Ethical Investment

By

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TABLE OF CONTENTS

I. INTRODUCTION 1

II. WHAT IS ETHICAL INVESTMENT 2

III. LEVEL OF SRI 3

IV. LEGAL ANALYSIS 5

A. AUTHORITIES PROHIBITING SRI 5

B. AUTHORITIES PERMITTING SRI 7

C. ANALAGOUS LEGAL PRINCIPLES 10

D. PROVISIONS OF PENSION LEGISLATION 12

E. INDUSTRY OR EMPLOYER SUPPORT CASES 14

F. CONCLUSIONS 16

V. IMPLEMENTING SRI 18

I. INTRODUCTION

At each of our previous annual conferences, the Panel has been asked a question about whether it is permissible for trustees of an employee-benefit plan to practise "ethical investment". Because of the time constraints, our answers have been short and consequently superficial. My sense is that this is a topic which continues, as it should, to be of interest and concern to trustees of pension and other employee-benefit funds.

The ability of trustees to adopt "ethical investment" criteria or approaches is usually given short shrift by lawyers, on the basis of one significant case authority from the United Kingdom. From a strict legal perspective, there are other authorities and lines of reasoning which support the prudent and responsible use of ethical criteria in investment by trustees in making investment decisions. Relevant statutory provisions must also be taken into account. As a result, in my view, the matter requires more discussion than it has received. However, trying to adopt in a prudent and responsible way an ethical approach to investing trust funds does give rise to a lot of issues, and I would surmise that many trustees would consider that the difficulties may outweigh the benefits.

My object in this presentation is not to propound the merits of ethical investment and the different approaches to it. There are many people who are more qualified than me to do that. Given the current state of the law, my aim is not to come to a definitive view as to whether it is permissible for trustees to invest with anything other than pure financial return in mind, but to lay out different legal arguments, all supported by authority, on this matter. Most of all, in the context of this conference, my emphasis is on exploring how trustees might tackle an issue such as this. I hope that this example and analysis may provide some guidance as to the way in which trustees should approach the performance of their duties generally.

The structure of this paper is as follows:

- Brief discussion of different approaches to "ethical investment" and the current status of such investment in Canada.

- Legal analysis

- Obstacles to overcome if considering adoption of an ethical investment policy.

II. WHAT IS ETHICAL INVESTMENT

In reviewing the literature one encounters a number of expressions. Socially responsible investment, socially conscious investment and ethically responsible investment are three. There are gradations of activism involved in different approaches. In reviewing these matters, one source I found helpful was a report (referred to in this paper as the "SIO Report") of the Social Investment Organization (a body headquartered in Toronto) entitled "Canadian Social Investment Review 2000 – A Comprehensive Survey of Socially Responsible Investme nt in Canada". (This report is available at www.socialinvestment.ca). I do not offer this as the last word on the topic, but it provides a framework for discussion and much more. The SIO Report uses the la bel "socially responsibly investment", and so I will use that label (and its acronym SRI) in this paper.

The SIO Report treats SRI as including these three concepts.[1]

"(a) Positive and negative screening. This is the application of social and environmental guidelines or "screens" to the investment process. Negative screens are criteria that exclude certain companies from investment portfolios based on such issues as tobacco, alcohol, gambling, pornography and military production, or companies with poor environmental records, or human rights and employee abuses such as sweatshop or child labour. Examples of positive screens are companies making a contribution to social, economic or environmental sustainability or industries with exemplary employee practices.

(b) Community Investment. This is the investment of money into community development or microenterprise initiatives that contribute to the growth and well-being of particular communities. The idea is to reverse the drain of capital and income that debilitate low-income communities.

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[1] Sio Report, at page 5

(c) Shareholder Advocacy and Corporate Engagement. This is the process of using shareholder influence to help to bring about corporate social and environmental change. This can include proxy voting (establishing policies for voting shares on social and environmental issues), corporate engagement (communicating with management on particular issues), shareholder resolutions (filing or supporting shareholder proposals on social and environmental issues) and divestment (selling of shares)."

These components run the gamut from the relatively passive (negative screening and divestment) to the activist (positive screening, community investment and corporate engagement). As a general proposition, trustees would find it easier to justify negative screening than to justify putting a substantial portion of their trust fund into community investment or into shares of one or two corporations for the purpose of trying to force management of those corporations to change certain aspects of their business.

The foregoing does not include elements that may be considered important in relation to employee benefit plans covering unionized employees: restricting investment in industries which compete with the industry in which the plan members are or were employed; restricting investment in non-union enterprises; or, going further, investing in corporations or projects in the particular industry covered by the plan for the purpose of preserving or creating employment.

III. LEVEL OF SRI

The SIO Report's main focus is on the level of SRI in mutual funds and institutional holdings, which the report found to be as follows (numbers as of June 30, 2000).[2]

" • $10.35 billion in retail investment funds. This includes $5.77 billion in assets of socially screened mutual funds and $4.58 billion in labour-sponsored venture capital funds that are members of the Alliance of Labour Funds.

- This includes pooled funds, segregated accounts and private stock portfolios subject to social and environmental screens. Total assets held by these companies (including accounts in screened mutual funds) are $14.3 billion. Most of this money is managed on behalf of institutional clients, including pension funds, endowments,

[2] SIO Report, at page 4

foundations, religious organizations and public institutions, such as hospitals and universities.

- $27.2 billion in assets of institutional investors managing their funds primarily or wholly in-house with regard to social or environmental screens.

- $1 billion in shareholder advocacy initiatives on social and environmental issues. This was comprised mostly of the 22 million shares voted in favour of the shareholder proposal on May 3, 2000 concerning Talisman Energy's activities in Sudan.

- $85 million in investments by locally-based community investment organizations, such as microloan funds.

- At $49.9 billion, socially responsible investment assets represent 3.2 per cent of the retail mutual fund market and the institutional investment market. This estimate is based on total mutual fund assets of $420.8 billion managed by members of the Investment Funds Institute of Canada and $1,132.7 billion managed by investment managers listed in the annual Benefits Canada survey (November, 2000) for total assets of $1,553.5 billion (June 30, 2000)."

(The SIO Report was conducted on the basis of voluntary responses by those money managers and institutional investors which chose to respond. The SIO did not extrapolate these results to non-respondents, and so the true picture may be somewhat higher.)

$50 billion is a significant amount of money, so it is difficult to dismiss SRI as a marginal activity. On the other hand, the SIO Report indicates that only 4% of "institutional" money is invested having regard to social or environmental screens. With respect to certain elements of SRI, it is obviously essential that only a small portion, if any, of a plan's assets would be devoted to the activity, eg. shareholder activism or community investment. By contrast, at the risk of stating the obvious, it does not make much sense to apply negative screening to only a portion of a fund. If it would not be repugnant to plan members to have some of the funds invested in the broadest universe of available investments, why would trustees or managers restrict investment for a portion of the funds? I have heard no case made that applying SRI to a portion of the funds is a necessary or prudent asset allocation technique. Accordingly, I view some techniques (e.g. negative screening) as an all or nothing approach, while others can (and I think must) be used, if at all, only on a partial or selective basis.

IV. LEGAL ANALYSIS

A. AUTHORITIES PROHIBITING SRI

Many people would consider the English case of *Cowan* v. *Scargill*[3] as the leading case on the factors which may influence trustees in investing the funds of an employee benefit plan. It concerned a pension scheme for the coal mining industry in the UK. The scheme had ten trustees, five appointed by the employer and five by the union. The union trustees proposed restrictions to the funds' investments, designed to reduce foreign investments and eliminate investments in "energies which are in direct competition with coal". (Much of the case contains reference to "French oil", which would have fallen afoul of both sets of restrictions.) The employer trustees refused to go along with the suggested restrictions, arguing that to do so would be in breach of their legal obligations. The employer also threatened that, if anything less than the most broadly based investment policy were adopted, it would discontinue the practice of making up any deficiency in income from the fund if that income did not suffice for increasing pensions in line with the rate of inflation.

The employer trustees commenced legal proceedings against the union trustees, claiming that the union trustees were in breach of their fiduciary duties by insisting on their proposed restrictions. The Judge who decided the matter, Vice-Chancellor Megarry, found that the union trustees were in breach of their duties by seeking to limit investment by reference to matters other than purely financial considerations. The judgment covers too much ground to discuss it fully in this paper. Perhaps the key holding by Vice-Chancellor Megarry was that, subject to unusual exceptions[4]:

> "… 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."

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[3] [1984] 2 All E.R. 750

[4] At page 762

He stated that this requires trustees to set aside their own views as to investment in certain countries or industries, and even the views of the beneficiaries. The judgment strongly implies that, even if a narrower range of investments chosen by reason of social or political views, or geography, produces as good a return or better than a broader range of investments, that would still technically be a breach of trust, although, in the words of the Judge,[5]

> "criticism would be difficult to sustain in practice, whatever the position in theory. But if the investment in fact made is less beneficial, then both in theory and in practice, the trustees would normally be open to criticism."

Cowan v. *Scargill* was cited as the authority for the following statement in a report on trustee investment powers (the "TIP Report") prepared for the British Columbia Law Institute by its Committee on the Modernization of the *Trustee Act.*[6]

> "As the law now stands in British Columbia, trustees are likely in breach of trust if they apply non-economic criteria in selecting investments, such as a policy of boycotting certain industries or securities of certain governments, and thereby obtain a lower level of return than would be the case if only economic considerations were used".

This statement recognizes that a positive outcome of such investments would not expose trustees to legal action, but that is cold comfort. Trustees who determine to operate under a negative screening approach will, on the basis of *Cowan* v. *Scargill*, only be immune from legal proceedings if the fund outperforms the alternatives. The TIP Report endorsed this approach and recommended that the law not change.[7]

> "There should be no change in the law regarding the application of non-financial criteria (e.g. ethical and philosophical criteria) for investment selection by trustees. Application of non-financial

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[5]At page 761

[6]TIP Report, at page 19

[7]At page 20

> criteria must be authorized by the terms of the trust if the trustees are to be excused from liability for obtaining a lower return than conventional financial investment criteria would produce.

B. AUTHORITIES PERMITTING SRI

Two cases, one each from the U.K. and U.S., take a broader approach than *Cowan* v. *Scargill.* In *Board of Trustees of Employee Retirement System of the City of Baltimore* v. *Mayor and City Councillors of Baltimore*[8], the City passed Ordinances requiring the pension funds covering the City's employees to disinvest from companies doing business in, or lending money to companies doing business in, South Africa. The disinvestment was to be over a period of time and could be suspended by the trustees on specified grounds, so that the process was a measured one. The trustees sought to have the Ordinances declared unconstitutional on a variety of grounds. The only ground relevant for personal purposes was that the Ordinances impaired the obligations of the beneficiaries' pension contracts with the City, in violation of the contract clause of the United States Constitution. The court agreed that the pension contracts incorporated the trustees' common law duties of prudence and loyalty, and assumed that if the Ordinances substantially altered those duties, then the Ordinances would be viewed as changing the obligations under the contract.

The trustees argued that the Ordinances altered the duty of prudence by radically reducing the universe of eligible investments, and the court agreed that the ordinances excluded a "not insignificant segment of the investment universe". However the court received and accepted evidence that the lowering of the rate of return to be expected from the disinvestment would only be about 10 basis point per annum, and the measured way in which the disinvestment was required to take place meant that the divesture program did not change the trustees' duty of prudence. The trustees also contended that the Ordinances altered the duty of prudence by mandating the consideration of social factors unrelated to investment performance. The court concluded that, if the cost of investing in

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[8] 562 A.2d 720 (Court of Appeals of Maryland, 1989)

accordance with the social considerations was *de minimis*, the duty of prudence would not be violated, which was the case in the matter at hand.

Finally the trustees contended that the Ordinances altered the duty of loyalty, because no longer would investment be made for the exclusive purpose of providing benefits to members and beneficiaries. Again the court held that the trustees would not violate 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 trustees ordinarily will not have transgressed" the duty of loyalty. In relation to that point, the court explicitly endorsed the view advanced by many that, by investing in businesses with a proper sense of social obligation, trustees will in the long run best serve the beneficiary's interest and most effectively secure the provision of future benefits.

In *Harries* v. *Church Commissioners for England*[9], the Church Commissioners (whom the court found were in the same position as trustees with respect to the funds in question) operated an "ethical investment" policy which among other things avoided investment in companies whose main business was armaments, gambling, alcohol, tobacco and newspapers. Certain commissioners sought to force a more "activist" approach by requiring adoption of an investment policy compatible with the promotion of the Christian faith, even if that involved the risk of incurring significant financial detriment. The court refused to direct the more activist approach. In doing so, however, the court, having quoted the investment policy, stated[10]:

> "It will be seen, therefore, that the commissioners do have an 'ethical' investment policy. They have followed such a policy for many years. Indeed, they have done so ever since they were constituted in 1948. Let me say at once that I can see nothing in this statement of policy which is inconsistent with the general principles I have sought to expound above".

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[9] [1993] 2 All E.R. 300

[10] At page 307

The court's "general principles" were as follows[11]. Though lengthy, they are set out in full since I suspect that proponents of SRI would find much in them to support their approach.

> "It is axiomatic that charity trustees, in common with all other trustees, are concerned to further the purposes of the trust of which they have accepted the office of trustee. That is their duty. To enable them the better to discharge that duty, trustees have powers vested in them. Those powers must be exercised for the purpose for which they have been given: to further the purposes of the trust. That is the guiding principle applicable to the issues in these proceedings. Everything which follows is no more than the reasoned application of that principle in particular contexts.
>
> Broadly speaking, property held by charity trustees falls into two categories … . Second, there is property held by trustees for the purpose of generating money, whether from income or capital growth, with which to further the work of the trust. In other words, property held by trustees as an investment. 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, whether by way of income or capital growth, which is consistent with commercial prudence. That is the starting point for all charity trustees when considering the exercise of their investment powers. Most charities need money, and the more of it there is available, the more the trustees can seek to accomplish.
>
> In most cases this prima facie position will govern the trustees' conduct. In most cases the best interests of the charity require that the trustees' choice of investments should be made solely on the basis of well-established investment criteria, having taken expert advice where appropriate and having due regard to such matters as the need to diversify, the need to balance income against capital growth, and the need to balance risk against return.
>
> In a minority of cases the position will not be so straightforward. There will be some cases, I suspect comparatively rare, when the objects of the charity are such that investments of a particular type would conflict with the aims of the charity. Much-cited examples are those of cancer research charities and tobacco shares, trustees of temperance charities and brewery and distillery shares, and

[11]At page 304

> trustees of charities of the Society of Friends and shares in companies engaged in production of armaments. If, as would be likely in those examples, trustees were satisfied that investing in a company engaged in a particular type of business would conflict with the very objects their charity is seeking to achieve, they should not so invest. Carried to its logical conclusion the trustees should take this course even if it would be likely to result in significant financial detriment to the charity. The logical conclusion, whilst sound as a matter of legal analysis, is unlikely to arise in practice. It is not easy to think of an instance where in practice the exclusion for this reason of one or more companies or sectors from the whole range of investments open to trustees would be likely to leave them without an adequately wide range of investments from which to choose a properly diversified portfolio."

In 1993 the Manitoba Law Reform Commission produced a report on Ethical Investment by Trustees. This involves an extensive discussion of a number of authorities, and is useful reading for those who desire a more in-depth analysis of those authorities. The report recommended that the *Trustee Act* be amended so as to provide that, where a trust instrument is silent concerning the use of non-financial criteria, the trustees should not be under a legal disability to consider non-financial criteria, provided that the predominant goal remains securing a reasonable financial return. Based on that recommendation, in 1995 the *Trustee Act of Manitoba* was amended to include Section 79.1 which provides:

> "Subject to any express provision in the instrument creating the trust, a trustee 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 if, in relation to the investment policy or investment decision, the trustee exercises the judgment and care that a person of prudence, discretion and intelligence would exercise in administering the property of others".

C. ANALAGOUS LEGAL PRINCIPLES

A number of cases under the statute which in this jurisdiction is now known as the *Trust and Settlement Variation Act*[12] (and equivalent statutes and other jurisdictions) have given a broader meaning to the word "benefit" than purely financial benefit. This statute

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[12] R.S.B.C. 1996, c.463

is a means whereby a trust can be varied, even in a manner inconsistent with the original intention of the settlor, if a sufficient number of adult beneficiaries agree and the court provides its consent on behalf of underage, unascertained and other beneficiaries. A court can generally only grant that consent on behalf of those groups if the proposed settlement is found to be for their "benefit". One would usually expect the courts to focus on financial benefit, and they do, but there are cases which strongly endorse a broader interpretation of the word benefit. One example is the English case of *Re Weston*[13]. A scheme was proposed that would have substantially reduced taxation of the trust and its beneficiaries, but would have required the beneficiaries to reside in Jersey, a tax haven. Undoubtedly, the scheme would have produced better financial results for the beneficiaries, but the court specifically stated that[14]:

> "The Court should not consider merely the financial benefit to the infants or unborn children, but also their educational and social benefit. There are many things in life more worthwhile than money."

This line of reasoning has been adopted in Canadian cases. See for example *Re Tweedie*[15] and *Re Ridalls*[16]. The Canadian case which is most often cited as containing the principles to be applied by the courts under the *Trust and Settlement Variation Act* is *Re Irving*[17]. After citing with approval cases which stated that "benefit" should be liberally interpreted and not confined to the financial benefit, Pennell J. propounded a three-part test for a court to assess the proposed variation, which test has been endorsed numerous times by subsequent decisions. The third part of the test is[18]:

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[13] [1968] 3 All E.R. 338

[14] At page 342

[15] (1976) 64 D.L.R. (3d) 569 (B.C.S.C.)

[16] (1983) 14 E.T.R. 157 (Sask. Q.B.)

[17] (1976) 11 O.R. (2d) 443

[18] At page 450

> "is the benefit to be obtained on behalf of those for whom the court is acting such that a prudent adult motivated by intelligence self-interest and sustained consideration of the expectancies and risks and the proposal made, would be likely to accept?"

This formulation does not suggest that a prudent adult motivated by enlightened (not venal) self-interest and sustained consideration would look exclusively to the financial aspects of the proposal.

I can anticipate arguments that the *Trust and Settlement Variation Act* empowers the court to determine benefit on a broader basis, but that trustees who exercise investment powers should not be accorded at the same latitude, so that the authorities cited in this Section C should not be applied to trustees. I find that hard to accept. Why should trustees not be able to invest in a manner which the beneficiaries, if acting prudently with respect to their own property, could themselves choose? It is appropriate to allow trustees to equate, as *Re Irving* does, the benefit of the beneficiaries with what the beneficiaries would themselves do if acting in a prudent and informed manner.

D. PROVISIONS OF PENSION LEGISLATION

The provisions of the various pension legislation are obviously relevant to the investment funds subject to their jurisdiction. Section 44 of the *British Columbia Pension Benefits Standards Act* ("B.C. PBSA") provides in part:

> "(1) Pension plan investments, loans and other pension plan financial decisions must be made in accordance with this Act and the regulations and in the best financial interests of plan members, former members and other plan beneficiaries.
>
> (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."

Section 41 of the *Alberta Employment Pension Plans Act* ("EPPA") provides:

> "Assets of a pension plan must be invested, and the investments must be made, in accordance with the regulations and in a manner that a reasonable and prudent person would apply to the plan's portfolio of investments having regard to the plan's liabilities."

Section 8(4.1) of the *Federal Pension Benefits Standards Act* ("Federal PRSA") provides:

> "The administrator shall invest the assets of a pension fund in accordance with the regulations and in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund."

It will be noted that alone of these, the B.C. PBSA makes explicit reference to the "best financial interests" of members etc. This provision is to be read in conjunction with, not in opposition to, the general duties set out in section 8.5 of the B.C. PBSA:

> "In the administration of a pension plan, the administrator must
>
> (a) act honestly, in good faith and in the best interests of the members and former members and any other persons to whom a fiduciary duty is owed, and
>
> (b) exercise the care, diligence and skill that a person of ordinary prudence would exercise when dealing with the property of another person."

This provision is a statutory codification of the common law principles applicable to trustees. All the cases cited above accept that "best interests" means "best financial interests", while all but *Cowan* v. *Scargill* accept that best financial interest can be consistent with respecting non-financial values, if investments are made prudently and in a measured way. There is no reason to read section 44 as changing that.

If, however, the purpose of including the word "financial" in section 44 of the B.C. PBSA was to do more than codify the common law and instead to prohibit the use of non-financial criteria, than British Columbia is out of step with other jurisdictions. The *Pension Commission of Ontario* articulated the position in 1992, in response to the question "is it imprudent for a pension fund to take the position that it will only make "ethical" investments?", that "ethical" investing (which was not defined) is permitted, but

the fund's Statement of Investment Policies and Goals must include the criteria for such investment. The PCO further suggested that the members should be notified of this[19].

In the U.K. matters have gone further. The Statement of Investment Principles is now by regulation required to contain discussion of the following considerations:

- the extent (if at all) to which social, environmental or ethical considerations are taken into account by trustees in the selection, retention and realization of investment; and
- the policy (if any) directing the exercise of the rights (including voting rights) attaching to investments.

These requirements do not compel ethical investment, but do require funds to disclose to what extent they practice SRI or if they do not. Contrary to *Cowan* v. *Scargill*, this is an implicit statutory endorsement that pension funds can consider ethical investment, and an explicit statutory requirement that they must consider and address the extent to which they should do so.

E. INDUSTRY OR EMPLOYER SUPPORT CASES

I should say a little about two U.S. cases which are cited in connection with these discussions. Both were cited in *Cowan* v. *Scargill.* In *Blankenship* v. *Boyle*[20], action was brought against the trustees of the UNWA Welfare and Retirement Fund. The court found that the trustees had, among other wrongdoing:

- conducted all the fund's banking with a bank controlled by the union, allowing substantial amounts (44% of the fund value) to accumulate in interest free accounts and thereby be available for use by the union;
- purchased large quantity of shares and electrical utilities in the hope of gaining sufficient influence to pressure them into buying union mined coal.

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[19]See PCO Bulletin, February, 1992

[20]329 F.Supp. 1089

These were found to be breaches of trust. The court clearly perceived that the trustees' motivation was to advance the union's interest, while ignoring their primary obligation to the plans members, even though 95% of the members belong to the union. Vice Chancellor Megarry in *Cowan* v. *Scargill* cited this case to support the duty of undivided loyalty owed by trustees to beneficiaries, so that in his words, regard should not be paid to the union, its members, or the industry as a whole when making investment decisions.

A subsequent case, *Withers* v. *Teachers Retirement System of the City of New York*[21], concerned the investment by the Defendant TRS of $860 million (in 1975 dollars) in speculative bonds issued by New York City to stave off bankruptcy. The Court upheld the investment, deciding that its primary motivation was preserving the fund, the continuing contributions to the City to which were vital, rather than preserving the jobs of the teachers. TRS had acted prudently by insisting on various safeguards.

If a pension plan were anywhere close to fully funded, I have a hard time seeing how a court would endorse risking the funds by reinvesting them in the employer or the industry for the purpose of job creation of preservation. Either the employer/industry can get financing elsewhere, in which case the fund should diversify, or the employer/industry can only raise financing from the plan, in which case the investment is exceptionally risky. Even if the plan is not fully funded and future wages are at risk, why risk the past accumulation of funds set aside for retirement benefits?

In British Columbia, there has been at least one high profile case of "industry support" which did not turn out well. A substantial portion of the assets of a pension plan for some of the workers in the building trades was invested in various land development projects. Part of the motivation appears to have been to provide work for union members. Some of the investments did not work out and the plan was left with a very substantial deficit, and was accordingly required to reduce benefits materially.

[21] 447 F. Supp. 1248

Cases of this kind demonstrate the dangers of trustees acting with mixed motives. Those motives were effectively characterized in *Blankenship* as a conflict of interest. The traditional legal view is that trustees should not be allowed to act with mixed motives, because it is impossible afterwards to determine whether the proper or improper motive led to a particular decision. Courts prefer to prohibit a trustee from acting with mixed motive than to allow for such motives and later assess whether the appropriate motive carried the day. It is for this reason that I doubt trustees could safely adopt a more activist approach, and push for shareholder engagement or positive screening, but I see no reason to worry about trustees' motivations in a negative screen or disinvestment situation. Vice Chancellor Megarry's mechanical application of *Blankenship* in *Cowan* v. *Scargill* misses this important difference.

The "industry support" cases really fall (or should fall) under a different set of rules. Both the B.C. PBSA and the EPPA require investments to comply with the Federal PBSA, which sets out prohibitions on transactions between pension funds and any "related party". Related parties include any participating employer or any union representing employees of the employer. Loans to, investments in or transactions with a related party are all prohibited by section 16 of Schedule III of the Regulations under the Federal PBSA, subject to certain limited exceptions which are set out in section 17 of Schedule III. These include the cases where the transaction is required for the operation or administration of the plan, where the investment is in publicly traded securities, or where the transaction is immaterial to the plan. Even then, the investment must be prudent, and courts typically apply a heightened standard of prudence if there is any element of self-dealing.

F. CONCLUSIONS

My starting point is the constant articulation in the cases of the principle that trustees must not pursue, through the way they invest, objects other than the best interests of the plan members. This principle means that all investments must be assessed prudently in terms of their financial returns. Investments aimed primarily at promoting job creation, growth of a union or social objects are viewed as unacceptable under nearly every legal

authority. This makes it very difficult for trustees to justify adopting some of the more activist manifestations of SRI, such as community investment (unless the investment can be justified in purely economic terms) or shareholder activism.

I am concerned that even positive screening would create difficulties for trustees. As I understand it, positive screening involves establishing criteria and then investing in those companies in each industry segment which do the best job of meeting those criteria. This gives rise to at least two concerns. First, the purpose of this approach is to reward those companies that do a better job of meeting the criteria, presumably in the hope that in time the greater popularity of their investments will encourage their competitors to emulate them. This attempt at behaviour modification seems to involve the kind of ulterior purpose on which the courts have traditionally frowned. Secondly, the result would be to concentrate investment in only certain companies within a particular segment. Proponents of that approach may justify this by saying that in the long term these companies should prosper because their social responsibility will keep them out of trouble and strengthen them. This is by no means certain to happen, and such companies could founder for other reasons. Concentrating investment in this way could produce insufficient diversification and lead to portfolio losses.

I see more scope for the adoption of negative screening by employee benefit funds. As discussed above, the concept of benefit is broad enough to include non-financial factors. I can imagine that pension plan members would not consider it a benefit to have a marginally higher pension if that marginal increase had been won by investing in companies which produce products that do harm, employ workers overseas and treat them badly, or cause environmental damage. Unionized workers may oppose investment in companies which oppose unions. Is it wrong for trustees to ask themselves whether such things matter to their members, and if they do, to consider whether it is possible to generate an appropriate level of return while steering clear of such investments?

The most ardent capitalists can (and do) determine not to invest in a particular company or industry for ethical reasons. A company which manages its company-sponsored defined benefit pension plan could introduce a negative screen and take the financial risk

of having to increase funding in the future if reduced investment returns are the result. A trustee or a plan member can invest his or her own funds in a socially responsible manner. Why should such investment become impossible, simply because the trustee and the beneficiary are put together in a trust? The trust is not a tyrannical or inflexible legal institution that cannot accommodate a course of action if the trustees and beneficiaries agree on it, particularly when every other investor is free to practice the approach, as many investors obviously do.

V. IMPLEMENTING SRI

Based on the foregoing, I believe there is adequate legal support for trustees to adopt SRI using a negative screen. In Canada, the matter has yet to be resolved, so I am unable to state definitively that trustees will be safe in adopting such an SRI policy provided they do so with prudence and care. Trustees who adopt an investment policy with prudence and care, and with the best interests of the beneficiaries as their motivation, would ordinarily avoid any liability even if the investment policy turned out to be less successful than some alternatives. I have only two reservations in concluding that the ordinary rule would apply. First *Cowan* v. *Scargill* places an unnecessary restriction on what can be perceived to be in the best interests of the members. Secondly, the introduction into section 44 of the B.C. PBSA of the word “financial” may be seen as limiting the factors that can be taken into account. As explained above, the use of the word financial only reflects the common law position.

Assuming trustees were minded to consider implementing an SRI policy, the following are some of the steps that I think they must take in order to demonstrate the necessary level of prudence and care. I make these observations only in the context of a negative screen, since in that case it is difficult to see how the issue of mixed motives can arise. I do not intend these comments to be extended to the more activist forms of SRI.

(a) The decision to adopt SRI must be fully analysed, thought out and supported as being in the best interests of the plan members and involving no material risk of a

poorer financial outcome. In *Martin* v *City of Edinburgh District Council*[22], the Council, which held various funds in trust, resolved to dispose of all securities of companies having links to South Africa. It was alleged that the Council acted in breach of trust. The court found that the Council had not turned its mind to the best interests of the beneficiaries but had acted on its own political beliefs. Accordingly, they were found to have breached their trust because they had not given consideration to their primary obligation, the best interests of the members. It is therefore essential that a proper process be followed, taking into account at least the following steps.

(b) Clear and thorough investment advice must be obtained on the historical returns (and to the extent possible, the prospective returns) from the range of permitted investments remaining following application of the proposed screen. It must be clear that such return is not materially less than could be obtained from a broader universe of investments. I have refrained from attempting in this paper to compare returns on "ethical funds" with returns on other funds. It is apparent to me that to do a proper job of that would require a lot of detailed analysis (much of which is beyond my capability) in order to ensure accurate comparisons. In addition, the timing of any snapshot of investment returns can be critical. The Domini Social Equity Fund in the United States claims to be "the established benchmark for measuring the impact of social screening on financial performance". (See their website at www.domini.com). Up to May, 2000, it claimed to have outperformed the S&P 500 in each of the five previous years, and by 5% per annum in each of the three previous years. However, by December, 2000, its three year, five year and longer numbers were marginally below the S&P 500, and for 2000, it was off by 15%, whereas the S&P 500 was down 9%.

Accurate measurement of the different rates of return over the appropriate timeframe is essential before embarking on any particular investment policy.

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[22] [1988] SLT 329

Before adopting a screen, the trustees would have to have an accurate measure of the financial impact of that screen. In addition, it would be essential to have discussed the change in investments with the plan's actuary, to determine whether the actuary would consider, in light of the investment policy, that a different assumption should be made about future investment rates of return in the plan.

(c) It would be highly desirable (perhaps necessary) to implement any SRI policy gradually, in two respects. Assuming an SRI policy is implemented, any resulting divestments should be handled gradually, so to average the exit cost and the cost of acquiring replacement securities.

Trustees would be well advised to inform their membership and gauge their reaction. If the members do not want SRI, then trustees should not force it on them. If the proposal is well received, then the trustees should feel encouraged to proceed with it. It is possible that such a proposal would generate a small amount of vocal opposition, which the trustees might not consider representative. In that case, the trustees might consider a more proactive canvass of members generally, in order to try and gauge the general feeling. I do not suggest, as did Vice Chancellor Megarry in *Cowan* v. *Scargill*, that such a policy could only be adopted with the unanimous consent of all the beneficiaries. In an employee benefit plan that level of consensus could never be achieved.

(d) Any change in the investment policy of a pension plan must be reflected in the Statement of Investment Policies and Goals.

(e) Trustees should consider whether they should seek an amendment to their trust instrument to include a specific authority to adopt an SRI policy. The TIP Report stated that the application of non-financial criteria must be authorized by the trust instrument. Including such a provision in the trust instrument in no way lessens the requirement that the trustees act prudently and carefully. I do not see how amending the trustee to provide this latitude could harm the trustees, always assuming that the power of amendment permits that.

If such an amendment were adopted in respect of a plan subject to the B.C. PBSA, it would have to be registered with the Superintendent of Pensions. The Superintendent is known to have concerns about the possible erosion of pensions as a result of the adoption of an SRI policy. She may be concerned that the inclusion in section 44 of the word "financial" would limit her ability to accept an amendment of this kind. I would think, however, that if the appropriate work has been done to satisfy the above conditions, it should be possible to demonstrate to the Superintendent that no harm is likely to result from adopting a negative screen. If it is not possible to demonstrate that, then the trustees should not be adopting the SRI policy in the first place.

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