fund's investment committee has stated:

> It is clear to us at CalPERS, however, that the present and future financial health of our trust fund is inextricably linked to the economic health of California. Beyond the obvious microeconomic analysis that is required to make specific investment decisions, isn't it also necessary for us, as prudent fiduciaries, to simultaneously consider macroeconomic conditions? I believe the answer to this question is a resounding yes! It is also necessary to consider the macroeconomic implications of our investments. In other words, it is not just

[140] *Cowan* v. *Scargill, supra* note 45 at 760.

[141] *Ibid*.

[142] This has been referred to as the "whole participant" approach. *See* Randy Barber & Teresa Ghilarducci, "Pension Funds, Capital Markets and the Economic Future" in Gary Dymski, Gerald Epstein & Robert Pollin (eds.) *Transforming the U.S. Financial System* (New York: M.E. Sharpe, 1993) at 287-319.

> acceptable to consider what are referred to as the collateral economic benefits of any investment, it would be imprudent not to include such considerations in the investment decision process.[143]

The facts in cases such as *Withers* and *Donovan* v. *Walton* provide examples of how broader considerations can influence the perspective of trustees regarding the best interests of plan participants. Similarly, the Dutch ABP pension scheme, with assets exceeding 170 billion Euros and 2.4 million active participants, states that its investment strategy focuses on sustainable economic growth as being in the best interest of beneficiaries and long-term investments.[144]

These considerations are still entirely defensible when discussing the best financial interests of plan members. The legal question arises where trustees consider the application of non-financial investment criteria absent of a financial rationale. In what instance and to what extent may trustees assume that the best interests of plan members are other than their financial interests? .

In his judgment, MeGarry V.C. suggested that the interests of plan members may not be limited to their financial interests.[145] He noted the word "'benefit' is to be given a very wide meaning, and there are circumstances in which arrangements which work to the financial disadvantage of a beneficiary may yet be for his benefit."[146] His Lordship also qualified his general interpretation of the scope of best interests:

> I am not asserting that the benefit of the beneficiaries which a trustee must make his paramount concern inevitably and solely means their financial benefit, even if the only object of the trust is to provide financial benefits.[147]

The court provided the example of divestment of South African securities as one possible interest that might supercede financial interests based on doubts about that nation's political stability and the long-term financial soundness of its economy. However, the court rejected other possible interests without providing reasons, including pay levels in South Africa, work accidents, pollution control, employment conditions for minorities, military contracting and consumer protection. In relation to the facts of the case, the court stated that the interests of the British coal industry to the beneficiaries of the miner's pension plan were too "speculative and remote".[148] Without attempting to compare the issue of worker rights in Britain and South African Apartheid, the political context in both situations involved governments that had policies which

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[143] Sean Harrigan, Vice Chairman, CalPERS Investment Committee. "Economically Targeted Investments: Doing Well and Doing Good." Paper presented to the Canadian Labor and Business Centre, 16 January 2002 cited in Goodman et al., *supra* note 30 at 49.

[144] www.adp.nl.

[145] Polling results would appear to support this view. Most investors and plan members are not aware of how their money is being invested because of lack of disclosure by pension funds and intermediaries, and what the companies in which they are invested are doing because of poor corporate disclosure. Recent survey shows that as many as 95% of 2,000 UK citizens surveyed said that they would be uncomfortable supporting certain activities with their investments. For 80%, the main areas of concern were the support of exploitative labour practices and oppressive regimes. Yet 30% did not know their savings could be being used to support companies involved with what they considered to be unethical practices. Haurant, supra note 43 citing study by Charcol Holden Meehan independent financial advisors.

[146] *Cowan* v. *Scargill, supra* note 45 at 761.

[147] *Ibid*.

[148] *Ibid*. at 767.

suppressed a segment of society (unions in the case of Britain; blacks in the case of South Africa) and which had the potential to affect the political and economic stability of each respective nation. In that respect, it is difficult to reconcile the court's position that the health of Britain's coal industry was any more "remote or insignificant" to the beneficiaries of the miner's pension plan than the interests of blacks were to North American investors.

Moreover, MeGarry V.C. stated that there will be very rare instances -- in which case the burden will rest heavy on the one making the assertion -- where strong views and common interests shared by plan members and beneficiaries may justify excluding specific investments:

> …if the only actual or potential beneficiaries of a trust are all adults with very strict views on moral and social matters, condemning all forms of alcohol, tobacco and popular entertainment, as well as armaments, I can well understand that it might not be for the 'benefit' of such beneficiaries to know that they are obtaining rather larger financial returns under the trust by reason of investments in those activities than they would have received if the trustees had invested the trust funds in other investments. The beneficiaries might well consider that it was far better to receive less than to receive more money from what they consider to be evil and tainted sources.[149]

Accordingly, we turn to discuss what standard pension trustees may apply to determine when the court will consider views to be strongly shared amongst plan members and beneficiaries.

4.3.2. How are best interests to be assessed?

The duty of loyalty requires that trustees treat all beneficiaries with an even hand. Critics of investment screening argue that trustees may not apply screening criteria because plan participants do not share the same values and interests, aside from a collective interest in receiving promised plan benefits, and applying values-based screens would favour the interests of some over others. Furthermore, they contend that even if unanimity existed amongst plan members, it would be difficult to determine because of the problems in ascertaining the interests of all current plan members, as well as current and future beneficiaries. Without this information, trustees fear their decision to apply non-financial screens could be seen to be motivated by personal interest or the interests of only some plan members.

The first criticism implies all plan members and beneficiaries must be in agreement regarding their interests. In theory, if one person believes that investing in tobacco is acceptable, then the argument is that trustees may not divest the portfolio of tobacco stock. Setting aside for the moment the point that trustees may not take direction from plan members, it is clear that unanimity is not the test for determining the best interests of plan members and beneficiaries. If it were, trustees would be incapable of setting investment policy (or making many other decisions with respect to plan funding and benefits). Virtually any investment decision would constitute a breach of the trustee's duty of loyalty since there is always going to be some level of disagreement with respect to any investment-related decision. As one commentator has stated:

> Unanimity is not the test. One cannot assume that beneficiaries would be unanimous about the question of maximizing raw dollar return. This is a false assumption. There will always be beneficiaries who disagree with investment decisions made by trustees.[150]

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[149] *Ibid*. at 761-762.

[150] Patricia Lane, "Ethical Investment: Towards the Best Interest of Everyone" (1986) *The Advocate* 171 at 176.

The duty of loyalty demands that pension trustees act impartially, treating all plan members and beneficiaries with an even hand.[151] This requires that pension trustees treat plan members and beneficiaries equitably, giving due consideration to the interests of all parties, not that their respective interests be given equal weight. The responsibility of trustees to provide equitable, not equal, consideration to the interests of plan members and beneficiaries accords with the position that their unanimous agreement is not required.

The second argument implies that investment policy concerning investment screening requires consideration of the views of plan members and beneficiaries. While surveys consistently demonstrate that the majority of pensioners do not want their retirement savings invested in ways that are harmful to others or the environment[152], the duty of loyalty prevents pension trustees from taking direction from plan members. As fiduciaries, trustees are charged with making decisions in the best interests of plan members based on a full understanding of all the relevant information; information that plan members may or may not have considered in formulating their views. The courts' approach is generally to consider whether the trustee had a reasonable belief, based on the facts in the case, that he or she was acting in the beneficiaries' best interests.[153] In *Cowan* v. *Scargill,* Megarry V.C. ignored evidence of plan member support for the investment prohibitions. According to one commentator:

> "Megarry V.C. simply assumed either that a unanimous decision passed at the [union] conference was not representative of what the beneficiaries considered to be their best interests, or that such a statement was irrelevant. Megarry V.C.'s judgment requires trustees to ignore any conceivable mechanism whereby pension fund beneficiaries could express their own opinion."[154]

Trustees may take the views of plan members and beneficiaries into consideration, but the investment decision is the trustees' alone.[155] The common law test focuses on whether pension trustees researched the issue and consulted adequately with experts in the process of making an informed decision.[156]

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[151] *Cowan* v. *Scargill, supra* note 45 at 760.

[152] Vector Research, public opinion poll (Toronto: Canadian Democracy and Corporate Accountability Commission, 2001). The survey of 2,006 adults conducted between September 28 and October 8, 2001 found that 54% of shareholders want pension funds that invest in firms with a good record of social responsibility even if it resulted in somewhat lower benefits to the shareholder. Fifty-nine percent of wealthy shareholders (i.e. incomes greater than $100,000) endorsed this view. Russell Sparkes, "SRI Comes of Age" (July 2000) *Pension Investor*: A national opinion poll conducted in Britain for the Ethical Investment Research Service (EIRIS) in September 1997 found that 73% of 700 adults surveyed wanted ethically-screened pensions; 44% stated that their pension plan should include an ethical policy if that could be done without any reduction in financial return; and a further 29% felt that their pension plan should adopt ethical policies even if this led to reduced returns.

[153] *See Withers v. Teachers' Retirement System, supra* note 91; *Blankenship* v. *Boyle*, *supra* note 120; *Cowan* v. *Scargill, supra* note 45.

[154] Richard Nobles, "Investment policies and trustees' duties (Sept. 1984) 13(3) *Industrial L.J*. 167 at 168 (case comment).

[155] Various judgments, including *Cowan* v. *Scargill, supra* note 45, have confused this principle by suggesting that trustees can act where there is unanimity amongst plan members. This implies that trustees are able to take direction from plan members, when the duty of loyalty prohibits such action. Ontario's *South African Trust Investments Act* remains the lone example of a statutorily imposed mechanism for making investment decisions based on a popular assessment of the interests of plan members: *South African Trust Investments Act*, R.S.O. 1990, c.S.16.

[156] *See e.g. Withers v. Teachers' Retirement System, supra* note 91; *Donovan* v. *Walton, supra* note 27.

4.3.3. Whose interests are pension trustees permitted to consider?

It is commonly argued that pension trustees must act solely in the best interests of plan members and beneficiaries. At issue is whether pension fiduciaries may also consider the interests of plan members and beneficiaries as employees and members of the larger community, and whether the rule allows for other interests to be satisfied incidental to those of plan members and beneficiaries.

It is well-established at law that the paramount duty of pension trustees, unless otherwise stated in the trust agreement, is to the members and beneficiaries of the plan.[157] Some argue based on American statutory law that trustees must act exclusively in the interests of plan members and beneficiaries as members and beneficiaries of the plan – the exclusive purpose rule. Canadian legislation and common law, however, does not articulate such a requirement.[158]

The exclusive purpose rule emanates from section 404(a)(1) of ERISA:

> Subject to sections 1103 (c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan…159

In interpreting the statutory fiduciary obligations of pension trustees under ERISA, the US Department of Labor has stated that fiduciaries may consider collateral benefits in making investment decisions provided that these interests are subordinate to those of the plan beneficiaries. The selected investment must provide an investment return commensurate to alternative investments having similar risks.[160]

The interpretation of the exclusive purpose rule has further qualified by American courts. In *Board of Trustees* v. *City of Baltimore,* the court stated:

> Even if the trustee has no personal stake in a transaction, the duty of loyalty bars him from acting in the interest of third parties at the expense of the beneficiaries… Nevertheless, we do not believe that a trustee necessarily violates the duty of loyalty by considering the social consequences of investment decisions. If, as in this case, the costs of considering such consequences are *de minimis,* the trustee ordinarily will not have transgressed that duty... Our conclusion is consistent with the requirement…that the trustees act "solely in the interests of the beneficiaries," and "for the exclusive purpose… of providing benefits."[161]

This view was shared by the court in *Donovan* v. *Walton* where the benefits received by the union that occupied space in the pension fund's building were viewed by the court as "parallel to

[157] *Cowan v. Scargill, supra* note 45 at 760.

[158] *Pensions Benefits Standards Act,* R.S.B.C. 196, C.352, s.8(5); *Pension Benefits Act,* S.N.L. 1996, c.P-4.01, s.14(1); *Pension Benefits Act,* S.S. 1992, c. P-6.001, s.11(2).

[159] *Employee Retirement Income Security Act,* 29 U.S.C. §1104(a)(1).

[160] Letter from Robert J. Doyle, Director, Office of Regulations and Interpretations, Department of Labor to William M. Tartikoff, Senior Vice President and General Counsel, Calvert Group Ltd. (May 28, 1998) ("Calvert letter").

[161] *City of Baltimore, supra* note 85 at 738.

and inseparable from the benefits derived the Fund and its participants."[162] The court went on to opine generally on third party interests:

> Even without these benefits to the Fund, ERISA §404(a)(1)(A) simply does not prohibit a party other than a plan's participants and beneficiaries from benefiting in some measure from a prudent transaction with the plan. Furthermore, by adopting the "exclusive purpose" standard, Congress did not intend to make illegal the fact of life that most often a transaction benefits both parties involved. The case law supports this view. What courts frequently find objectionable is an imprudent plan transaction in which the trustee has a personal stake.[163]

The latitude granted to trustees in both cases appears to be strongly influenced by the absence of any conflict of interest.[164] In contrast, conflicts of interest played a significant role in *Blankenship* v. *Boyle* – the American case that stands in opposition to this line of cases. In that instance, the trustees of the jointly-administered plan were found to have breached their duty of loyalty to plan members and beneficiaries, in part, by investing in various utility stocks at the recommendation of the union trustee for the benefit of the Union and the signatory operators.[165] The court surmised in that instance that the trustees had made the investments as part of a union campaign to force the utilities to purchase union-mined coal. A bank in which the union held a majority ownership stake held the fund's assets. The union trustee on the pension plan was also a director of the bank. The pension plan had no formal investment policy and the trustees meet irregularly with many decisions being taken without the presence of all trustees. Throughout its history, the pension plan elected to maintain a significant portion of its assets in the bank rather than investing them, which assisted the union in carrying out its activities. The court did temper the relief granted based on consideration of the collateral benefits that the union had provided to plan beneficiaries during the life of the pension plan.[166] Clearly, it is a conflict of interest for a trustee to apply screens or select particular investments based on personal objectives or those of any entity with which the trustee is associated (e.g. plan sponsor, company or union). Aside from breaching a trustee's common law duty of loyalty, most Canadian jurisdictions have also incorporated statutory prohibitions into their pension legislation.[167] Trustees must therefore ensure that their actions do not and are not perceived to be in conflict with those of plan members and beneficiaries.

Conflicts of interest underlay findings of breach of fiduciary duty in both British decisions on point. However, British courts have not adopted the exclusive purpose rule. In *Cowan* v.

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[162] *Donovan* v. *Walton, supra* note 27 at 1245.

[163] *Ibid*.

[164] In *Donovan* v. *Walton, ibid. at* 1234, a trustee who was the union's business manager and a member of the committee overseeing the construction of a building by the pension plan in which the union was to be the anchor tenant, and who acted for the union in negotiating the rent, and whose office the court found was "quite large and handsomely furnished", was not deemed to be in a conflict of interest.

[165] *Blankenship* v. *Boyle, supra* note 120 at 1106.

[166] *Ibid*. at 1112: "...the Court notes that while the beneficiaries have suffered as a result of the Fund's loss of investment income, they have benefited to some extent from the Union's activities over the past twenty years. In the longer view of matters, the Union's strength protects the interests of the beneficiaries, past and prospective; the Union should not be weakened to a point where its stance at the bargaining table will be substantially impaired."

[167] *See e.g. Pension Benefits Standards Act,* R.S.B.C. 1996, c.352, s.8(9); *Pension Benefits Act,* R.S.O. 1990, c.P-8, s.22(4).

Scargill, Megarry V.C. noted that the word "benefit" is to be given a very wide meaning when considering the obligation of trustees to act for the benefit of plan members and beneficiaries:

> …I am not asserting that the benefit of the beneficiaries which a trustee must make his paramount concern inevitably and solely means their financial benefit, even if the only object of the trust is to provide financial benefits…. 'Benefit' is a word with a very wide meaning, and there are circumstances in which arrangements which work to the financial disadvantage of a beneficiary may yet be for his benefit…But I would emphasise that such cases are likely to be very rare, and in any case I think that under a trust for the provision of financial benefits the burden would rest, and rest heavy, on him who asserts that it is for the benefit of the beneficiaries as a whole to receive less by reason of the exclusion of some of the possibly more profitable forms of investment.[168]

His Honour was clearly referring to the implications of considering the interests of plan members, other than as plan members, and where such considerations resulted in lower returns. On that basis, he rejected the potential additional benefits to be too "remote and insubstantial."[169]

In *Evans, supra,* while the trustees were found in breach of trust for failing to exercise discretion in loaning plan assets to the parent Society at a competitive rate of return, the court's comments also affirm that the interests of plan members as employees could be taken into consideration:

> I also bear in mind that the members of the Pension Fund are all employees of the Society and therefore dependent for their employment on the financial health of the Society. No doubt that is always so in the case of the pension fund of a trading concern. If under the rules of a superannuation scheme the trustees of a pension fund have express power to lend money to the parent concern it would, in my view, be wrong to suppose that the trustees are forbidden to give the parent concern financial accommodation on preferential terms if the trustees consider that the security of the employment of their members may otherwise be imperiled. I therefore reject the argument that Rule 7 forbids the Society to agree [to] a rate of lower than that at which the Society can borrow elsewhere.[170]

The conclusion drawn from these decisions is that trustees must put the financial interests of plan members and beneficiaries first. In addition, the majority of existing jurisprudence is also in agreement that pension trustees may take into consideration the interests of plan members and beneficiaries *qua* employees and community members, as well as the interests of third parties where there is minimal or no adverse financial consequences for the pension plan. Collateral benefits may be considered where the expected rate of return and associated risk is commensurate with that of alternative available investments. The thin line of cases is split on whether trustees may consider other interests in making investment decisions where there is a greater risk of poorer investment returns. Relying on *Cowan* v. *Scargill,* such practice is acceptable where the trust agreement allows or where there is a substantial and proximate connection between the decision and strongly held views of plan members and beneficiaries.[171] In such instances, the decision should be documented in the plan's Statement of Investment Policy and Procedures and communicated to plan members.

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[168] *Cowan v. Scargill, supra* note 45 at 762.

[169] *Cowan v. Scargill, supra* note 45 at 764 ("remote and insubstantial") and 767 ("speculative and remote").

[170] *Evans* v. *London Co-operative Society Ltd., supra* note 104.

[171] *Cowan* v. *Scargill, supra* note 45 at 761.

Summarizing the discussion in this section, the weight of existing authority and subsequent industry practice supports the view that investment screening and ETI do not violate the fiduciary duties of prudence and loyalty *per se*. Yet, pension trustees continue to face a range of legal barriers – both real and imaginary –when applying non-financial investment screens to plan investments and investing in ETI. The analysis provided in this section indicates that trustees may adopt these practices provided that: anticipated returns across the entire portfolio are not compromised; there are adequate returns within accepted levels of risk; adequate portfolio diversity is maintained; the practice is permitted under the plan's trust agreement and investment policy; and the practice is communicated to plan members. Furthermore, while the cases are conflicting, there is legal authority supporting the view that the best interests of plan members extends beyond their financial interests and that trustees are not limited to considering the interests of plan members and beneficiaries when making investment-related decisions. The investment decisions of pension trustees will ultimately be judged based on the process applied in arriving at the decision, not the ultimate performance of the investment.[172] As one court has stated, "the fiduciary duty of care requires prudence, not prescience."[173] Accordingly, the following section of the paper presents elements of a process that trustees should consider when contemplating the incorporation of investment screening and ETI into their plan's investment policy.

5. A prudent process for investment screening and ETI

This section sets out seven elements of a prudent investment process. These are general principles which should be followed with respect to any investment-related decision, although they have particular importance for screening and ETI mandates. They are not to be read as a comprehensive list, but as a starting framework for pension trustees to develop an investment process tailored to their plan's specific needs and characteristics.

5.1. Conduct necessary research and obtain expert advice

The application of investment screens and ETI are not common practice for Canadian pension funds. It is therefore imperative that trustees undertake the necessary research and obtain ongoing expert advice when incorporating them into the plan's investment policy. Prudence requires that trustees thoroughly research the relevant law[174], plan information, and particulars regarding the specific investment in question.

The efforts of pension trustees in this regard have historically been a significant determinant in the court's assessment. In *Cowan* v. *Scargill,* the court found the defendant union trustees in breach of their fiduciary duties for failing to seek additional legal advice about whether the

[172] The Pension Commission of Ontario (now FSCO) has confirmed in past policy statements (now deemed inactive due to the adoption of federal investment guidelines) that the standard of prudence should be measured principally by the investment selection and monitoring process. *See* PCO Bulletin (May 1990) 1(2) *Prudence* at 2 (Index no. I400-600).

[173] *DeBruyne* v. *Equitable Life Assurance Society of the United States*, 720 F.Supp. at 1349, cited with approval in 920 F.2d 457 at 465 (7^{th} Cir. 1990).

[174] *McIntyre et al*. v. *Bank of Montreal* (1957), 22 W.W.R 379 (Alta. Q.B.).

proposed investment prohibitions were in breach of their fiduciary obligations.[175] In *Donovan* v. *Cunninghham,* the trustees were found to have breached their duty in basing their decision to invest in company stock on an outdated appraisal.[176] In another instance, trustees were held to be in breach of their duties for evaluating an investment based on two-year-old information.[177] In contrast, in both *Martin v. City of Edinburgh District Council*[178] and *Donovan v. Walton*[179] the trustees were exonerated because the court found that they had conducted extensive research and obtained ongoing expert advice.[180] These last cases demonstrate how a prudent process can assist in shielding trustees from liability and deflecting allegations of conflicts of interest.

According to one legal opinion, a court will likely consider the following factors in assessing whether adequate advice was obtained[181]:

- Did the administrator employ proper methods to investigate, evaluate, and structure the investment?
- Did the administrator exercise independent judgment when making investment decisions?
- Did the administrator conduct an impartial study of the advantages and disadvantages of the investment policies, and/or the particular transaction under consideration?
- Did the administrator exercise due diligence in researching all aspects of the investment policy, or transaction?
- Did the administrator retain qualified experts and consultants as appropriate in the circumstances?
- Did the administrator rely on complete and up-to-date information in reaching its decision?

While some jurisdictions and common law provide a general defence for trustees who rely on expert opinion, it is not an absolute shield from liability. In the words of Justice Gee in *Donovan* v. *Cunningham*, "an independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled."[182] Trustees are still responsible for scrutinizing the issue in question, making necessary inquiries, and reaching an independent decision.

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[175] *Cowan* v. *Scargill, supra* note 45 at 766. *See also Martin* v. *City of Edinburgh District Council, supra* note 93*:* trustees must obtain professional advice in order to help ascertain whether a particular investment policy is in the best interests of plan beneficiaries.

[176] *Donovan* v. *Cunningham, supra* note 27.

[177] *GIW Inc*. v. *Trevor, Stewart, Burton & Jacobsen,* 895 F.d 729 (11th Cir. 1990).

[178] *Martin* v. *City of Edinburgh District Council, supra* note 93.

[179] *Donovan* v. *Walton, supra* note 27.

[180] Calabrese, *supra* note 10 at 123. It is also important to balance the need for expert advice against unnecessarily high costs for consulting services when a lower-cost option is available.

[181] Murray Gold, *supra* note 55 at 15.

[182] *Donovan* v. *Cunningham, supra* note 27.

5.2. Incorporate practices into the plan's investment policy

Investment screening and ETI are permissible provided that the practices are authorized in the plan's investment policy.[183] In addition to authorizing the practice, it is advisable to identify the process to be followed, the roles and responsibilities of individuals with respect to the practice including authorization procedures, and methods for valuing investments and monitoring performance, ensuring adequate diversification of the portfolio, and managing conflicts.

A number of pension plans in Canada and the United States that employ screens and ETI do authorize these practices in their investment policy, however, many do not. A recent UK government survey gives some sense of the variation in practice. The survey found that only 18% of 1,500 pension schemes surveyed have an explicit policy on SRI, while 52% accept the policies of their investment managers, 26% have no policy at all, and 5% do not know their scheme's policy on SRI.[184] Anecdotal evidence suggests that the situation is similar in Canada.

5.3. Incorporate protective measures to reduce risk

The courts have tended to look on trustees favourably in instances where the trustees exercised care and diligence in reviewing their investment policies and practices and applying protective measures to help mitigate risk. In *Donovan* v. *Walton,* the court found that the trustees had exercised care and diligence in planning for the financing, construction and lease of the Administration Building and had not breached their fiduciary duty to the plan's participants and beneficiaries.[185] In *Withers v. Teachers Retirement System,* the trustees put in place numerous protections – including legislation authorizing the investment and requiring investment income in excess of four percent to be applied to fund past service liabilities -- to minimize the risk associated with the large investment in city bonds.[186] In *Brock v. Walton,* borrowers were required to comply with a number of preconditions in order to benefit from a home mortgage loan program.[187] These included completing a background check, pledging their accrued pension benefits, and obtaining mortgage insurance if the borrower's equity was less than 20 percent. Such measures do not guarantee protection for pension trustees, but do demonstrate that care and diligence was applied in evaluating an investment decision.

In specific reference to diversification, pension trustees can take several practical measures to optimize diversification when first engaging in investment screening and ETI. Pension plans will often adopt a "best of sector" approach to screening investments in order to minimize the impact of exclusionary screens on the diversity of a portfolio. This approach selects the best companies in each sector based on the criteria identified rather than excluding entire sectors of the economy. In the case of ETIs, where there is often initial uncertainty about the potential risk associated with a particular investment, pension plans may allot a small portion of their assets

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[183] FSCO, *supra* note 50.

[184] Sarah Horack, John Leston and Margaret Watmough, *The Myners Principles and Occupation Pension Schemes* (vol. 2 of 2)(UK: Department of Work and Pensions, 2004) at 129.

[185] *Donovan* v. *Walton, supra* note 27 at 1240.

[186] *Withers* v. *Teachers Retirement System, supra* note 91 at 1253.

[187] *Brock* v. *Walton, supra* note 102 at 588.

consistent with a risk diversification strategy so that any possible losses will not materially impact the fund's overall performance.

5.4. Establish appropriate benchmarks to measure performance

In monitoring the performance of any investment – not just screened investments and ETI -- it is important to use appropriate benchmarks for the purpose of comparison. Trustees should also make sure that decisions taken and the evaluation of investments are based on current information.[188]

5.5. Delegate responsibilities and monitor agents

Pension trustees have a duty at common law not to delegate their responsibilities (*delegates non potest delgare*).[189] This principle has since been relaxed in recognition of the complexities involved in administering a large, institutional trust, such as a pension fund. Pension legislation in a number of provinces expressly permits delegation by the plan administrator to an agent.[190] However, all jurisdictions require that the fiduciary personally select the agent, be satisfied of the agent's suitability to perform the requisite tasks, and carry out prudent and reasonable supervision of the agent. Common law requires that trustees retain control over setting policy and monitoring compliance; however, delegating responsibility for implementing policy is permitted.[191]

5.6. Provide trustees with the discretion to withdraw

Several cases have considered the issue of pension trustees providing discretion in the plan's investment policy to deviate or withdraw from particular investments where they are performing poorly or otherwise not in the best interests of plan beneficiaries. In *Cowan v. Scargill*, the court disapproved of the union trustees' demands for absolute prohibitions on certain investments because they left no discretion to amend the plan's investment policy in the event that the prohibitions had an adverse affect on the performance of the plan's portfolio.[192] Alternatively, the court in *Board of Trustees v. City of Baltimore* found that the City Ordinance prohibiting investment in companies operating in South Africa did not impair the fiduciary duties of prudence and loyalty because the Ordinances gave the trustees discretion to suspend divestiture under certain circumstances.[193] Consequently, it is advisable that screening and ETI policies

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[188] *Donovan v. Walton, supra* note 27 at 1238 where trustees always worked with current information, and *Donovan* v. *Cunningham, supra* note 27; *GIW Ind. V. Trevor, Stewart, Burton & Jacobsen,* 895 F.2d 729 (11th Cir. 1990) where they did not.

[189] *Boe* v. *Alexander*, *supra* note 21; *Re Floyd* [1961] O.R. 50, 26 D.L.R. (2d) 66 (Ont. H.C.); *Re Blow* (1977), 18 O.R. (2d) 516, 89 D.L.R. (3d) 721 (Ont. H.C.).

[190] *Pension Benefits Standards Act,* R.S.B.C. 196, C.352, s.8(7-8); *Pension Benefits Act,* C.C.S.M., c.P32, s.28.1(6-8); *Pension Benefits Act,* S.N.B. 1987, c. P-5.1, s.8(1-3); *Pension Benefits Act,* N.S.R.S. 1989, c.340, s.29(4-6) as amended 2000, c.29; *Pension Benefits Act*, R.S.O. 1998, c.P.8, s.23(5-7).

[191] Donavan Waters, *Law of Trusts in Canada* (2nd ed.) (Toronto: Carswell, 1984) at 707.

[192] *Cowan* v. *Scargill, supra* note 45 at 755.

[193] *Board of Trustees v. City of Baltimore, supra* note 85 at 724.

include escape provisions to allow trustees and other investment fiduciaries latitude to make changes to the plan's investments where necessary.

5.7. Communicate to plan members

It is essential to communicate with plan members when applying non-financial investment screens or investing in ETI.[194] Communication is part of good plan governance. It keeps plan members informed, instills confidence in them about the plan's management, and helps to manage their expectations. However, communicating with plan members does not mean taking direction from them which amounts to a delegation of the fiduciary responsibility of pension trustees and is prohibited.

6. Conclusion

It is clear from a review of the law that – despite lingering uncertainty with respect to some important aspects of the law – pension plans may take non-financial criteria into consideration for financial or non-financial reasons and that neither unanimity nor additional legislative authorization is required. Specifically, this paper finds that the application of non-financial criteria by way of investment screens and economically targeted investing is compatible with the fiduciary obligations of pension trustees. While Canadian courts have not had occasion to provide a clear pronouncement on the issue, the weight of current policy and practice indicates that trustee fiduciary duties include, and arguably require, consideration of non-financial factors, both where it can be demonstrated to be in the financial interests of plan members and also where there is support for such considerations being in the long-term interests of plan members. Indeed, because pension funds are long-term, universal investors,[195] considering the potential risks and opportunities that political, social, environmental and ethical practices have and will have on financial markets and the fund's investments is prudent.

A modern reading of pension trustee fiduciary duties supported by the majority of existing jurisprudence from the United States and Britain suggests that, when making investment policy, the law permits pension trustees to take values-based, non-financial criteria into consideration,, including screening investments and ETI, provided a prudent process is followed that includes authorization from the plan's investment policy and communication to plan members. In all cases, pension trustees must exercise prudence through the consideration of expert advice and ongoing monitoring of investments while placing the interests of plan members and beneficiaries first and abstaining from any conflicts of interest. Unless the trust otherwise provides, investment decisions must be made with a view towards obtaining adequate returns and portfolio diversity in accordance with the plan's risk tolerance. The best interests of plan members and beneficiaries must remain paramount at all times, but other interests may be considered provided

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[194] FSCO, *supra* note 50.

[195] Pension funds as "universal owners" of a cross-section of the investment universe have a vested interest in investing in a manner that supports a sustainable economy: James P. Hawley & Andrew T. Williams, *The Rise of Fiduciary Capitalism* (Philadelphia: University of Pennsylvania Press, 2000); Robert A.G. Monks, *The New Global Investors* (Oxford: Capstone Publishing Limited, 2001); Gil Yaron, "Canadian Institutional Shareholder Activism in and Era of Global Deregulation" in Janis Sarra, ed., *Corporate Governance in Global Capital Markets* (Vancouver: UBC Press, 2003).

they do not infringe on the interests of plan participants. The position of trustees in overseeing all aspects of plan administration requires that they make investment-related decisions based on a determination of the best interests of plan members and beneficiaries.

These conclusions reflect an understanding that the fiduciary duties of prudence and loyalty are evolving principles to be given a flexible interpretation in light of the specific circumstances of each pension plan. It is this flexible and evolving nature that allows them to respond to constantly changing macro-economic conditions and the specific investment environment of the individual pension plan. Viewed in this light, non-financial criteria are simply one more input into the investment decision matrix that seek to address developments in international norms around human rights, the environment and behavioural standards for multi-national corporations, as well as mounting evidence suggesting a relationship between non-financial indicia and corporate financial performance.[196]

An evolution in thinking is also required to transcend the traditional narrow reading of fiduciary law that is increasingly out-of-step with common institutional investment practices. It remains for Canadian regulators to provide interpretation and guidance with respect to existing fiduciary standards of prudence and loyalty to keep in step with current fiduciary practice.

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[196] *Supra* note 43.