Institute for Sustainable Finance

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SUSTAINABLE FINANCE PRIMER SERIES:

Fiduciary Duty, Climate Change and ESG Considerations

WHAT IS FIDUCIARY DUTY?

The concept of *fiduciary duty* is defined differently, if in fact the specific term is identified at all, in different countries around the globe. However, across numerous jurisdictions, the following duties are among the two most important and frequently referenced that apply to investment decision makers:[1]

- **Loyalty:** Fiduciaries should act honestly and in good faith in the **interests of their beneficiaries,** should impartially balance the conflicting interests of different beneficiaries, should avoid conflicts of interest and should not act for the benefit of themselves or a third party.
- **Prudence:** Fiduciaries should act with **due care, skill and diligence,** conducting activities such as investing as a 'prudent person' would.

From a regulatory framework, the concept of *fiduciary duty* is most commonly reflected in the duties of corporate Directors and Officers (including those in not for profit organizations), pension fund regulations, stewardship codes for managers of assets, trusts and estates, as well as in appropriate banking and insurance regulations. For example, the Supreme Court of Canada has stated:

> *"Every director and officer of a corporation in exercising their powers and discharging their duties must exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."*
>
> (SCC, Peoples, BCE)

WHY DISCUSS FIDUCIARY DUTY AND CLIMATE CHANGE?

The understanding of *fiduciary duty* by corporate directors and officers shapes the very nature of corporate behaviours and investment practices. As such, providing clarity on the proper interpretation of *fiduciary duty* has the potential to significantly affect current and future investment decisions, thus impacting how our economy will evolve. For example, a redefinition of *fiduciary duty* for institutional investors during the 1990s changed the face of the investment landscape, transforming large pensions from boring, passive investors in government bonds and treasury bills, to significant players in public equity markets, and eventually in hedge funds, private equity, real estate and infrastructure. Learn more

Until recently, many actions and investments have been based on the premise that environmental, social and governance (ESG) factors, including climate change, are either immaterial or irrelevant and should not detract from other considerations – in summary, they were not viewed as 'risk factors' when evaluating an investment. However, incorporating ESG considerations is fast becoming the investment norm. For example, by December 2020, the Principles for Responsible Investment (PRI) had grown to over 3,000 signatories, representing over **$100 trillion,** and the list continues to grow. One of the motivating factors for the PRI's growth is the fact that investors have come to realize that ESG matters, including climate change, are **financially material.** As such, they must be considered when assessing investment opportunities and must be incorporated in risk management processes. Ignoring these considerations has

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increasingly led to legal risks. For example, the Royal Bank of Canada's 2020 Responsible Investment Survey of 809 global institutional investors and investment consultants found that 75% of those surveyed integrate ESG factors into their investment decisions, and that 63% did so because they believed it was a component of their fiduciary duty. The recognition that ESG and climate change are relevant risk factors will create added pressure for companies to provide more comprehensive and standardized ESG and climate–related disclosures. Learn more

In short, clarification regarding the importance of including ESG and climate change within the scope of *fiduciary duty* will have a direct impact on the **amount** of the $100 trillion or so of global investable assets that integrates these considerations, as well as improving the **quality** of the resulting investment and business decisions.

WHAT IS HAPENNING IN THE REGULATORY LANDSCAPE?

Since 2013, Australian rules require that the investment strategies of pensions must demonstrate how ESG factors have been considered, even when they may not be quantifiable. Since 2015, the *Korean National Pension Services Act* requires pensions to consider ESG issues and provide declarations regarding the extent to which such issues have been taken into account.

The EU issued a directive in 2016 dictating that appropriate governance required that ESG factors be incorporated into investment decisions, while 2019 proposals advocate required disclosures regarding policies related to sustainability. Revisions to UK regulations that were implemented in 2019 clarified that consideration of ESG factors is a component of prudent investment decision making, and is therefore required by pension trustees.

The U.S. provided guidance on ESG issues in a 2018 bulletin that essentially says that when ESG considerations are material, they should be treated similarly to other material economic factors that could be expected to affect risk and return levels. In November 2020, the Department of Labour issued additional ERISA guidance, which generated significant opposition from many participants in the investment industry. The new rules made it clear that ESG considerations should only be considered if they could be proven to be "pecuniary" – in the sense that such considerations would have a material impact on the fund's risk-return profile. Essentially this regulation would require funds to justify the materiality of incorporating ESG integration into their investment process, and it would also make it difficult (i.e., virtually prohibitive) for funds to include ESG-themed investments in the portfolio (unless they can clearly justify such investments on a risk-return basis).

In Canada, as of 2016, *Section 78(3) of the Ontario Pension Benefits Act* requires: "that a statement of investment policies and procedures include a statement about **whether environmental, social, and governance (ESG) factors are incorporated** into the plan's investment policies and procedures, **and if so,** how they have been incorporated." More recently, the Office of the Superintendent of Financial Institutions (OSFI) released a consultation paper regarding climate-related risks and the financial sector (Discussion paper: Navigating Uncertainty in Climate Change: Promoting Preparedness and Resilience to Climate-Related Risks). With respect to its oversight of federally regulated financial institutions (FRFIs) and federally regulated pension plans (FRPPs), the paper notes that while "OSFI's current guidance does not reference climate-related risks specifically, it includes principles and expectations that are relevant to FRFI's (FRPPs) management of these risks." In other words, while climate-related considerations may not be specifically identified in current legislation, if they are relevant, they should be addressed, as would be the case for any other relevant factors.

WHAT IS THE ROLE FOR FIDUCIARY DUTY IN PROMOTING SUSTAINABILITY?

As can be seen from the examples noted above, global policy and regulatory frameworks currently range from strong to weak in terms of the requirements to incorporate ESG and climate change considerations. However, exluding the November 2020 U.S. announcement, the overall movement is towards further strengthening of the interpretation of the role of these considerations in *fiduciary duty*. Such integration is a **necessary, but not a sufficient, condition** to adequately shift the required amount of resources towards sustainable investments and business decisions. In other words, fiduciary duties are evolving to require consideration of how sustainability issues affect the investment decision, but not necessarily how the investment decision affects sustainability.

Other non-regulatory developments are also providing insight as to the direction of expanding the 'scope' of *fiduciary duty*. For example, in August 2019 a statement was released by the Business Roundtable regarding the Purpose of a Corporation. This statement was signed by 181 of the largest U.S. CEOs, who committed to lead their companies for the benefit of all "stakeholders" – i.e., customers, employees, suppliers, communities, and shareholders. This represents a significant shift from the pre-existing emphasis on shareholder interests, which is consistent with existing U.S. fiduciary regulations.

Carol Hansell of Hansell LLP recently published a legal opinion indicating that Canadian directors are obligated to consider climate change risks and opportunities relevant to the companies of which they sit on the board. Her analysis iterates the need for directors to ensure that, where material, management must develop strategies to address both climate change risks and opportunities. A failure to do so could facilitate legal liability, not dissimilar to any other kind of risk.

The Canadian Expert Panel on Sustainable Finance emphasized the critical role that is played by the definition of *fiduciary duty*, as well as its interpretation by market participants. In particular, Recommendation #6 of the final report states: "Clarify the scope of *fiduciary duty* in the context of climate change." We agree with the Expert Panel that this represents an important step in moving the needle forward for sustainable finance in Canada.

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[1]Source: Page 12, Fiduciary Duty in the 21st Century (UNEP Finance Initiative)

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