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Responsible Investing: Access Denied

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RESPONSIBLE INVESTING:

ACCESS DENIED

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DEDICATION

This thesis is dedicated to:

- All my former retail investor clients who wanted to invest responsibly but could not due to the lack of available product
- My parents, who are also former clients, who encouraged me throughout the LLM
- Professor Sara Seck, for her incredibly beneficial assistance as my thesis supervisor, through the LLM thesis writing process
- Professor Meinhard Doelle, for his immensely valuable feedback in reviewing my thesis
- Professor Kim Brooks, for examining the thesis

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ABSTRACT

Retail investors are increasingly demanding responsible investments. Retail investors also require the services of an advisor. Many responsible funds may not be responsible. This is due to many factors, including incomplete disclosures, and lack of financialization of risks. The thesis shows that traditional mutual funds, while structurally able to provide responsible investments, have not provided responsible holdings to mass affluent clientele. Institutional investors, and wealthy retail investors, have options to avail themselves of responsible investments; mass affluent investors have less choice to invest responsibly. The thesis recommends enhanced material disclosures and financial valuation models to better identify responsible investments. Advisors and investors do not have access to the majority of responsible investments, nor are advisors properly trained or compensated to provide advice on these products. Regulatory changes to advisor licensing and advisor training are recommended to address these problems, to provide mass affluent investors with better access to responsible investments.

CHAPTER 1: INTRODUCTION

1.1 General Introduction

Most individuals in the developed world have privileges not available to those in the developing world. At the same time, most people in the developed world are not rich. The reality is that the vast majority of individuals are characterized as 'middle income' earners. They have jobs which afford them good incomes, but they are by no means wealthy. These individuals are known as the "Mass Affluent" retail investor.[1] This is in contrast to the High Net Worth retail investor, who has greater wealth.[2] Many individuals in the developed world have a safety net in the form of government sponsored pension plans.[3] These plans are not designed to fully fund their retirements, nor do they help to save or invest for other purposes, such as a new home, a car, education for their children, or a vacation. While government pension plans were developing, many large companies also offered company pension plans. This was during an era where the

[1] Rob Garver, "Banks Try, Try Again to Woo the Mass Affluent" (2010) 10 American Banker 10-14. The precise definition of mass affluent is not very important to the thesis. Some definitions, puts the range of investable assets of $50,000 - $1,000,000. Other sources, such as PWC's *Strategy&, Wealthy, Young & Ambitious: How banks can profitably serve the rising mass affluent* (PwC/Booz & Company, 2013) online at: https://www.strategyand.pwc.com/media/file/Strategyand_Wealthy-Young-and-Ambitious.pdf state that it is $250,000-$1,000,000. The author believes the correct number is $50,000-$1,000,000. The important note is that they have money to invest, they need retirement help, both financially and structurally, and that most importantly, they are not considered high net worth, or in Securities Law terms "Accredited Investors". The first category would maximize the number of potential investors, especially as it would capture younger investors who may care more about RI than older investors.

[2] High net worth investor, who can access the Accredited Investor exemption; see Chapter 5 for a description on Accredited Investor. Accredited investors are not to be confused with sophisticated investors.

[3] For example, in Canada, The Canada Pension Plan (CPP) provides contributors and their families with partial replacement of earnings in the case of retirement, disability or death. See Government of Canada, Canada Pension Plan – Overview, online at: https://www.canada.ca/en/services/benefits/publicpensions/cpp.html accessed April 18, 2018. The USA equivalent is the social security system. See https://www.ssa.gov/benefits/retirement/ accessed April 18, 2018. Norway, Sweden, UK, Japan and others have similar systems.

retirement period was very short, only a few years.[4] Today, retirement for people in the developed world can be twenty five years or longer.[5] Companies today are either moving away from these pension plans, or switching them to plans less favourable to the middle income person.[6] Mass Affluent investors, on average, must personally save for their retirements. Together, the government pension plans account for approximately 1/3 of a person's retirement income, whereas 1/3 would come from a work/company pension plan, and 1/3 from their own savings.[7] Many, including small business owners and other self-employed people, do not have access to the CPP or to an employer pension plan and must invest solely in retail products to fund their retirements.

Most individuals are unskilled at creating a financial plan and require the services of a financial advisor.[8] The financial services, mutual fund, and investment industry

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[4] William Graebner, *A History of Retirement: The Meaning and Function of an American Institution, 1885-1978* (New Haven, CT: Yale University Press, 1980). See also Kenneth S. Shultz & Mo Wang, "Psychological Perspectives on the Changing Nature of Retirement" (2011) 66:3 American Psychologist 170 –179

[5] *Ibid at 172*

[6] Ian Genno, "There's more to pensions than defined benefit versus defined contribution" (2006) 19:3 Canadian HR Reporter 14-19; see also John Kilgour, "Public Sector Pension Plans: Defined Benefit Versus Defined Contribution" (2006) 38:1 Compensation & Benefits Review 20-29 This thesis is not designed to be a comparison of one plan versus another. The point is that individuals, many if not most of whom are Mass Affluent would have different inputs to investment selection in a DC plan as opposed to a DB plan. Most DC plans have a mix of standard mutual funds, or institutional versions of these funds. DB plans are more difficult, for the most part, to know what is being invested. As such, access to RI, as will be shown, will differ.

[7] Sun Life Financial Inc. *Retirement Now Report* (Toronto: Sun Life, 2016) at 7; see also Treasury Board Canada, Sources of Retirement Income, online at: https://www.canada.ca/en/treasury-board-secretariat/services/pension-plan/plan-information/retirement-income-sources.html ; for the US Context, see Emily Brandon, "The Top 10 Sources of Retirement Income" Press Release (13 May 2014) US News, online at: https://money.usnews.com/money/blogs/planning-to-retire/2014/05/13/the-top-10-sources-of-retirement-income, and Standard & Poor's ("S&P") "How Much Do you Need to Retire", online at: http://fc.standardandpoors.com/sites/client/wfs2/wfs/article.vm?topic=6065&siteContent=8365 Retirement vehicles include RRSPs, TFSAs, 401(k), IRAs, etc.

[8] Kevin Dorey, "When do you need a financial advisor?" News Release (1 February 2017) Chronicle Herald, online, accessed from http://ezproxy.library.dal.ca/login?url=https://search-proquest-com.ezproxy.library.dal.ca/docview/1863911710?accountid=10406 April 18, 2018; see also Meryl Landau, "Do You Need a Financial Adviser?" News Release (1 September 2011) *U.S. News & World Report,* accessed via *ProQuest*; see also "Do Mom and Dad need a financial adviser?" (2014) 10;29(10) Work & Family Life 4; W.S. Hersch, "Use of alternative investments rising among the affluent" (2014) Life Health Pro 1; There are "Do it yourself" investors and investment platforms, such as RBC's Direct Investing, or

supports over 192,000 jobs.[9] There is over $1.27 Trillion in invested mutual funds in Canada alone.[10] Without the retail investment industry, most individuals would not have the access or the abilities to invest for their goals.

Many Mass Affluent investors want to be able to invest for retirement (or other purpose), make a substantial return on their money, and do so in an ethical, environmentally friendly, and responsible manner.[11] This type of investing is known as either Socially Responsible Investing ("SRI") or Responsible Investing ("RI"). SRI places responsibility above profit, and is concerned with religious, "ethical" or non-quantifiable idiosyncratic factors.[12] RI places profit and responsibility at an equal footing. Impact investing, a subtype of RI, is generally defined as "targeted investments, typically made in private markets, aimed at solving social or environmental problems" and is included within the broader RI definition.[13] Non-RI only considers financial measures in portfolio analysis. Inconsistencies abound in the literature as many RI studies still use the broader SRI terminology. Richardson notes that "there is no authoritative definition of SRI (sic)."[14] While there is no universally accepted single definition of RI, the various RI associations have compiled a list of generally accepted classifications.[15] They include:

Scotiabank's iTrade. However most mass affluent, and even most HNW individuals either cannot or do not want to use these platforms.

[9] *Ibid*

[10] *Ibid*

[11] Benjamin Richardson, *Socially Responsible Investment Law: Regulating the Unseen Polluters* (New York: Oxford University Press, 2008)

[12] *Ibid* at 73

[13] Global Sustainable Investment Alliance, *2016 Global Sustainable Investment Review*, online at: http://www.gsi-alliance.org/members-resources/trends-report-2016/ accessed July 21, 2018 at 4

[14] Benjamin Richardson, "Socially Responsible Investing for Sustainability: Overcoming Its Incomplete and Conflicting Rationales" (2013) 2:2 Transnational Environmental Law 311–333 at 313

[15] Global Sustainable Investment Alliance, *supra* n 13. The GSIA is an alliance of various RI associations, including the Canadian Responsible Investment Association, the US Social Investment Forum, the UK Social Investment Forum, Eurosif (the European Social Investment Forum, the VBDO (the Dutch

- Negative/exclusionary screening: the exclusion from a fund of certain sectors, companies or practices;
- Positive/best-in-class screening: investment in sectors, companies or projects selected for positive Environmental, Social & Governance ("ESG") performance relative to industry peers[16];
- ESG integration: the systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis;
- Sustainability themed investing: investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture);
- Impact/community investing: solving social or environmental problems, where capital is specifically directed to traditionally underserved individuals or communities
- Corporate engagement and shareholder action: the use of shareholder power to influence corporate behavior[17]

The long held belief is that the sole responsibility of business is to maximize profit.[18] Sustainable Finance is a new and rapidly developing field of interdisciplinary research that seeks to change this notion. "The concept of sustainable finance seeks to align the goals of sustainable development and the incentives of actors in the global financial system."[19]

1.2 Literature Review as a Historical Narrative

SRI was first created in the 1700s, and in its original form, was used almost exclusively for religious reasons.[20] It began with "idiosyncratic, faith-based investors who wished to avoid bankrolling sin stocks, such as companies peddling alcohol or gambling."[21] The main drivers at this time were the Quakers, who waged an anti-slavery

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Association of Investors for Sustainable Development), online at: http://www.gsi-alliance.org/alliance-members/ accessed July 25, 2018

16 ESG will be detailed in next section

17 Global Sustainable Investment Alliance, *supra* n 13 at 7

18 Milton Friedman, "The Social Responsibility of Business is to Increase its Profits" News Article (13 September 1970) *New York Times*, SM17

19 Stephen Kim Park, "Social Bonds for Sustainable Development: A Human Rights Perspective on Impact Investing" (2018) 0:0 Business and Human Rights Journal 1-23 at 13

20 Steve Schueth, "Socially Responsible Investing in the United States" (2003) 43:3 Journal of Business Ethics 189-194

21 Benjamin Richardson, *Socially Responsible Investment Law, supra n 11* at 74

campaign in the 1700s.[22] In 1948, UK church investors established certain exclusionary criteria for their investments.[23] SRI still exists but is focused on religious or 'ethical' norms, and is less focused on a firm's profit.[24] Studies indicate a willingness of these investors to support ethical investing even if it underperforms the market.[25] The sanctions against the apartheid regime in South Africa, for example, were prompted by ethical concerns, rather than profit concerns.[26] "Modern" ethical investing evolved in the 1960s.[27] It began to encompass broader social and human issues.[28] The environmental movement took a step forward with the creation of the United Nations Environment Programme, which as affected the evolution of investing.[29] Environmentalism took another step forward with the creation of the UNEP Finance Initiative, ("UNEP FI") launched in 1992.[30]

The Social Investment Forum ("SIF"), the prevailing US based responsible investing organization, lists screens, shareholder advocacy, and community investing as

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[22] *Ibid* at 112

[23] Russell Sparkes, *Socially responsible investment: a global revolution* (England: Wiley, 2002)

[24] William Dilla, Diane Janvrin & Jon Perkins, "Investor views, investment screen use, and socially responsible investment behavior" (2016) 7:2 Sustainability Accounting, Management and Policy Journal 246-267

[25] Geoffrey Williams, "Some Determinants of the Socially Responsible Investment Decision: A Cross-Country Study" (2007) 8 Journal of Behavioural Finance 43-57 at 43

[26] Benjamin Richardson & Wes Cragg, "Being Virtuous and Prosperous: SRI's Conflicting Goals" (2010) 92 Journal of Business Ethics 21–39 at 22

[27] Benjamin Richardson, *supra* n 11 at 75

[28] Russell Sparkes, "A Historical Perspective on the Growth of Socially Responsible Investment" in Rodney Sullivan & Craig Mackenzie, (eds) *Responsible Investment* (Sheffield: Greenleaf, 2006) at 39

[29] Maria Ivanova, "Institutional design and UNEP reform: historical insights on form, function and financing" May (2012) 88:3.International Affairs 565-584. See also, UNGA (A/RES/2997 (XXVII), 19 Jan. 1973); Held in Stockholm, Sweden in 1972, this conference revolutionized international environmental law. See Martin Mattes, "The U.N. Environment Programme" (1975) 1:2 *Environmental Policy and Law* 53-70

[30] UN Environment Programme Finance Initiative, *Background*, online at: http://www.unepfi.org/about/background/ accessed February 27, 2018; see also United Nations, *Rio Declaration on Environment and Development*, UN Doc. A/CONF.151/26 (vol. I); 31 ILM 874 (1992); *United Nations Framework Convention on Climate Change* 1771 UNTS 107; S. Treaty Doc No. 102-38; U.N. Doc A/AC.237/18 (Part II)/Add.1; 31 ILM 849 (1992); SJ Fowler & C. Hope, "A critical review of sustainable business indices and their impact" (2007) 76:3 Journal of Business Ethics 243–252

important SRI criteria.[31] There are two screening techniques typically adopted. The first, the "Positive Screen", includes only companies that have positive influences.[32] These influences may be based on hiring practices, production of renewable energy or a number of other factors.[33] The second, the "Negative Screen," eliminates undesirable companies and/or industries.[34] These screens exclude companies in abortion, adult entertainment, alcohol, animal testing, contraceptives, controversial weapons, fur, gambling, genetic engineering, meat, nuclear power, pork, (embryonic) stem cells, tobacco and many more.[35] The potential list is endless, very personal and individual ethics may override objective financial criteria.

Nuclear activity is a controversial ethical negative screen. There have been several instances of nuclear explosions (Three Mile Island, Chernobyl, Japan); yet many environmentalists think nuclear energy is necessary to prevent the 2 degrees Celsius threshold for major climate change.[36] Even if nuclear is excluded from retail investments, an investor still finds fossil fuel companies present in many RI funds.[37]

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[31] Thomas Berry & Joan Junkus, "Socially Responsible Investing: An Investor Perspective" (2013) 112 Journal of Business Ethics 707–720 at 708; H. Boerner, "SRI: Passing Fad or an Investment Approach on the Rise? Sustainable and Responsible Investment Outpaces Most Traditional Indexes and Equity Returns during Downturn" (2011) 16:1 Corporate Finance Review 37-40 at 38. See also Schueth, *supra* n 20 at 190

[32] Jacquelyn Humphrey & Darren Lee, "Australian Socially Responsible Funds: Performance, Risk and Screening Intensity" (2011) 102 Journal of Business Ethics 519–535 at 520

[33] Mark Jonathan Rhodes, "Information Asymmetry and Socially Responsible Investment" (2010) 95 Journal of Business Ethics 145–150

[34] See Thomas Berry & Joan Junkus, *supra* n 31 for a list of categories

[35] Pieter Trinks & Bert Scholtens, "The Opportunity Cost of Negative Screening in Socially Responsible Investing" (2017) 140 Journal of Business Ethics 193–208

[36] For a review on the subject, see Natalie Kopytko & John Perkins "Climate change, nuclear power, and the adaptation–mitigation dilemma" (2011) 39 Energy Policy 318–333. See also, Adam Corner, Dan Venables et al, "Nuclear power, climate change and energy security: Exploring British public attitudes" (2011) 39 Energy Policy 4823–4833

[37] RIA, Responsible *Investment Funds in Canada* (March 2018) online at: https://www.riacanada.ca/wp-content/uploads/2018/05/RIA-Canada-Report-Q1-2018-Final5.pdf ; Arjan Trinks, Bert Scholtens et al, "Fossil Fuel Divestment and Portfolio Performance" (2018) 146 Ecological Economics 740–748; see also Shirin Aguliar, "SRI funds caught investing in fossil fuel companies" Press Release (22 October 2015) Financial Adviser, accessed via ProQuest; As a contrast, see Emma Agyemang, "BMO to exclude fossil fuels from its Responsible funds" (18 May 2017) Investors Chronicle, accessed via ProQuest

The use of screens as exclusive portfolio building factors is one reason why there is still so much debate about whether it is possible to create a unifying RI theory. RI screens are based on environmental, social or governance factors, whereas SRI screens are based solely on 'ethics'. Richardson commented, "SRI can be viewed as reflecting an ethical position; it does not reflect standards that can promote sustainability."[38]

There has been a gradual evolution from the pure ethical concerns of SRI, to a more holistic RI.[39] In the early 1990's, investors began to demand profit and 'ethical' behaviour.[40] ESG was developed from the "Triple Bottom Line," a term first used by John Elkington.[41] In this iteration, the "bottom line" included financial, environmental, and social goals.[42] This 'bottom line' then evolved into the three factors (ESG) that RI now uses to take a 'best in class' approach and rate companies within an industry.[43]

Environmental goals in investing (the E in ESG) focus on combating climate change, water pollution, ocean acidification, and other environmental problems. The largest global emitters are generally the developed nations with well-established stock markets and a robust Mass Affluent market.[44] Canada currently represents less than 2%

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[38] Benjamin Richardson, "Keeping Ethical Investment Ethical: Regulatory Issues for Investing for Sustainability" (2009) 87:4 Journal of Business Ethics 555-572 at 560
[39] Christophe Rivelli, "Socially Responsible Investing: From Mainstream to Margin?" (2017) 39 Research in International Business and Finance 711-717 at 716
[40] Benjamin J Richardson , *Fiduciary Law and Responsible Investing, In Natures Trust* (Routledge: 2013)
[41] John Elkington, *Cannibals with Forks: The Triple Bottom Line of the 21st Century* (Gabriola Island, BC: New Society, 1998)
[42] *Ibid*
[43] Peter Roselle, "The Evolution of Integrating ESG Analysis into Wealth Management Decisions" (2016) 28:2 Journal of Applied Corporate Finance 75-79 at 76
[44] Environment and Natural Resources Canada, *Global greenhouse gas emissions*, (2013) online at: https://www.canada.ca/en/environment-climate-change/services/environmental-indicators/global-greenhouse-gas-emissions.html, Union of Concerned Scientists, *Each Country's Share of CO2 Emissions*, 2015, online at: https://www.ucsusa.org/global-warming/science-and-impacts/science/each-countrys-share-of-co2.html#.W2HuFWBKhdg Tom Boden, Greg Marland, and Robert Andres, National CO2 Emissions from Fossil-Fuel Burning, Cement Manufacture, and Gas Flaring: 1751-2014, Carbon Dioxide Information Analysis Center, Oak Ridge National Laboratory, U.S. Department of Energy, (2017) online at: http://cdiac.ess-dive.lbl.gov/trends/emis/tre_coun.html accessed June 7, 2018, compared to Visual

global carbon emissions, and is illustrative of the potential impact of climate responsible RI on a stock market.[45] Approximately 33% of the companies listed on the Toronto Stock Exchange ("TSX") are companies in the extractive industries (namely oil and gas and mining).[46] Fifty-seven (57%) of all financings in the mining industry are completed on the TSX or TSX-Venture.[47] Extractive companies' practices are facing increased scrutiny from investors and stakeholders for their social and environmental behaviours.[48] If extractive companies were completely excluded from investment portfolios, many mutual fund and pension funds would have a difficulty meeting their diversification mandates as required by their fiduciary duties and pension laws.[49] RI therefore faces challenges in resource-based economies like Canada, Australia and South Africa.

The second component of ESG is "Social." A 'Social license to operate' means that a company must deal effectively with the public, by protecting and promoting human rights, especially Aboriginal/Indigenous rights.[50] A 'social contract' can impact a firm's reputation, brand, and loyalty.[51] Human rights issues are often difficult to quantify but human rights due diligence ("HRDD") can identify "rights holders and avoid

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Capitalist, *Top 20 Stock Exchanges by Market Capitalization*, online at: http://www.visualcapitalist.com/20-largest-stock-exchanges-world/

45 Environment and Natural Resources Canada, *Ibid*

46 The TSX is the major stock market in Canada. Statistics are based on market capitalization as of February 2018 TMX Market Intelligence Group, *Current Market Statistics, TSX and TSX-V Listed Companies* (15 February 2018). Available at: https://www.tsx.com/listings/current-market-statistics accessed February 27, 2018

47 TMX, *Global Leaders in Mining*, online at: https://www.tsx.com/listings/listing-with-us/sector-and-product-profiles/mining accessed June 13, 2018

48 For example, see Sara Seck, "Canadian Mining Internationally and the UN Guiding Principles for Business and Human Rights" (2011) 49 Canadian Yearbook of International Law 51-116

49 Modern Portfolio Theory (MPT) will be discussed in Chapter 3

50 Daniel Franks et al., "Conflict translates environmental and social risk into business costs" (2014) 111:21 PNAS 7576-7581; published ahead of print (12 May 2014) online at: https://doi.org/10.1073/pnas.1405135111

51 Cristal Russell, Dale Russell, & Heather Honea, "Corporate Social Responsibility Failures: How do Consumers Respond to Corporate Violations of Implied Social Contracts?" (2016) 136 Journal of Business Ethics 759–773

violations."[52] A risk based due diligence procedure could identify a range of potential issues including in the areas of employment, bribery, extortion, and consumer interests.[53] Relying on the UN Guiding Principles on Business and Human Rights ("GPs"),[54] Wörsdörfer argues that there are positive responsibilities for multinational companies to engage in HRDD due to the moral nature of the rights and the power and authority of the company.[55] Park notes "in order for investors to be able to assess human rights impacts, they must be able to analyse the outcomes of their investments."[56] Many investors are unable to effectively assess human rights risk, given the current slate of frameworks and disclosures.[57]

The third ESG component is "Governance." There is now a heightened sense that good governance practices are part of the duties of the board of directors:

> translating this duty into clear, operational guidance for directors lies at the heart of one of the great, unresolved debates in corporate law – whether and to what extent the interests of the corporation are limited to those of its shareholders or extend to the "stakeholder" constituencies that contribute to or are impacted by the corporate enterprise.[58]

The promotion of women in business is a new governance priority. [59] Studies have shown that the greater the number of women on a board of a corporation, the greater the

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[52] Sara Seck, "Indigenous Rights, Environmental Rights, or Stakeholder Engagement? Comparing IFC and OECD Approaches to Implementation of the Business Responsibility to Respect Human Rights" (2016) 12:1 McGill Journal of Sustainable Development Law 51-88 at 61

[53] *Ibid* at 83, referring to the *OECD Guidelines for Multinational Enterprises*, OECD, *Guidelines for Multinational Enterprises* (OECD Publishing, 2011)

[54] United Nations, *Guiding principles on business and human rights*, (2011) online at: www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf (accessed 2 Feb 2018).

[55] Manuel Wörsdörfer, "The Equator Principles and Human Rights Due Diligence – Towards a Positive and Leverage-based Concept of Corporate Social Responsibility" (2015) 14 Philosophy of Management 193–218 at 195

[56] Stephen Kim Park, *supra* n 19 at 5. Park quoted from United Nations Environment Programme, The Financial System We Need (17 October 2015) online at: http://unepinquiry.org/wp-content/uploads/2015/11/The_Financial_System_We_Need_EN.pdf accessed August 3, 2018

[57] *Ibid* at 13

[58] Ed Waitzer & Johnny Jaswal, "Peoples, BCE, and the Good Corporate 'Citizen'" (2009) 47:3 Osgoode Hall Law Journal 441

[59] Johanne Grosvold, "Where Are All the Women? Institutional Context and the Prevalence of Women on the Corporate Board of Directors" (2011) 50:3 Business & Society 531–555

likelihood that company has in making voluntary climate change disclosures to investors.[60] Women are also seen to help corporate performance when on corporate boards.[61] Recent amendments to the *Canada Business Corporations Act* would enhance governance disclosures to include other groups.[62]

The financial crisis of 2008 offered the next evolutionary step for RI, creating a greater awareness of risk.[63] A new theory, the "reasonable investor hypothesis," surmises that the best way to generate returns going forward is to understand the long term economic, social and environmental realities, and relates to a desire to reduce risk.[64] Investors increasingly see ESG factors as methods to reduce risk in their portfolios.[65] ESG is now seen as adding financial benefits to the company.[66] Companies that place an emphasis on ESG will have less risk, and better returns.

RI is moving away from command and control laws, in favour of a soft international law base. This is due, in part, to the weakness of domestic laws regarding

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[60] Walid Ben-Amar, Millicent Chang & Philip McIlkenny, "Board Gender Diversity and Corporate Response to Sustainability Initiatives: Evidence from the Carbon Disclosure Project" (2017) 142 Journal of Business Ethics 369–383

[61] Martin Conyona & Lerong He, "Firm performance and boardroom gender diversity: A quantile regression approach" (2017) 79 Journal of Business Research 198–211 at 207

[62] Bill C-25, *An Act to amend the Canada Business Corporations Act, the Canada Cooperatives Act, the Canada Not-for-profit Corporations Act and the Competition Act*, 1st Sess, 42nd Parl, 2015-2016-2017-2018, (assented to 1 May 2018) SC 2018, c. 8

[63] Benjamin Richardson, Conflicting Rationales, *supra* n 14 at 313

[64] Cary Krosinsky, Nick Robins, and Stephen Viederman, "After the Credit Crisis – The Future of Sustainable Investing" in *Next Generation of Responsible Investing*, *supra* n 65, Ch. 2

[65] Tessa Hebb, Introduction – The Next Generation of Responsible Investing, in *The Next Generation of Responsible Investing, supra* n 65, Ch. 1 at 2

[66] Mark DesJardine, Pratima Bansal, & Yang, "Bouncing Back: Building Resilience Through Social and Environmental Practices in the Context of the 2008 Global Financial Crisis" (2017) 3 Journal of Management 1-27

disclosures and management of risk.[67] This soft law evolution is consistent with a "New Governance" theoretical model as RI is a complex mix of hard and soft norms.[68]

The most recent evolution in RI is the Corporate Social Responsibility ("CSR") movement, which measures an entity's voluntary activities in environmental, social, and charitable activities.[69] CSR helps to promote accountability so that companies will voluntarily engage in self-regulation.[70] Corporate citizenship sees the company as a "good citizen" to promote the "ethical accountability of a corporation."[71] CSR measures may not impact an investor's view of the company.[72] There is a growing recognition by companies that CSR risks do pose a threat to a firm's profit.[73]

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[67] Natalie Nowiski, "Rising above the Storm: Climate Risk Disclosure and its Current and Future Relevance to the Energy Sector" (2018) 39:1 Energy Law Journal 1-46 at 8

[68] WA Bogart, *Permit but Discourage: Regulating Excessive Consumption* (New York: Oxford University Press, 2011) at 49-50

[69] Bert Scholtens & Riikka Sievanen, "Drivers of Socially Responsible Investing: A Case Study of Four Nordic Countries" (2013) 115 Journal of Business Ethics 605–616; Deborah Rupp, Cynthia Williams, & Ruth Aguilera, "Increasing Corporate Social Responsibility through Stakeholder Value Internalization (and the Catalyzing Effect of New Governance): An Application of Organizational Justice, Self-Determination and Social Influence Theories" in *Managerial Ethics: Managing the Psychology of Morality*, Marshall Schminke (ed.) (New York: Routledge, 2010) 69–88

[70] Laurence Vigneau, Michael Humphreys & Jeremy Moon "How Do Firms Comply with International Sustainability Standards? Processes and Consequences of Adopting the Global Reporting Initiative" (2015) 131 Journal of Business Ethics 469–486 at 474

[71] Jacob Rendtorff, "Institutionalization of Corporate Ethics and Corporate Responsibility Programmes in Firms" in Corporate Social and Human Rights Responsibilities, Karin Buhmann, Lynn Roseberrgy and Mette Morsing (eds) (UK: Palgrave MacMillan, 2011) at 245, 247

[72] For example, the author was involved in the drafting of a portion of the environmental section of TD Bank's CSR report from 2009-2011. While the bank did very impressive environmental activities (such as being the first bank in Canada to become carbon neutral) the amount of financial savings and cost was extremely immaterial to the profitability of TD Bank at the time. See Toronto-Dominion Bank, *2016 Corporate Social Responsibility Report,* (Toronto, TD Bank, 2016) at 32, available at : https://www.td.com/document/PDF/corporateresponsibility/2016-Final-CRR_EN.pdf accessed February 23, 2018

[73] Lauren Caplan, "Regulating the Levers of Globalization: Integrating Corporate Social Responsibility into the Capital Raising Process" in *Corporate Social and Human Rights Responsibilities: Global Legal and Management Perspectives*, Karin Buhmann, Lynn Roseberry & Mette Morsing (eds) (UK: Palgrave Macmillan, 2011) at 235

1.3 Application of RI on the Mass Affluent Retail Investor

RI is now understood as investing in a socially and environmentally responsible manner, while requiring the fund to maximize profits.[74] This thesis focuses on the application of RI to Mass Affluent retail investors. This includes the creation of RI products, and the ability of Mass Affluent investors to access these products. Portfolio managers create retail products. These portfolio managers require information to access companies, and techniques to value these companies.

There have been many problems with the application of responsible principles to retail products, with most of the current research focusing on performance studies of mutual funds. There are studies showing RI outperforming non-RI funds.[75] There are also studies that conclude that RI underperforms non-RI.[76] Many studies show no statistical difference in the performance of RI funds versus non-RI funds.[77] Of the ones

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[74] Benjamin Richardson & Wes Cragg, "Being Virtuous and Prosperous SRI's conflicting goals" Paper presented in the Principles of Responsible Investment Academic Conference (Ottawa, ON: October 2009)

[75] Benjamin R. Auer, "Do Socially Responsible Investment Policies Add or Destroy European Stock Portfolio Value?" (2016) 135 Journal of Business Ethics 381–397; This study shows the importance of screens on performance of funds…"(i) Negative screens excluding unrated stocks from a representative European stock universe allow investors to significantly outperform a passive investment in a diversified European stock benchmark portfolio. (ii) Additional negative screens based on environmental and social scores neither add nor destroy portfolio value, when cut-off rates are not too high. In contrast, governance screens can significantly increase portfolio performance under similar conditions. Thus, investors in the European stock market can do (financially) well while doing (socially) good. (iii) Because of a loss of diversification, positive screens can cause portfolios to underperform the benchmark. This implies that investors should concentrate on eliminating the worst firms"; For the Canadian context, see Tessa Hebb, *Canadian SRI Mutual Funds Risk / Return Characteristics* (Carleton Centre for Community Innovation: Carleton University, 2015) pub R15-02; In the Indian context, see Vanita Tripathi & Varun Bhandari, "Do Ethical Funds underperform conventional Funds? – Empirical Evidence from India" (2015) 4:2 International Journal of Business Ethics in Developing Economies; Gunnar Friede, Timo Buschi and Alexander Bassen, "ESG and financial performance: aggregated evidence from more than 2000 empirical studies" (2015) 5 Journal of Sustainable Finance & Investment 210-233

[76] Kathrin Lesser, Felix Rößle & Christian Walkshäus, "Socially responsible, green, and faith-based investment strategies: Screening activity matters!" (2016) 16 Finance Research Letters 171–178

[77] Michael Trudeau, "Non-ethical funds outperform ethical rivals" (2011) Financial Advisor 1
Yet, this same article stated "prior to the unravelling of the financial crisis and the subsequent economic downturn, ethical funds had their noses ahead of their non-ethical peers over the short term and were holding their own over the long term."

that show no statistical difference,[78] or the ones that show negative results,[79] the conclusions often still note a need for greater transparency, by requiring additional disclosures or other legislative reform.[80]

Hawken, in 2004, concluded that many mutual funds are masquerading as responsible when they really adopt conventional investment approaches.[81] Hawken reached several conclusions including:

- The investment portfolio of SRI (sic) mutual funds is virtually no different than the combined portfolio of non SRI [mutual funds]
- The screening criteria practically allows any company to be included in a portfolio, and there is a bias towards global brand names
- Fund names can be deceptive, and language used in documents is vague
- Few SRI funds engage in activism, even though it is cited as a reason to invest[82]

Karen Benson, in 2006, believed that the problems with performance studies also were linked to a problem with RI portfolio construction. She concluded that returns of SRI (sic) funds are from different industry weights.[83] This study only included US equity mutual funds, used negative screens as sole exclusionary criteria and only examined at the industry level, not the holdings level.[84] A more recent Canadian news article exposed

[78] Paulo Leite, & Maria Céu Cortez, "Style and performance of international socially responsible funds in Europe" (2014) 30 Research in International Business and Finance 248-267; see also M Cortez, F Silva, & N Areal, "The Performance of European Socially Responsible Funds" (2009) 87:4 Journal of Business Ethics 573-588; J. Humphrey, & D. Tan, "Does it Really Hurt to be Responsible?" (2014) Journal Of Business Ethics 375-386

[79] See e.g. Jon Entine, *Pension Fund Politics: The Dangers of Socially Responsible Investing* (Washington: The AEI Press, 2005); Richard Copp, Michael L Kremmer & Eduardo Roca, "Should Funds Invest in Socially Responsible Investments during Downturns?: Implications for the Fiduciary Responsibilities of Investment Fund Trustees" (2010) 19:1 Griffith Law Review 86–104

[80] *Ibid* at 99

[81] Paul Hawken, *Socially Responsible Investing: How the SRI Industry has Failed to Respond to People who Want to Invest with a Conscience and what can be Done to Change it* (California: National Capital Institute, 2004); Hawken uses the term SRI, even though the study refer to RI.

[82] *Ibid* at 16

[83] Karen Benson, TJ Brailsford & JE Humphrey, "Do socially responsible investment managers really invest differently?" (2006) 64:4 Journal of Business Ethics 337-357 at 352

[84] *Ibid* at 340- 341

the fact that many RI funds are 'plain vanilla' funds, holding the same companies as non-RI funds.'[85] There is a need for new research on RI mutual funds for the Mass Affluent.[86]

More importantly, there is a dearth of research on fixed income based RI investments and newer types of investment vehicles. This thesis will study other financing vehicles, such as green bonds, hedge funds, and carbon funds, as there has not been a significant amount of research conducted on these structures for the Mass Affluent.[87] There is research on these structures showing that certain products are promoted more enthusiastically than others due to the larger sales commissions embedded in these products.[88] However, these studies do not look at problems of advisor licensing as an underlying root cause.

1.4 Research Questions

This thesis focuses on the Mass Affluent retail investor. Its underlying premise is that the way the investment industry for retail investors is structured and regulated creates access barriers for the Mass Affluent. The overarching research question is: "how can Canadian Mass Affluent retail investors access RI, and is legal, regulatory, and policy reform required to achieve this goal?" Sub-questions addressed in the thesis are:

- Do current domestic securities disclosure requirements provide for sufficient material ESG disclosures, and if not, do transnational frameworks fill in the gaps in disclosures of material information? (RQ1)
- Is there sufficient disclosed information (both quantitative and qualitative) to allow portfolio managers to create accurate ESG valuations, or does the

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[85] Guy Dixon, "Confused about Ethical Investing? Here's a primer" Press Release (15 April 2017) Globe and Mail, online at: https://www.theglobeandmail.com/globe-investor/confused-by-ethical-investing-heres-a-primer/article34332548/ accessed July 12, 2018; for other statistics, see The Forum for Sustainable and Responsible Investment, *Fast Facts*, online at: https://www.ussif.org/content.asp?contentid=40

[86] For example, even in 2015, the research was focused on mutual funds; Tessa Hebb, *supra* n 75 at 8

[87] Jessica Papini, "Responsible Returns? It's not always easy being virtuous, but hedge funds are trying" (2017) the Investment Dealers Digest 1; see also Gerasimos Grompotis, "Evaluating a New Hot Trend: The Case of Water Exchange-Traded Funds" (2016) 6:4 The Journal of Index Investing 103-128

[88] See Rhys Bollen, "'There is no Alpha': Bounded Rationality in the Mutual Funds Market" (2013) 28:2 Banking and Finance Law Review 225-247 at 227

finance community require new models that more accurately incorporate ESG risk? (RQ2)

- Do regulatory licensing requirements need to be updated to allow mutual fund licensed representatives (regulated under the Mutual Fund Dealers Association, "MFDA") to be able to sell a broader array of investment vehicles to ensure that Mass Affluent retail investors have access to RI? (RQ3)
- Are the underlying holdings of RI funds any different from their non-RI counterparts? (RQ4)
- How can investment funds be utilized to address a particular problem or two (such as GHG emissions causing climate change, or water pollution issues)? (RQ5)
- Are pension funds currently the only practical way for a Mass Affluent retail investor to access RI? (RQ6)

Three types of investments will be analyzed in this thesis including:

- Publically traded Securities and Investment Funds
- Private equity structures including infrastructure projects
- Unique legal structures such as carbon credit funds and Community Economic Development Investment Funds

1.5 Research Methodologies

1.5.1 Doctrinal Research

In doctrinal work, "arguments are derived from authoritative sources, such as existing rules, principles, precedents, and scholarly publications."[89] It is necessary to understand portfolio fund managers' obligations and the availability of material ESG information. In Ontario, the governing legislation is the *Securities Act,*[90] with similar securities acts proclaimed across Canada.[91] These materials will be analyzed to investigate current limitations of material disclosures of ESG information. If there is insufficient materially disclosed ESG information, then it is unlikely that proper RI funds can be constructed. The doctrinal method is used to interpret regulatory guidelines, such as the recent proposal to update advisors standard of care and

[89] R. Van Gestel & H.W. Hicklitz, "Revitalizing Doctrinal Legal Research in Europe: What About Methodology?" (2011) 5 *European University Institute Working Papers Law* at 26
[90] *Securities Act*, RSO 1990, c. S .5
[91] For example, see the *Securities Act*, RSNS 1989, c. 418

embedded compensation structures.[92] Changes to governing legislation, regulations and licensing provisions will be recommended, based upon doctrinal analysis.

1.5.2 Interdisciplinary Research

Legal academics are pursuing other lines of research methodologies to assist with reforms and recommendations.[93] Interdisciplinary research is the bringing together of two or more disciplines of study.[94] Sustainable finance is a rapidly growing interdisciplinary field of research, and "brings together research in finance and the natural sciences to develop financial solutions."[95] Scholars have called for new transdisciplinary foundations to develop powerful insights that extend beyond narrow disciplinary boundaries.[96] The finance literature has itself focused on one type of retail investment, the mutual fund. There is a lack of research on other retail investment vehicles. Interdisciplinary (using financial analysis) research will be conducted for the review of the financial products available to retail investors.

1.5.3 Comparative Research

Comparative legal research methodologies investigate the laws and regimes of different jurisdictions, including customary law.[97] Comparative methods compare

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[92] RIA, Comments Regarding CSA Consultation Paper 33-404: *Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives toward their Clients September 26, 2016*, available at: http://www.osc.gov.on.ca/documents/en/Securities-Category3-Comments/com_20160926_33-404_abbeyd.pdf

[93] Terry Hutchinson, "The Doctrinal Method: Incorporating Interdisciplinary Methods in Reforming the Law (2015) 8 Erasmus L. Rev. 130 at 130

[94] Moti Nissani, "Ten Cheers for Interdisciplinarity: The Case for Interdisciplinary Knowledge and Research" (1997) 34:2 The Social Science Journal 201-216

[95] Martina K. Linnenluecke, Tom Smith & Brent McKnight, "Environmental finance: A research agenda for interdisciplinary finance research" (2016) 59 Economic Modelling 124–130 at 124

[96] M.I. Winn, & S. Pogutz, "Business, ecosystems, and biodiversity: new horizons for management research" (2013) Org. Environ. (1086026613490173).

[97] Mark Van Hoecke, "Methodology of Comparative Legal Research" Law and Method 1-35 at 3

national and international law, and international legal instruments.[98] Comparisons of Canadian and USA securities laws on disclosure requirements will be conducted. The thesis will also compare the licensing provisions of Canadian retail advisers with their American and Australian counterparts. The licensing of retail advisors impacts RI investments in terms of both the legal structures utilized and the accessibility of these structures to the Mass Affluent. Canada may need to adopt certain US and Australian licensing provisions to allow a broader array of investment vehicles to be made available to the Mass Affluent.

1.5.4 Transnational Approaches

Peer Zumbansen defines Transnational Law as the "study of law in the context of evolving global governance debates.[99] Companies, and their environmental damage, do not have national borders. International mechanisms, both mandatory and voluntary, will be investigated. Transnational normative frameworks provide guidance to asset managers in the creation of retail funds and need to be reviewed.

1.6 Organization of Thesis

Chapter 1 has three parts. The first part introduced the concept of retail RI for Mass Affluent investors. The second provided a historical review of SRI/RI. The third posed the research questions to be addressed in the thesis.

Chapter 2 details 'soft law' international approaches and domestic securities laws in Canada and the USA in terms of disclosures and materiality.[100] These disclosures are

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[98] E. Morgera, "Global Environmental Law and Comparative Legal Methods" (2015) 24:3 *Review of European, Comparative & International Environmental Law* 254-263

[99] Peer Zumbansen, "Defining the Space of Transnational Law: Legal Theory, Global Governance, and Legal Pluralism" (2012) 21 Transnat'l L. & Contemp. Probs. 305-336 at 323

[100] These countries were selected as they fit within the criteria of being developed nations with the majority of its citizens being middle income and all having government sponsored pension plans.

used by portfolio managers to examine the material ESG risks of companies. Chapter 2 shows that domestic ESG disclosures are insufficient and current transnational frameworks do not fill in all the gaps in disclosing material information. This will cause problems for identifying ESG risk in portfolios.

Chapter 3 explains several financial approaches to portfolio construction. Portfolio Managers use financial and valuation tools to construct fund portfolios for retail investors. Material ESG risks are not completely disclosed. This chapter posits that it is difficult to construct comprehensive and accurate valuations of companies due to lack of incorporating ESG factors. The chapter will offer several possible ways that ESG factors could be incorporated into valuation models.

Chapter 4 scrutinizes current investment vehicles available to retail investors, and investigates the benefits and drawbacks of each investment type. The chapter shows that many products available to retail investors are not available to the Mass Affluent. Securities laws focus on the type of structure, rather than its underlying complexity, as a way to regulate products. This line of thinking may be partly to blame for the dearth of RI investments available to the Mass Affluent.

Chapter 5 describes the regulatory requirements for licensing financial advisors and retail portfolio managers in Canada, the USA and Australia. This chapter shows that the lack of availability of RI products is not solely dependent on the construction of these vehicles, but also on their accessibility. Mass Affluent retail advisors need access to a broader range of RI products for their clients, and also need enhanced training and education to better inform them of RI issues.

Chapter 6 analyses real world RI funds. The chapter takes the available RI funds in Canada and the USA and analyzes them. It breaks down each RI investment by the type of vehicle from Chapter 4, and compares them against the six classifications noted by the GSIA in Chapter 1. The chapter will show that specialized, niche funds that focus on one area of ESG may be the only true RI investments available to the retail investor. Mass Affluent retail investors cannot access these investment vehicles. There is a need for construction of RI investments that Mass Affluent investors can access.

Chapter 7 addresses pension funds. Institutional investors have the ability to create structures that retail investors cannot access, and can use activist investor strategies that Mass Affluent retail investors cannot. It may be incumbent upon these "universal investors"[101] to create and access RI products on behalf of Mass Affluent investors. Pension funds such as the Canada Pension Plan or a work pension may be the only way for a Mass Affluent investor to access RI. Not all individuals have access to a pension or even to CPP, so pension plans cannot be the only entities to be allowed to access RI.

Chapter 8 concludes with recommendations for change, showing the need for greater material disclosures of ESG risks, and the need for enhanced financialization of these risks. These changes will assist retail portfolio managers in creating new RI retail products that more accurately incorporate ESG factors. It concludes with recommendations to change MFDA licensing to allow for advisors to access a slightly broader array of investment types. This will allow the Mass Affluent access to RI.

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[101] Benjamin J. Richardson & Maziar Peihani, "Universal Investors and Socially Responsible Finance: A Critique of a Premature Theory" (2015) 30 Banking & Finance Law Review 405-455 at 406

Chapter 2: DISCLOSURE & MATERIALITY – DOMESTIC SECURITIES LAWS AND INTERNATIONAL FRAMEWORKS

> Investors' responsibility to use beneficiaries' money in line with their best interests extends beyond providing a return on their capital: it includes ensuring that that money is being invested in ways that support sustainable development[102]

Portfolio managers create retail funds and need access to material information in order to create these funds. Without information, a portfolio manager cannot make accurate valuations of companies. They essentially would be "throwing darts at a dartboard" to pick investments. This chapter investigates the material ESG information available to portfolio managers in order to create RI products. First, domestic securities laws are presented, focusing on the disclosure of material information. This chapter discusses some of the problems with current disclosures and ideas of materiality. Second, international normative frameworks are introduced. These frameworks provide guidance for voluntary disclosure of material ESG information. It is difficult to establish clear criteria for what constitutes responsible investments. It is also difficult to establish which companies and investments meet the criteria because of the lack of material disclosures.

2.1 Domestic Securities Laws - the Need for Standardized Disclosure

Securities and Investment Funds in Canada are regulated provincially.[103] Complementing provincial securities acts are National Instruments ("NIs"), which are uniform legal consensus among the provinces and adopted by the Canadian Securities Administrators ("CSA").[104] NIs hold the same authority as regulations.[105]

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[102] Martin Skanche, PRI Chair, *A Blueprint for Responsible Investment* (London: UNPRI, 2016) at 4

[103] Christopher Nicolls, *Securities Law*, 2nd ed. (Toronto: Irwin Law, 2018), *Securities Act*, RSO 1990 c C.5, *Securities Act*, RSNS 1989, c. 418 ("NSSA")

[104] Canadian Securities Administrators, *A Provincial/Territorial Memorandum of Understanding Regarding Securities Regulation* (2004), Available at: https://www.securities-administrators.ca/aboutcsa.aspx?id=77 accessed March 10, 2018

Securities laws are designed to "provide protection to investors from unfair, improper or fraudulent practices; and to foster fair and efficient capital markets and confidence in capital markets."[106] From an historical perspective, corporate and securities laws in North America were loathe to give any weight to factors other than primacy of profit and maximization of shareholder value.[107] This is changing, as shareholders may ultimately benefit by the adoption of non-financial measures, which could give some weight to adding ESG factors to investor decisions.[108] The new paradigm for investors and fund managers is the gradual shifting away from "Shareholder Primacy" to a multi-stakeholder engagement primacy model.[109]

Timely, accurate, and efficient disclosure of information, restrictions on unfair market practices, and requirements for the maintenance of high standards of fitness and business conduct are the primary means for achieving the purposes of securities

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[105] *OSA*, s. 143(13); see also *Nova Scotia Securities Act ("NSSC")* at s 1.2(aab) "Nova Scotia securities laws" means this Act, the regulations, any decisions made by the Commission or the Director and any extra-provincial securities laws adopted or incorporated by reference under Section 149D; (an) "regulations" means the regulations made pursuant to this Act and, except in Sections 150, 150A and 150B, includes the rules;

[106] *OSA,* s.1.1; Ontario was selected as an example. The NSSC reads: 1A (1) The purpose of this Act is to provide investors with protection from practices and activities that tend to undermine investor confidence in the fairness and efficiency of capital markets and, where it would not be inconsistent with an adequate level of investor protection, to foster the process of capital formation. (2) In pursuing the purpose of this Act, the Commission shall have regard to such factors as may be viewed by the Commission as appropriate in the circumstances, including any principles enunciated in the regulations. See also, NSSC, s. 1A

[107] L. Mitchell, "Groundwork of the Metaphysics of Corporate Law" (1993) 50 Washington and Lee Law Review 1477-1505 at 1485; G. Crespi, "Maximizing the Wealth of Fictional Shareholders: Which Fiction Should Directors Embrace?" (2007) 32 Journal of Corporation Law 381-396 at 383-386; Andrew Keay, 'Shareholder Primacy in Corporate Law: Can It Survive? Should It Survive?" (2010) 7 European Company and Financial Law Review 369-413

[108] See Andrew Keay & Rodoula Adamopoulou, "Shareholder Value and UK Companies: A Positivist Inquiry" (2012) 13 European Business Organization Law Review 1-29 at 11

[109] Edward J. Waitzer and Johnny Jaswal, "The Good Corporate Citizen" in in *The Next Generation of Responsible Investing*, Tessa Hebb (ed) (New York: Springer, 2012) at 127; Virginia Harper Ho, "'Enlightened Shareholder Value': Corporate Governance Beyond the Shareholder-Stakeholder Divide" (2010) 36:1 Journal of Corporation Law 59-112. For an opposing view, see Eric Orts & Alan Strudler, "Putting a Stake in Stakeholder Theory" (2009) 88 (Supplement 4) Journal of Business Ethics 605-615

legislation.[110] Two of these methods directly relate to RI. The first requires accurate and efficient disclosures. RI disclosures have been found to promote 'good' market behavior.[111] The second is the standard of fitness and business conduct, which could move market participants to adopt RI practices into their portfolios.[112] The "good management hypothesis" posits that the better the governance of a firm, the better the results should be both financially and reputationally.[113]

Mandatory disclosures of material information are a critical component of securities regulation.[114] Climate and other ESG related disclosures, both in Canada and worldwide, are weak and are not uniform among countries.[115] Disclosures are required for financial risk management.[116] Securities law is concerned with disclosing material risk factors relating to the issuer and its business.[117] According to Professor Christie Ford, "core definitions of materiality and disclosure should be broad and principles-based."[118] Often, though, they are not.

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[110] *OSA*, s. 2

[111] Robert Heinkel, Alan Kraus & Josef Zechner, "The Effect of Green Investment on Corporate Behavior" (2001) 36:4 The Journal of Financial and Quantitative Analysis 431-449 at 447

[112] Tihana Bule & Cristina Less, "Promoting sustainable development through responsible business conduct" (2016) *Development Co - Operation Report* 119-136

[113] For an overview, see Benjamin Auer, & Frank Schuhmacher, "Do Socially (ir)Responsible investments pay? Evidence from international ESG Data" (2016) 59 Quarterly Review of Economics and Finance 51-62 at 51-52

[114] Nicolls, *Securities Law*, *supra* n 103, Ch. 5, 6 & 9; see also Zhen Shi, "The impact of portfolio disclosure on hedge fund performance" (2017) 126 Journal of Financial Economics 36–53

[115] Task Force on Climate Related Disclosures*, Final Report – Recommendations of the Task Force on Climate Related Financial Disclosures* (June 2017)

[116] See generally: Andrew Ang, Joseph Chen & Yuhang Xing, "Downside risk" (2006) 19:4 The Review of Financial Studies 1191 -1239

[117] *Continuous Disclosure obligations, OSC* NI 51-102 *(30 June 2015),* Form 51-102F2 Item 5.2

[118] Cristie Ford, "Principles-Based Securities Regulation in the Wake of the Global Financial Crisis" (2010) 55 McGill Law Journal 257-307 at 268

The Prospectus is the primary disclosure document mandated for issuances of all new securities.[119] The determination of 'materiality' is vitally important as to whether ESG factors need to be disclosed in the prospectus.[120] A Material Fact is defined as "a fact that would reasonably be expected to have a significant effect on the market price or value of the securities."[121] The Prospectus must provide "full, true and plain disclosure of all material facts relating to the securities issued or proposed to be distributed."[122] The Prospectus shall also be accompanied by interim financial reports and annual financial statements.[123]

Continuous Disclosure obligations are equally important as Prospectus disclosure.[124] Any material fact or material change is required to be disclosed.[125] A Material change is defined as any change in the issuer that would reasonably be expected to have a "significant effect on the market price or value of a security of the issuer" or "whether a reasonable investment fund considers it important in determining whether to purchase or hold the security."[126] The Management Discussion and Analysis ("MD&A"), included in continuous disclosure documents such as the annual report, provides a

[119] *OSA*, s. 53(1),"No person or company shall trade in a security on his, her or its own account or on behalf of any other person or company if the trade would be a distribution of the security, unless a preliminary prospectus and a prospectus have been filed and receipts have been issued for them by the Director." Accredited Investors are exempt from these prospectus requirements
[120] *Disclosure Standards*, OSC NP 51-201 (12 July 2002)
[121] *OSA* s. 1.1
[122] *OSA* s. 61 (1); see also *General Prospectus Requirements,* OSC NI 41-101 (6 July 2017) which provides information regarding the contents of a prospectus
[123] *OSA* ss. 61 (2), 67(1)
[124] NI 51-102 *supra* n 117 at s. 4(A.3); *See also Continuous Disclosure Obligations CP 51-102CP (30 June 2015)*
[125] *Ibid*, s. 1.1 and Part 7
[126] *OSA*, s. 2.1(v)

financial overview of how the company performed during the previous period, its current financial condition, and its future financial outlook.[127]

CSA Staff Notice 51-333 provides guidance on continuous disclosure requirements for environmental issues.[128] Environmental disclosures are material if a "reasonable investor's decision whether or not to buy, sell or hold securities of the issuer would likely be influenced or changed if the information was omitted or misstated."[129] This Staff Notice lists five key material disclosure requirements: "environmental risks, trends and uncertainties, environmental liabilities, asset retirement obligations, and financial and operational effects of environmental protection requirements."[130] Environmental risks are further broken into five categories: litigation, physical, regulatory, reputation and business model.[131] These material environmental issues must be disclosed in filings in continuing disclosure documents such as the Annual Information form.[132] Material financial information required in the MD&A may not be captured because their "long term or contingent nature can make them difficult to quantify."[133] Other issues also pose materiality concerns. Targets and goals, such as carbon reduction targets or water reduction targets, may be considered forward looking

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[127] *Management's Discussion & Analysis, NI* Form 51-102F1 (30 June 2015); See also *Filing of Management's Discussion and Analysis and National Instrument 51-102 Continuous Disclosure Obligations, CSA Staff Notice 51-308 (19 Dec 2013).*
[128] *Environmental Reporting Guidance,* CSA Staff Notice 51-333 (27 October 2010)
[129] *Ibid* at 5-7
[130] *Ibid* at 8
[131] *Ibid* at 9-10
[132] *Ibid* at 8. The Annual Information Form (or "AIF") discloses comprehensive business and financial information about the issuer. The USA equivalent is the "10-k". *Annual Information Forms*, BCSC Form 51-102F2 (30 June 2015), see OSC, Continuous Disclosures, online at: http://www.osc.gov.on.ca/en/Companies_continuous-disclosure_index.htm See Thompson Reuters, Annual Information Form (AIF), online at: https://ca.practicallaw.thomsonreuters.com/0-570-0162?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1
[133] *Ibid* at 13

information ("FLI") and require disclosure.[134] There is considerable uncertainty on which targets constitute FLI. There is guidance to assist with materiality determinations of targets as FLI.[135] It does not solve all materiality questions.

Gender diversity is gaining momentum as an important material disclosure topic. OSC Staff Notice 58-401 resulted from a roundtable highlighting the importance of gender diversity in broadening the skills and perspectives of boards.[136] CSA Multilateral Staff Notice 58- 309,[137] mandates in depth disclosures on the number of women on boards of directors and whether the corporation has policies and/or targets for female representation.[138] These disclosures have been criticized as weak.[139] Gender diversity disclosure has been criticized as being unnecessary, ineffective and not material.[140] Certain human rights issues are difficult to quantify and this may underlie some of the concerns.

Taxes and other royalties and revenues paid to governments need to be disclosed, as was recently mandated by the Canadian government for extractive industries.[141]

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[134] *Ibid* at 20

[135] *Guidance Regarding the Application of Forward Looking Information Requirements under NI 51-102 Continuous Disclosure Obligations*, CSA Staff Notice 51-330 (20 November 2009)

[136] *Disclosure Requirements Regarding Women on Boards and in Senior Management,* OSC Staff Consultation Paper 58-401 (20 July 2013) at 5

[137] CSA Notice, *Staff Review of Women on Boards and in Executive Officer Positions – Compliance with NI 58-101 Disclosure of Corporate Governance Practices*, CSA Multilateral Staff Notice 58- 309 (5 October 2017). See also CSA Notice, *Staff Review of Women on Boards and in Executive Officer Positions - Compliance with NI 58-101* CSA Notice 58-307, (28 September 2015) and CSA Notice, *Staff Review of Women on Boards and in Executive Officer Positions – Compliance with NI 58-101* CSA Notice 58-308 (28 September 2016)

[138] *Ibid* at 5. A recent update of the *Canada Business Corporations Act* would broaden the definition to include not only women, but also representation of minorities, aboriginals and peoples with disabilities, see Bill C-25, *supra* n 62

[139] Kim Willey, ''Bringing Canadian Women on Board'': A Behavioural Economics Perspective on Whether Public Reporting of Gender Diversity Will Alter the Male-Dominated Composition of Canadian Public Company Boards and Senior Management" (2017) 29:1 Canadian Journal of Women and the Law 182-210 at 209

[140] For a review of the debate, see Galit Sarfaty, "Human Rights Meets Securities Regulation" (2013) 54:1 Virginia Journal of International Law 97-125

[141] *Extractive Sector Transparency Measures Act*, S.C. 2014, c. 39, s. 376

Recent cases like the bribery charges against SNC-Lavalin ("SNC") highlight the need to add more social metrics in RI analyses.[142] In this class action, the plaintiffs claim is based on SNC committing misrepresentation in the company's continuous disclosure obligations.[143] Misrepresentation occurs from an "untrue statement of material fact, or an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made."[144] There are civil liabilities for misrepresentation, whether or not the party relied upon the misrepresentation.[145] Consequently, if improper ESG factors are omitted or misstated, a company could be held liable to its investors.[146]

Executive Compensation is an important material governance issue.[147] Form 51-102F6 provides insight into executive compensation as a key aspect of the overall stewardship and governance of the company.[148] Bill Rice, the chair of the CSA, notes that "greater transparency on the compensation policies of public companies will allow investors to make better informed voting and investment decisions, and will help them

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[142] *Drywall Acoustic Lathing and Insulation, Local 675 v. SNC-Lavalin Group Inc*., 2015 ONCA 718 (CanLII), SNC has been charged with bribery of officials in Libya and corruption and defrauding Libyan businesses. https://www.ctvnews.ca/business/ottawa-vows-legislation-allowing-firms-to-settle-corporate-corruption-1.3816239 see also: *The Trustees of the Drywall Acoustic Lathing and Insulation Local 675 Pension Fund v SNC-Lavalin Group Inc*., 2017 ONSC 2188 (CanLII)
[143] *Ibid* at para 1
[144] *OSA*, s. 1.1
[145] *OSA*, ss. 130, 130.1, 131, 138.3, *Drywall Acoustic Lathing, supra n 154 at para 2*
[146] *Drywall Acoustic*, *supra* n 142 at para 62, 66. The court stated at para 62 that "on the initial leave motion, the appellants pleaded that various representations made by SNC in specified core documents6, such as the fact that it was a "socially responsible company", were false because SNC paid US$56 million to agents and because its former employees were involved in criminal activity connected to the Padma Bridge Project in Bangladesh. The motion judge was satisfied that sufficient material facts were pleaded in respect of these misrepresentation claims. He also accepted that the claims were made in good faith and that there is a reasonable possibility they will be resolved in the appellants' favour."
This issue is to proceed to trial to determine if correct disclosure exists. See *Drywall Acoustic Lathing and Insulation Local 675 Pension Fund (Trustees of) v. SNC-Lavalin Group Inc*., [2016] O.J. No. 4918 at para 47, 51
[147] *Statement of Executive Compensation, OSC* NI 51-102, Form 51-102F6 (31 Oct, 2011)
[148] *Ibid*, s. 1.1

determine whether management's incentives are aligned with their interests."[149] There are still deficiencies, especially as it relates to material ESG disclosures and compensation.[150] It is clear that not all material ESG information is disclosed in Canada.

United States ("USA") based companies form a significant portion of many Mass Affluent clients fund portfolio holdings and many Canadian companies are cross-listed on US exchanges.[151] A discussion of USA material disclosures is necessary; in order to show that portfolio managers may not have enough material information to make comprehensive ESG valuations of companies. It is also useful to compare USA disclosures with Canadian requirements.

In the USA, the federal government has jurisdiction to regulate securities.[152] The Securities and Exchange Commission ("SEC") provides oversight on the securities industry.[153] The *Securities Acts* and *Securities and Exchange Commission Acts* in the USA mandate disclosures of material facts, like their Canadian counterparts.[154] This mandate requires disclosure if a reasonable investors would attach importance to the fact

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[149] Bill Rice, Chair of the CSA, *Canadian Securities Regulators Proceed With Enhanced Executive Compensation Disclosure Requirements* Press Release (22 July 2011)
[150] Eugene Ellmen, Social Investment Organization, ``Comments on proposed amendments to statement of executive compensation, and form 51-102F6`` *Letter to CSA* (17 February 2011)
[151] TMX, *Interlisted Companies*, (23 July 2018) online at: https://www.tmxmoney.com/en/research/interlisted.html ; NASDAQ, *Companies in Canada*, https://www.nasdaq.com/screening/companies-by-region.aspx?region=North+America&country=Canada accessed July 26, 2018
[152] *Securities Act of 1933* 15 U.S.C. § 77a et seq., *Securities and Exchange Act, 1934*, 15 U.S.C. § 78a et seq. Pub.L. 73–291, 48 Stat. 881, enacted June 6, 1934; There are state securities laws, but which for purposes of this paper will be applicable to licensing
[153] *Securities Exchange Act of 1934*, s. 4
[154] *Securities Commission Act*, 15 U.S.C. §§ 77a-77aa 20, 15 U.S.C. §§ 78a-78pp

in whether they would purchase the security.[155] The SEC has been criticized as having weak enforcement policies for environmental disclosures.[156]

Prospectus and continuous disclosure obligations are similar in the USA as in Canada, as both require full true and plain disclosures of material facts.[157] Like in Canada, the MD&A provides a narrative to the financial statements from management's perspective, enhancing the disclosures of financial information, and improving the quality of cash flow and earnings.[158] The MD&A discusses past performance but emphasizes future earnings potential.[159] The disclosure provided in the MD&A should be "clear, communicating to shareholders management's view of the company's financial condition and prospects."[160] Like all other disclosure requirements, the threshold of MD&A reporting is that of materiality.[161]

Environmental reporting in the US originated in the 1970s.[162] These early disclosures focused on litigation and the cost of environmental discharges.[163] *Securities*

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[155] *Securities Act Rule* 405, 17 C.F.R. § 230.405; *Exchange Act Rule* 12b-2, 17 C.F.R. § 240.12b-2
[156] David Gelles, "S.E.C. Is Criticized for Lax Enforcement of Climate Risk Disclosure" Press Release (23 January 2016) the New York Times, online at: https://www.nytimes.com/2016/01/24/business/energy-environment/sec-is-criticized-for-lax-enforcement-of-climate-risk-disclosure.html
[157] Nowiski, *supra* n 67 at 5
[158] *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, SEC, 17 CFR Parts 211, 231 and 241 [Release Nos. 33-8350; 34-48960; FR-72] (29 December 2003)
[159] SEC, *Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures*, Release No. 33-6835 (May 18, 1989) [54 FR 22427 (May 24, 1989)] ("1989 MD&A Interpretive Release") (setting forth a two-step analysis for disclosure of material forward-looking information in MD&A;
[160] Instruction 2 to Item 303(a) of Regulation S-K [17 CFR 229.303(a)];
[161] Item 303 of Regulation S-K 17 CFR 229.303
[162] Release No. 33-5170 (July 19, 1971) [36 FR 13989]; see also Interpretive Release No. 33-6130 (September 27, 1979) [44 FR 56924] (the "1979 Release"), which includes a summary of the legal and administrative actions taken about environmental disclosure during the 1970s. More information relating to the Commission's efforts in this area is chronicled in Release No. 33-6315 (May 4, 1981) [46 FR 25638].
[163] Interpretive Release No. 33-6130 (September 27, 1979) [44 FR 56924] (the "1979 Release"), which includes a summary of the legal and administrative actions taken about environmental disclosure during the 1970s. More information relating to the Commission's efforts in this area is chronicled in Release No. 33-6315 (May 4, 1981) [46 FR 25638]

Act Rule 408[164] and *Exchange Act* Rule 12b-20, added in the early 1980s, require a registrant to disclose "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made."[165] Item 101 deals with discharge of materials on the capital expenditures of companies,[166] while Item 103 details disclosures required for environmental litigation.[167]

Currently, R*egulation S-K*[168] and *Regulation S-X* require disclosure of certain environmental issues.[169] SEC Guidance in 2010 ("2010 Guidance") stated:[170]

> "…financial risks associated with climate change may arise from physical risks to entities other than the registrant itself. For example, climate change-related physical changes and hazards to coastal property can pose credit risks for banks whose borrowers are located in at-risk areas. Companies also may be dependent on suppliers that are impacted by climate change, such as companies that purchase agricultural products from farms adversely affected by droughts or floods."[171]

According to this Guidance, climate change issues may trigger disclosure requirements.[172] Climate change risk (which could include reputation and weather risk) is a new and important risk that may need to be disclosed in MD&A.[173] In the case of MD&A disclosures, the impact of pending legislation or cap and trade systems may also trigger disclosure.[174] There is also specific guidance for the insurance industry.[175]

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[164] 17 CFA 230.408
[165] 17 CFR 240.12b-20
[166] Release No. 33-6383 (3 March 1982)
[167] 17 CFR 229.103. At this point environmental litigation was not really an environmental disclosure. Rather any litigation that could materially alter the financials of a company would be included.
[168] 17 CFR Part 229
[169] 17 CFR Part 210
[170] SEC, *Commission Guidance Regarding Disclosure Related to Climate Change* 17 CFR PARTS 211, 231 and 241 [Release Nos. 33-9106; 34-61469; FR-82] (effective February 2, 2010) ("SEC Guidance")
[171] *Ibid* at 7
[172] *Ibid* at 22; See Items 101, 103, and 303 & 503(c) of Regulation S-K
[173] SEC, *Commission Guidance*, *supra* n 177 at 25
[174] *Ibid* at 23
[175] On March 17, 2009, the NAIC adopted a mandatory requirement that insurance companies disclose to regulators the financial risks they face from climate change, as well as actions the companies are taking to respond to those risks. All insurance companies with annual premiums of $500 million or more will be

Several states have mandatory GHG reporting mandates, although it is beyond the scope of this thesis to research them.[176] There is no guidance for water, or other environmental issues, and it is clear that not all environmental issues are covered by these disclosure requirements.

Human rights' reporting is also coming into the mainstream in the USA.[177] Issues ranging from conflict minerals and payments to governments are beginning to be reported.[178] The SEC produced standards for assessing diversity policies and practices of regulated entities.[179] The standards included organizational commitment to diversity and inclusion; employment practices; procurement and business practices; and practices to promote transparency of organizational diversity.[180] Diversity in this standard is defined as minorities and women.[181]

As in Canada, there is great debate on whether securities laws are the best avenue to legislatively address human rights concerns. It is argued that securities laws may make these measures become effective as companies notice securities laws.[182] Securities laws

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required to complete an Insurer Climate Risk Disclosure Survey every year, with an initial reporting deadline of May 1, 2010. The surveys must be submitted in the state where the insurance company is domesticated. See NAIC, "Insurance Regulators Adopt Climate Change Risk Disclosure" (2009) online available at: www.naic.org/Releases/2009_docs/climate_change_risk_disclosure_adopted.htm. Accessed March 14, 2018

[176] For a discussion of specific state requirements, see EPA, *State and Local Climate Change Laws*, Available at: http://epa.gov/climatechange/wycd/stateandlocalgov/state_reporting.html accessed March 10, 2018. Note that this is beyond the scope of this paper.

[177] Sarfaty, *supra* n 14

[178] *Ibid* at 98, 106-107; However, the Trump Administration is rolling back several environmental regulations. See Harvard University, *Harvard Regulatory Rollback Tracker*, online at: http://environment.law.harvard.edu/policy-initiative/regulatory-rollback-tracker/

[179] *Final Interagency Policy Statement Establishing Joint Statements for Assessing the Diversity Policy and Practices of Entities Regulated by the Agencies*, SEC Release No. 34-75050; File No. S7-10-15 (10 June 2015)

[180] SEC, "Standards for Assessing the Diversity Policies and Practices of Entities Regulated by the Securities and Exchange Commission - Frequently Asked Questions" SEC 80 FR 33016 at 1

[181] *Ibid* at 3

[182] Sarfaty, *supra* n 140 at 109

may also raise the profile on human rights issues.[183] The main argument against disclosures of human rights issues is that this information may be 'information overload' while not being material.[184] It is also argued that human rights reporting has little to do with the purpose of securities laws,[185] may not have any effect on changing corporate behaviour,[186] and could even push peoples to conflict.[187] Thus there is great debate on materiality and disclosures of human rights issues and even claims that diversity could cause investors to lose money.[188]

In 2009, the SEC adopted disclosure rules intended to enhance corporate governance factors, such as executive compensation,[189] and diversity on boards.[190] This rule requires disclosure of whether the board nominating committee has a policy on diversity.[191] In 2016, the SEC issued a Concept Release[192] on the Business and Financial Disclosure under *Regulation S-K* (the "2016 Concept Release.")[193] The 2016 Concept Release was developed due to calls from investors interested in the potential relevance of ESG variables in assessing shareholder value, due to the inadequate disclosure of climate change and other environmental risks.[194] The 2016 Release requested comments related

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[183] *Ibid* at 110
[184] *Ibid* at 113
[185] *Ibid* at 100
[186] *Ibid* at 106
[187] *Ibid* at 110
[188] Amanda Packel, "Government intervention into board composition: Gender quotas in Norway and diversity disclosures in the United States" (2016) 21:2 Stanford Journal of Law, Business & Finance 192-239 at 201. See also Aaron Dhir, *Challenging Boardroom Homogeneity* (Cambridge University Press, 2015) at 67
[189] Regulation S-K, *supra* n 168, Item 402
[190] *Ibid,* Item 407(c)(2)(vi)
[191] SEC, *Proxy Disclosure Enhancements*, online at: https://www.sec.gov/rules/final/2009/33-9089-secg.htm
[192] Precursor to a proposed rule: U.S. SEC, *Business and Financial Disclosure Required by Regulation S-K* [hereinafter 2016 Release], 81 Fed. Reg. 23915; Release No. 33-10064; 34-77599; File No. S7-06-16 (Apr. 13, 2016
[193] SEC, 17 CFR Parts 210, 229, 230, 232, 239, 240 and 249 Release No. 33-10064; 34-77599; File No. S7-06-16
[194] *Ibid, Part* 208

to whether ESG disclosures were necessary.[195] Many comments were received requesting additional disclosures; however, it is beyond scope to address all of them.

The CFA Institute's response will represent all responses requesting the SEC to implement additional ESG disclosures. Materiality of ESG issues should vary on an industry-by-industry, (or company-by-company basis), and the SEC should work with investors and issuers on material ESG issues relevant to specific industries.[196] The SEC needs to ensure that adequate measurement, authentication and disclosure of ESG factors are undertaken by issuers so that investors can have a full understanding of the long-term value of a company.[197] The CFA Institute then noted that "to the extent that the effects that other regulations may have on a registrant's capital expenditures, earnings and competitive position are material and are measureable and knowable, they should be disclosed."[198] The CFA Institute recommended a flexible approach that allows industries not to have to worry about disclosures that do not apply to them.[199] They conclude:

> …many issuers already provide lengthy sustainability or ESG reports to their investors; so many issuers will not face a new and burdensome cost by collecting, verifying and disclosing ESG information. However, costs may be saved if instead of producing large sustainability reports that cover a broad range of sustainability information, issuers can instead focus on only collecting, verifying and disclosing information concerning the factors that are material to them and their investors. We believe that all issuers should be held to the same disclosure standards on sustainability and public policy issues. [200]

GM, one of the many companies arguing against additional ESG disclosure, responded by stating that line item disclosures for sustainability or public policy issues will

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[195] William Thomas & Annise Maguire, *SEC Studying Change of Regulation S-K to Require ESG Disclosures Client Memorandum* (7 November 2016) (Willkie Farr and Gallagher, LLP: New York, 2016)
[196] CFA Institute, *Re: Business and Financial Disclosure Required by Regulation S*-K (File No. S7-06-16), (letter to SEC) (6 October 2016) at 10; the CFA Institute governs the Chartered Financial Analyst ("CFA") designation. The CFA is the preeminent designation required to become a portfolio manager.
[197] *Ibid* at 10
[198] *Ibid* at 10
[199] *Ibid* at 18
[200] *Ibid* at 19

overburden what is principally a financial and operational report with information that is immaterial to financial or operational performance, and immaterial to an investor's investing or voting decisions.[201] GM "acknowledges that companies are obligated to discuss climate change and related matters only to the extent material and without materiality this will result in increased disclosure burdens for companies and overload for investors."[202] GM was only one of many companies pushing back on disclosure requirements. Unfortunately, the Trump administration does not take climate change seriously.[203] They are rolling back many environmental protections, and further rollbacks could weaken disclosures.[204] This could have large scale human effects.[205] There are still many gaps in ESG disclosures in the USA.

Securities law mandates certain disclosures, but there is a lack of uniformity and comparable data is not easy to find. Both Canada and the USA struggle with finding a balance between material disclosure and information overload. This creates uncertainty. To overcome this uncertainty, companies are making voluntary disclosures in accordance to international frameworks, the subject of the next section.

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[201] Thomas Timko, General Motors Corp, *Re: File No. 57-06-16, Release No. 33-10064, 34-77599; Business and Financial Disclosure Required by Regulation S-K Letter to SEC*, (30 September 2016) at 5 This viewpoint is not surprising given the industry of the firm, i.e. automotive. GM is primarily dependent on fossil fuel vehicles sales for revenue. Most climate change action would see a decrease in fossil fuel use, which would impact GM. That being said, GM is a leader in electric and hydrogen vehicles. Fossil fuel free investments will be investigated in Chapter 7 as part of a pension funds divestiture strategy.

[202] *Ibid* at 2

[203] Michael Greshko, Laura Parker & Brian Howard, "A running list of how President Trump is changing Environmental Policy" Blog (23 July 2018) National Geographic, online at: https://news.nationalgeographic.com/2017/03/how-trump-is-changing-science-environment/

[204] Harvard University, *Harvard Regulatory Rollback Tracker*, online at: http://environment.law.harvard.edu/policy-initiative/regulatory-rollback-tracker/

[205] David Cutler & Francesca Dominici, "A Breath of Bad Air: Cost of the Trump Environmental Agenda May Lead to 80 000 Extra Deaths per Decade" (2018) 319:22 JAMA 2261-2262

2.2 Transnational Law and RI

RI fits well within theories of Transnational Legal Pluralism.[206] Instruments of transnational governance are not 'hard' international law, but are 'soft law' normative mechanisms that regulate and guide behaviours of the target entities.[207] These soft law instruments are neither irrelevant nor non-binding.[208] Rather, they serve three purposes; rule setting, monitoring, and agenda setting.[209] Many standards are based on New Governance theories, which propose that societies should transcend traditional deterrence and punitive measures and move towards normative and self-regulating activities.[210] The results of these frameworks posit improved disclosures of material ESG risks. Financial institutions ("FIs") are perceived as "unseen polluters" as they finance activities that cause pollution, such as oil and gas.[211] FIs could have a pivotal role in the development of the risk adjustment metrics to address environmental and social issues.[212]

FIs finance many types of projects and have a strong voice in the financing and investing of environmental projects.[213] Companies listed on stock exchanges require capital to finance projects.[214] UNEP FI urges FIs to promote sustainable finance.[215]

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[206] Peer Zumbansen, "Transnational Legal Pluralism" (2010) 1:2 Transnational Legal Theory 141-189
[207] David Ong, "From 'International' to 'Transnational' Environmental Law: A Legal Assessment of the Contribution of the 'Equator Principles' to International Environmental Law" (2010) 79 Nordic Journal of International Law 35–74 at 45
[208] For a discussion on the soft international law see A Boyle, "Some Reflections on the Relationship of Treaties and Soft Law" (1999) 48:4 International and Comparative Law Quarterly 901-913
[209] B Jacobsson & K Sahlin-Andersson, "Dynamics of soft regulations" in *Transnational governance: Institutional dynamics of regulation,* M Djelic & K. Sahlin-Andersson (eds.) (Cambridge: Cambridge University Press, 2006)
[210] Eric Orts, "A Reflexive Model of Environmental Regulation" (1995) 5:4 Business Ethics Quarterly 779-794 at 780; see also Aaron Dhir, *supra n 188* at 95
[211] Benjamin Richardson, "Financing Sustainability, the New Transnational Governance of Socially Responsible Investment" (2009) 74 Yearbook of International Environmental Law 73-110 at 75
[212] John Conley & Cynthia Williams, "Global Banks as Global Sustainability Regulators?: The Equator Principles" (2011) 33:4 Law and Policy 542-575
[213] Erin E Dooley," UNEP finance initiative" (2006) 114:8 Environmental Health Perspectives 1
[214] Many firms on the TSX-V are junior mining companies with offshore projects (often in less developed countries in Africa). See, TMX Market Intelligence Group, *TSX-V YTD New Listings*, (15 February 2018) online at: https://www.tsx.com/listings/current-market-statistics accessed February 28, 2018

UNEP FI created a framework attempting to embed ESG principles in an FI's financial operations.[216] This framework provides guidance for financial institutions to incorporate ESG factors, including commitments, practices and policies, to better account for, ESG risks.[217] UNEP FI's framework integrates RI factors into retail banking, (which includes RI mutual funds), and also illustrates the need to have access to banking services recognized as a quasi-human right.[218]

The 2015 Sustainable Development Goals ("SDGs") are the most recent movement that will impact RI.[219] Developed from the Millennium Development Goals,[220] the seventeen (17) SDGs support issues including the elimination of hunger and poverty, the necessity of clean water, and the mitigation of the effects of climate change.[221] It is hoped that these SDGs will influence corporate disclosures.[222] Best practices for corporate disclosures have not yet materialized, although they are being

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[215] UNEP FI, *Guide to Banking and Sustainability, Edition 2* (New York, UNEPFI, 2016) online at: http://www.unepfi.org/wordpress/wp-content/uploads/2017/06/CONSOLIDATED-BANKING-GUIDE-MAY-17-WEB.pdf at 4

[216] UNEP FI, *Statement of Commitment by Financial Institutions (FI) on Sustainable Development* (UNEP, online: 2011) Available at: http://www.unepfi.org/about/unep-fi-statement/ accessed February 27, 2018 at s. 2.3

[217] UNEP FI, Guide to Banking, *supra* n 215 at 23, 29

[218] *Ibid* at 62-63, 65; Two and a half billion people do not have access to financial services; precluding access to banking, credit and financing, which would help to alleviate poverty through business/start up financing, education funding, and micro finance/debt lending.

[219] United Nations, *Transforming Our World: The 2030 Agenda for sustainable development. Draft resolution referred to the United Nations summit for the adoption of the post-2015 development agenda*, United Nations General Assembly, 2015) sixty-ninth session. UN Doc. A/70/L.1 of (18 September 2015)

[220] United Nations, Resolution 56/326, *Road Map towards the Implementation of the United Nations Millennium Declaration* (6 September 2001) online at: http://www.un.org/millenniumgoals/sgreport2001.pdf accessed February 27, 2018

[221] SDGs, *supra* n 219, Other SDGs will be investigated where appropriate. SDG 17 aims to ensure that multinational corporations pay their 'fair share of taxes' and pay employees a living wage. SDG Targets 17.1 and 17.3 support tax collection on corporate entities in developing countries. Target 17.4 will assist developing countries in long-term debt sustainability

[222] Libby Bernick, "Can SDGs Shape the Future of Corporate Disclosure?" Blog (25 October 2017) online at: http://www.csrwire.com/blog/posts/1862-can-sdgs-shape-the-future-of-corporate-disclosure accessed July 28, 2018

developed.[223] For transparency, a set of disclosures is being developed, to assisted companies with qualitative and quantitative disclosures per SDG target.[224] Recommended disclosures include carbon emissions,[225] the number of indigenous rights violations,[226] air quality,[227] gender equality,[228] infrastructure spending,[229] number of women in leadership positions,[230] access to water and other water issues,[231] and many others. There are still gaps where disclosures are not available.[232] This is especially true for social inclusiveness, the equitable sharing of transnational resources, and the lack of meaningful environmental targets such as water access and carbon emissions reductions.[233] The SDGS posit a heightened notion of sustainable development, and RI should evolve to incorporate the SDG principles.

The United Nations Global Compact ("GC") is one of the most prominent CSR initiatives implemented by companies.[234] The GC is a set of ten (10) principles that strives to promote human rights, environment, anti-corruption, and improved labour behaviours.[235] UN Secretary General Moon notes "Our United Nations Global Compact

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[223] UN GC, *Action Platform: Reporting on the SDGs*, online at: https://www.unglobalcompact.org/take-action/action-platforms/sdg-reporting accessed August 1, 2018
[224] GRI, *Business Reporting on the SDGs, Analysis of the Goals and Targets, a study by PwC* (15 February 2018) (GRI, Global Compact & PwC, 2018) at 2, 11, 198
[225] *Ibid*, Target 1.5 at 26
[226] *Ibid*, Target 2.3 at 31
[227] *Ibid* at 48, 49
[228] *Ibid* at 61
[229] *Ibid* at 65
[230] *Ibid* at 67
[231] *Ibid* at 72-75
[232] *Ibid* at 15, 22, 38
[233] *Ibid* at 52 (children's education), 61 (equal pay), 72 (water footprint), 77 (wastewater) 88 (renewable energy) 102 (labour) & 105 (human rights) 126 (pay gaps) 138 (supply chain management) and 154 emission reduction targets; see also, Joyeeta Gupta & Courtney Vegelin, "Sustainable development goals and inclusive development" (2016) 16 International Environmental Agreements 433–448 at 441
[234] Eduardo Ortas, Igor Álvarez & Ainhoa Garayar, "The Environmental, Social, Governance, and Financial Performance Effects on Companies that Adopt the United Nations Global Compact" (2015) 7 Sustainability 1932-1956
[235] UN GC, *The Ten Principles of the UN Global Compact*, Available at: https://www.unglobalcompact.org/what-is-gc/mission/principles accessed February 4, 2018

is the starting point for any company seeking to advance the Sustainable Development Goals."[236] There are currently over 9700 signatories to the GC.[237] The GC's Ten Principles are derived from: *The Universal Declaration of Human Rights*, the International Labour Organization's *Declaration on Fundamental Principles and Rights at Work*, the *Rio Declaration*, and the *United Nations Convention against Corruption.*[238] The GC is especially relevant to RI, as it focuses on the environment, human rights, and labour issues.[239] The GC provides engagement platforms, best practices and other resources to embed the SDGs into business practice.[240]

The GC is in process of developing a framework for corporate reporting for the SDGs. Trucost, an ESG rating agency, believes a framework should, as best practices: incorporate ESG into valuations, assess materiality of impacts, quantify impacts, measure additional metrics, compare against targets, make targets sector specific, and make these practices comparable across industries and companies."[241]

Increasingly, companies are adding a labour due diligence process on their processes and the processes of their supply chains.[242] Labour and human rights are often less analytically quantitative, so it is more difficult to judge a company's social

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[236] UN Secretary-General Ban Ki-moon's remarks, as prepared for delivery, at the United Nations Private Sector Forum, see US Fed News Service, "United Nations Global Compact 'Starting Point' for any Business Seeking to Advance the Sustainable Development Goals, Secretary General tells Forum" Release (28 September 2015) US State News, accessed via ProQuest databased June 14, 2018
[237] UN GC, *2017 UN Global Compact Progress Report, Building Solutions to Sustainable Development* (New York: UNGC, 2017)
[238] Global Compact, *Mission and Principles*, accessed February 21, 2018. Available at: https://www.unglobalcompact.org/what-is-gc/mission/principles
[239] UN GC, *supra* n 237
[240] UN GC, *SDG Toolbox*, online at: https://www.unglobalcompact.org/sdgs/sdg-toolbox
[241] Libby Bernick, *supra* n 222
[242] George Benaur, David Dixon & Jonathan Lenzner, "Evolving Compliance Regulations Impact Scope of Due Diligence; Corporations face greater obligations regarding international supply chain management" (2014) 217:9 New Jersey Law Review 38-40; see also Lahra Liberti, "OECD 50th anniversary: The updated OECD guidelines for multinational enterprises and the new OECD recommendation on due diligence guidance for conflict-free mineral supply chains" (2012) 13:1 Business Law International 35-50

metrics.[243] This 'leverage based responsibility' provides a rationale of investors to promote social and environmental returns to society.[244] Adoption of the GC and the SDGs is said to lead to new growth opportunities (through innovative solutions such as energy efficiency, renewable energy and green buildings) and lower risk profiles (through strengthening stakeholder relations, improving trust, and others).[245] Companies that actively align the practices from the GC, SDGs and the GRI (described below) should help to reduce poverty, strengthen education, and empower women.[246] However, the GC is designed to be a learning framework rather than a set of compliance standards.[247]

The Global Reporting Initiative ("GRI") "helps businesses and governments understand and communicate their impact on critical sustainability issues such as climate change, human rights, governance and social well-being."[248] The GRI was the first organization to develop a set of global standards for sustainability reporting on the economy.[249] The current iteration of the GRI focuses on materiality of information, contextual disclosures about an organization, and the proper management approach to report how a company manages its material topics.[250] This includes reporting requirements, recommendations, and guidance.[251] The GRI is regarded as the most

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[243] UN Human Rights, *Conceptualizing Indicators for Human Rights, Issues to Address in Human Rights Measurement*, (18 January 2013) online at: https://www.ohchr.org/documents/issues/HRIndicators/AGuideMeasurementImplementationChapterII_en.pdf accessed July 26, 2018

[244] GC, *supra n 235*, preamble; see also Richardson, Conflicting Rationales, *supra* n 14 at 322

[245] GRI, GC & World Business Council for Sustainable Development, *SDG Compass: The guide for business action on the SDGs* (2015) online at https://sdgcompass.org/ at 8-9

[246] PwC, *Business Reporting on the SDGs, supra* n 224 at 10

[247] Ortas et al, *supra* n 234 at 1935

[248] Global Reporting Initiative, *Consolidated Set of GRI Sustainability Reporting Standards 2016*, (19 October 2016) online at: https://www.globalreporting.org/Pages/default.aspx accessed February 4, 2018

[249] *Ibid*

[250] *Ibid*

[251] *Ibid*

comprehensive guide to develop sustainability reports.[252] Despite criticisms, the GRI impacts and shapes corporate CSR activities.[253] Studies with the GRI show that even A and A+ rated companies have problems with vague disclosures.[254] More work on defining materiality and what material information needs to be disclosed is required so that accurate comparisons of companies can be completed. Disclosure practices can (and must) be improved.[255]

The CDP is a collection of globally reported climate change, water, and forest risk data.[256] The CDPs 820 institutional investors, holding over US$95 Trillion in assets, include Canadian FIs RBC Global Asset Management, TD Asset Management,[257] and Canadian Pension Plan Investment Board, among others. USA signatories include Blackrock Inc., Bank of America, Calvert Investment Management Inc. ("Calvert"), the New York State Common Fund, among others.[258] Research papers showing financing benefits are a key driver of companies adopting the CDP.[259]

In 2017, fifty-four (54%) of USA board members believe that climate disclosure is important information.[260] This has increased from 24% in 2016.[261] The use of the CDP as a reporting tool in the USA has increased steadily, from 50% in 2011 to 71% in

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[252] KPMG, *International survey of corporate responsibility reporting 2011* (Zurich: KPMG International, 2011)
[253] Vigneau, et al *supra* n 70 at 472
[254] David Talbot & Olivier Boiral, "GHG Reporting and Impression Management: An Assessment of Sustainability Reports from the Energy Sector" (2018) 147 Journal of Business Ethics 367–383
[255] *Ibid* at 375
[256] CDP, *About Us*, online at: https://www.cdp.net/en-US/Pages/About-Us.aspxaccessed February 21, 2018
[257] As full disclosure, the author assisted in the drafting of the TD annual corporate responsibility report from 2009-2011
[258] For a complete list, see, CDP Investor Members and Signatories, online at: https://www.cdp.net/en/investor/signatories-and-members#7045b83784a78ee84c56f99c6ad0eb78
[259] Gunnar Friede, Timo Busch & Alexander Bassen, "ESG and financial performance: aggregated evidence from more than 2000 empirical studies" (2015) 5:4 Journal of Sustainable Finance & Investment 210-233
[260] CDP, *US Report 2017 Key Findings on Governance, ESG and the Role of the Board of Directors* (New York: CDP, 2017) at 8
[261] *Ibid* at 9

2017.[262] Unfortunately, the US still lags in water and deforestation reporting and board oversight,[263] showing flaws with voluntary reporting. Canada fares better on all three measures. There is board level oversight for 76% of reporting companies on climate change, 71% on water and 33% for forests.[264] Reporting is very sector specific, ranging from a 73% response rate for IT and Telecommunications services sector, to a low of 35% for utilities.[265] Forty percent (40%) of Canadian energy companies report to the CDP.[266] Canada is also a leader for companies incorporating an internal price on carbon. As of 2017, 60 companies, including 18 from the energy sector, have developed a price on carbon.[267] Going forward, CDP will take a sector-based approach to disclosure, which is important as not all ESG issues apply uniformly.[268] There will also be a greater emphasis on board and senior management oversight of climate related issues.[269]

The lack of standardized data evidences a strong problem with RI analyzes. Studies have also shown that carbon emissions reported in CDP are larger than those reported in CSR reports.[270] Even within the CDP, there are still inconsistencies in reporting and data content.[271] This is one of the primary reasons why there is no one set of standards used by industry, and why ESG reporting is very difficult to compare across companies and funds. It is time consuming to undertake to review all financial data for a

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[262] *Ibid* at 10
[263] *Ibid* at 11
[264] CDP, *Canada Report 2017* (New York, CDP, 2017) at 4
[265] *Ibid* at 4
[266] *Ibid*
[267] *Ibid* at 7
[268] CDP, *Disclosure in 2018*, online at: https://www.cdp.net/en/companies-discloser/disclosure-in-2018 accessed July 26, 2018. Sectors included are: Agriculture, Energy (including oil & gas), Materials (including mining), and Transport
[269] CDP, *CDP Question Changes and Map: 2017 to 2018*, (21 June 2018) online at: https://www.cdp.net/en/guidance/guidance-for-companies accessed July 26, 2018
[270] Florence Depoers, Thomas Jeanjean & Tiphaine Jerome, "Voluntary Disclosure of Greenhouse Gas Emissions: Contrasting the Carbon Disclosure Project and Corporate Reports" (2016) 134 Journal of Business Ethics 445–461
[271] *Ibid* at 447

company. Standardizing information should be a priority. Accounting entries are standardized; it should be apparent that carbon and water reporting should also become standardized.[272] Standardization should lead to enhance integration and financialization.[273]

The United National Principles of Responsible Investing ("UN PRI" or "PRI") is the seminal work as it relates to asset management and RI.[274] Since its inception in 2005, signatories under the PRI have increased significantly, with over $68 trillion in assets under management and over 1700 signatories.[275] Signatories believe that the ESG principles under the PRI will lead to long term financial benefits.[276] Under the 'stakeholder salience' theory, companies become signatories to the PRI for pragmatic reasons, including organizational legitimacy, utilitarian power and enhanced management values.[277] Initial PRI signatories were ESG oriented investors, but as time passed, mainstream investors have become members, driven by its growing legitimacy and business case.[278] Unfortunately, the PRI does not demonstrate or necessitate any

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[272] Lauren Caplan, *supra* n 73 at 238-239
[273] *Ibid* at 242-243
[274] United Nations, *Principles of Responsible Investing*, online at: https://www.unpri.org/ accessed February 4, 2018. The six principles are:
Principle 1 – We will incorporate ESG issues into Investment Analysis and decision making processes.
Principle 2 – We will be active owners and incorporate ESG issues into our ownership policies and practices.
Principle 3 – We will seek appropriate disclosure on ESG issues by the entities in which we invest.
Principle 4 – We will promote acceptance and implementation of the Principles within the investment industry.
Principle 5 – We will work together to enhance our effectiveness in implementing the principles.
Principle 6 – We will each report on our activities and progress towards implementing the principles.
[275] MSCI & PRI, *Global Guide to Responsible Investment Regulation 2016* (New York: MSCI, 2016)
[276] Riikka Sievanen, John Sumelius et al., "From struggle in responsible investment to potential to improve global environmental governance through UN PRI" (2013) 13 International Environmental Agreements 197–217
[277] Arleta Majoch, Andreas Hoepner & Tessa Hebb, "Sources of Stakeholder Salience in the Responsible Investment Movement: Why Do Investors Sign the Principles for Responsible Investment?" (2017) 140 Journal of Business Ethics 723–741 at 735
[278] *Ibid* at 736

performance standard nor require any audit or verification system.[279] For pension funds to implement the PRI, "the struggle is real."[280]

Principle 1 of the PRI instructs on how to integrate ESG into portfolio analysis.[281] There are four principal strategies used by the PRI. The first incorporates fundamental financial strategies in company valuation.[282] PRI provides guidance to incorporate ESG into financial and valuation models for the expected impact of ESG.[283] Second, the PRI includes quantitative strategies to build models that integrate ESG factors.[284] Third, "smart beta strategies" financialize risk.[285] Smart beta strategies attempt to enhance risk adjusted returns through exposure to certain desired characteristics.[286] They use "simple, rules based and transparent" portfolio construction.[287] Typical characteristics used include capitalization/size, dividend yield, value, momentum, and volatility.[288] These factors are then weighted according to certain schemes, such as capitalization weighted, equal weighting, and factor weighing.[289] ESG factors would become a weight and a desired factor in portfolio construction to reduce risk.[290] Finally, for passive/index managers, the PRI has strategies to influence index construction to account for potential

[279] Richardson and Cragg, *supra* n 26 at 31
[280] Sievanen et al, *supra* n 276 at 205
[281] UN PRI, *A Practical Guide to ESG Integration for Equity Investing* (New York, PRI, 2016) online at: https://annualreport.unpri.org/docs/PRI_A-Practical-Guide-to-ESG-Integration-for-Equity-Investing_2016.pdf at 13
[282] *Ibid* at 22
[283] *Ibid* at 23
[284] *Ibid* at 36
[285] *Ibid* at 43
[286] Ronald Kahn & Michael Lemmon, "Smart Beta: The Owner's Manual" (2015) 41:2 Journal of Portfolio Management 76-83 at 76
[287] *Ibid* at 77
[288] Ben Laurence, "In search of Patterns" (2017) London Business School Review 52-55 at 52
[289] Nicholas Alonso & Mark Barnes, "Efficient Smart Beta" (2016) 25:1 Journal of Investing 103-115 at 104
[290] PRI, *ESG Integration for Equity Investing, supra* n 281 at 43-44

risk in the index.[291] These methods are only useful if the underlying information is complete.

Spurred on by success, the PRI has added additional guidelines, including guidelines for private equity.[292] Limited partners will use these guidelines to incorporate RI into fund terms when committing to private equity.[293] The 2016 Montreal Carbon Pledge signatories commit to measure the carbon footprint of their investment portfolios and disclose them. [294] Stated:

> "The first step to managing the long-term investment risks associated with climate change and carbon regulation is to measure them and this initiative sets a clear path forward for emissions reductions."[295]

Prior to this Pledge, subscribing to the PRI or CDP were 'nice to haves" often with only brand recognition resulting for their efforts. This provides evidence that the international community recognizes the need for material information. Voluntary information is only useful is acted upon. There is a need for mandated domestic disclosures.

Together, the CDP, the GC, and others, have committed to the Non-State Actor commitments to climate action ("NAZCA").[296] NAZCA investor signatories, including FIs and other portfolio managers, have made various commitments, which include setting an internal carbon price, climate change reporting as a fiduciary duty, divestment strategies, and the Montreal Carbon Pledge.[297] These groups are beginning to realize the

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291 *Ibid* at 50

292 UN PRI, *Incorporating Responsible Investment Requirements into Private Equity Fund Terms* (UNPRI, 2017) online at: https://www.unpri.org/press-releases/pri-launches-private-equity-fund-terms-guide accessed February 22, 2018

293 *Ibid* at 7

294 UN PRI, *2016 Montreal Pledge, accelerating investor climate disclosure*, (25 September 2015) (Montreal: UNPRI, 2014) online at: http://montrealpledge.org/ accessed February 28, 2018

295 Fiona Reynolds, Managing director of the PRI, PRI Annual Conference, Montreal (25 September 2014)

296 NAZCA, *Tracking Climate Action*, at http://climateaction.unfccc.int/ ; Tracking the data is one of the critical necessary steps.

297 NAZCA, *Private Finance*, online at: http://climateaction.unfccc.int/total-commitments?theme=private-finance accessed August 3, 2018

power of bringing together data sources, but NAZCA only represents a small portion of ESG issues.[298] Each signatory has not made the same commitments, goals or targets. Comparing company commitments is still difficult and NAZCA has not solved the problem of a lack of fulsome material disclosures, especially with regards to qualitative human and social rights data.

The OECD Guidelines for Multinational Enterprises ("Guidelines") recommend due diligence in order to identify, prevent and mitigate potential adverse social impacts.[299] The Guidelines enlighten portfolio managers on the ESG risks that should be considered material.[300] ESG integration depends on materiality, and materiality is only relevant if properly disclosed.[301] Investment companies are now expected to influence investee companies to prevent or mitigate adverse impacts.[302] These influencing behaviours including active voting, direct contact with management, exclusionary/divestment policies,[303] and ESG covenants in bond agreements.[304] Human rights are less inherently quantifiable than certain environmental factors like carbon emissions, and due diligence techniques are required to identify impacts.[305] In other words, the "S" in ESG is difficult to quantify.

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298 *Ibid*
299 OECD, *OECD Due Diligence Guidance for Responsible Business Conduct*, online at: http://mneguidelines.oecd.org/due-diligence-guidance-for-responsible-business-conduct.htm
300 OECD, *Responsible business conduct for institutional investors Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises* (2017) at 12
301 *Ibid* at 43
302 *Ibid* at 13 & 15
303 *Ibid* at 32 & 39
304 *Ibid* at 37, Active investing will be discussed later in the thesis (Chapter 7).
305 Sally Engle Merry, *The Seductions of Quantification, Measuring Human Rights, Gender Violence and Sex Trafficking* (University of Chicago Press: Chicago Series in Law and Policy, 2016); see also Claret Vargas, "Measuring What Matters: A Key Challenge in Human Rights and Business" Blog, (21 June 2016) online at: http://blogs.lse.ac.uk/businesshumanrights/2016/06/21/claret-vargas-measuring-what-matters/#more-767

FI's engage in project finance which involves potentially greater ESG risks due to the scale of projects.[306] The Equator Principles ("EPs") are a set of benchmarks for determining and managing environmental and social risk in projects.[307] The EPs establishes guidelines for the assessment of these risks, including a recent addition of Free, Prior and Informed consent ("FPIC") as a requirement for the signatories in their project finance lending activities.[308] If FIs adopt the EP, "access to capital may depend on borrowers proving that a project can meet standards like FPIC, even if not required by law."[309] The EP signatories have reporting mechanisms to ensure compliance.[310] Unfortunately, there are no penalties or liabilities from the EPs and as such banks still finance projects with substantial environmental risks.[311] Currently, 92 financial institutions have adopted the EPs.[312]

Studies have shown that adoption of the EPs leads to abnormal positive returns.[313] Mass Affluent retail investors rarely, if ever, can access project finance. Disclosure to the public is less relevant for the EPs. Credit risk management mitigation for lenders, is

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[306] David Ong, *supra* n 207 at 38-39

[307] Equator Principles, *The Equator Principles*, online at: http://www.equator-principles.com/resources/equator_principles_III.pdf accessed February 21, 2018; Conley and Williams, *supra* n 212 at 565 & 568; the EPs are proof that interest groups and activist investors can have a profound effect on responsible investing practices; see also Manuel Wörsdörfer, *supra* n 55

[308] EPs, *Review of the Equator Principles – Towards EP4* (16 March 2018) online at: http://equator-principles.com/ep4/. There is a targeted review of EP4, to specifically enhance FPIC and climate risk disclosures and to create an enhanced risk management framework to support FIs to identify, assess and manage ESG risks.

[309] Michael Torrance, "Banks look to apply free prior and informed consent in North America" (2017) 138:7 Canadian Mining Journal 9-10 at 9. Canadian FI's that are signatories to the EPs include Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, Export Development Canada, Manulife Financial Corp., Royal Bank of Canada, and TD Bank Financial Group. US companies include Bank of America, Citigroup, Ex-IM bank, JP Morgan Chase, and Wells Fargo Bank.

[310] Manuel Wörsdörfer, "Equator Principles: Bridging the Gap between Economics and Ethics?" (2015) 120:2 Business and Society Review 205-243 at 211-212

[311] Richardson, *Natures Trust supra* n 40 at 94

[312] EPs, *supra* n 307

[313] Sebastian Eisenbach, Dirk Schierkec et al, "Sustainable Project Finance, the Adoption of the Equator Principles and Shareholder Value Effects" (2014) 23 Business Strategy & Environment 375–394 at 390

highly relevant.[314] The EPs "help to reduce information asymmetries between lenders and borrowers and the risks inherent to incomplete contracting."[315] If FIs can manage and financialize risk in the project finance context, why can they not do so for the public equity and fixed income market?

2.3 Summary Conclusions

The credibility of disclosure is difficult to assess, which is the reason that reputable international projects like the CDP provide quantifiable metrics.[316] Enhanced disclosures would allow better comparisons between companies and thus would allow for better construction of RI portfolios for Mass Affluent investors. The current available information needs to be organized, combined and aligned so that CSR reports and financial disclosures contain identical information.[317] This would ensure accurate comparisons can be made. This also serves to provide the legitimacy firms need to promote ESG activities.[318] NAZCA is one unifying model attempting to integrate basic ESG data. A holistic solution would unify a significantly greater amount of information, including carbon, water, forest, human rights, tax, royalty, female/minority/diversity representation, aboriginal rights, SDG, etc., into one cohesive dataset. The frameworks to provide the necessary data exist: CDP provides the carbon, water and forest data, the GRI provides the CSR data, the GPs provide the human rights data, the EPs provide the project finance data, ESTMA and other sources provide royalty data, and other provisions provide the women/diversity data. Technologies will improve and an IT solution to

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314 Wörsdörfer, *supra* n 310 at 213
315 *Ibid* at 214
316 CDP, s*upra* n 257 at 28; ESG agencies such as Sustainalytics will be noted in Chapter 6
317 Lauren Caplan, *supra* n 73 at 242-243
318 F Fortanier, A Kolk, & J Pinkse, "Harmonization in CSR reporting" (2011) 51:5 Management International Review 665–696

unify all ESG data should be created. However, it is beyond the scope of this thesis to construct such a solution.

Robust domestic securities laws are still required to mandate the incorporation of underlying information into financial disclosure documents. Material disclosures should be conducted on an industry basis. The debate on whether or not to disclose information is based on the materiality of said information. Many companies argue about a lack of impact these disclosures have on portfolio manager behaviour.[319] Without proper disclosures, neither investors nor financial advisors will be aware of the potential ESG risks that may occur within a particular investment. Having a unified set of data, brought together on an IT platform, would streamline reporting processes and simplify comparisons. The answer to RQ1 is no, there are not sufficient material disclosures of ESG information mandated by securities regulators in Canada or the USA, and transnational frameworks fill in some, but not all of the gaps. Proper comparisons can only be made once data is incorporated into financial models. Financializing information is the subject for Chapter 3.

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[319] Sitikantha Parida, & Terence Teo, "The impact of more frequent portfolio disclosure on mutual fund performance" (2018) 87 *Journal of Banking and Finance* 427-445

CHAPTER 3 – FINANCIAL ASPECTS TO RETAIL FUND CONSTRUCTION

Portfolio managers use financial models to create funds. This chapter introduces certain financial concepts, including the lack of integrated ESG metrics into financial models. There are too many theories to outline their impacts on RI, and it is beyond scope to attempt such a task. The goal of this chapter is to explore certain measures of Modern Portfolio Theory ("MPT"), including risk, return, and alpha. The chapter posits the need for ESG metrics to be incorporated into valuations – that is, they need to be financialized. At present, ESG factors are not properly understood and not properly priced. The chapter shows problems with performance studies and shows that ESG organizations, such as Sustainalytics, are attempting to better understand ESG factors and create better ESG 'scores' for company valuations.

3.1 Modern Portfolio Theory

MPT was envisioned by Harry Markowitz in the 1950s.[320] Conceptually, MPT is a framework on portfolio construction that attempts to maximize the expected return of an asset per given unit of risk.[321] It formalized the theory of diversification of assets as a necessary part of a properly created investment portfolio.[322] In other words, it formalized the concept of "don't put all your eggs in one basket." Two important sub concepts in MPT are the theory of risk and the 'risk free asset', and the Capital Asset Pricing Model

[320] Harry Markowitz, "Portfolio Selection" (1952) 7:1 The Journal of Finance 77–91
[321] *Ibid*; See also Mehdi Beyhaghi & James P. Hawley, "Modern portfolio theory and risk management: assumptions and unintended consequences" (2013) 3:1 Journal of Sustainable Finance & Investment 17-37 at 21
[322] Jonathan Hoekstra, "Improving biodiversity conservation through modern portfolio theory" (2012) 109:17 PNAS 6360-6361

("CAPM").[323] Risk in context for this section is defined from a financial and mathematical perspective, and is used in pricing equity and debt instruments. According to MPT, having certain restrictions that narrows down the number of potential investments will increase risk.[324]

MPT created the 'efficient frontier.'[325] The efficient frontier represents the combination of assets that provides the maximum return per unit of risk.[326] In other words, risk adverse investors can construct an investment portfolio to optimize their expected return based upon their personal acceptable level of risk.[327] With more risk comes more reward, however, risk/reward it is not a linear relationship and an investor cannot simply look at the risk of one particular investment. An investor must calculate the risk of the portfolio as a whole. Portfolios that fall 'below' the efficient frontier are too risky for their expected level of return.[328]

There are many risk measures (like value at risk measures) that may reflect investors' true preferences.[329] For certain investors, risk is simply the mathematical standard deviation between a price of a stock or a bond.[330] Standard deviation is based

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[323] Stephen Ross, Franco Modigliani, et al., *Corporate Finance, 11th ed*., (McGraw-Hill, 2015) at Ch. 11
[324] Elisabeth Ausen Engen, Erika Nylander, "Risk and Return of Ethical Funds: The Case of UN PRI" (2015) Master's Thesis (unpublished); see also Philippe Bertrand & Vincent Lapointe, "How performance of risk-based strategies is modified by socially responsible investment universe?" (2015) 38 International Review of Financial Analysis 175–190 at 176
[325] Silvio dos Santos & Humberto Brandi, "Selecting portfolios for composite indexes: application of Modern Portfolio Theory to competitiveness" (2017) 19 Clean Technology Environmental Policy 2443–2453 at 2444
[326] *Ibid* at 2445
[327] Investopedia, *Modern Portfolio Theor*y, online at: https://www.investopedia.com/walkthrough/fund-guide/introduction/1/modern-portfolio-theory-mpt.aspx
[328] *Ibid*
[329] Benjamin Peyo, "a synthesis of Modern portfolio theory and sustainable investment" (2012) 33 Journal of Investing 33-46 at 34
[330] Tessa Hebb, *supra* n 75 at 8

on an assets variance. Variance is a symmetric measure that counts abnormally high returns as just as risky as abnormally low returns.[331]

Mathematical risk measurements are useful only to the degree that they reflect investors' true concerns. For some investors, risk is relevant only for a downward drop in prices ("downside risk").[332] This is the case for most retail investors (including the Mass Affluent) as they often have a specific goal (like retirement) and timeframe to invest.[333] The psychological phenomenon of "loss aversion" relates to investors being more concerned about losses than gains.[334] Thus, for retail investors, the intuitive concept of risk is fundamentally asymmetric in nature.[335] Standard deviation measures risk both on the upside and the downside, but no retail investor worries about the upside standard deviation.[336]

Risk is often measured in finance circles as Beta, which measures how the movement of a stock/bond moves with the market as a whole.[337] A Beta of 1.0 indicates that the investment's price will move in lock-step with the market.[338] A beta of less than 1.0 indicates that the investment will be less volatile than the market, and, correspondingly, a beta of more than 1.0 indicates that the investment's price will be

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[331] *Ibid*
[332] Matthew Sherwood & Julia Pollard, "The risk-adjusted return potential of integrating ESG strategies into emerging market equities" (2018) 8:1 Journal of Sustainable Finance & Investment 26-44 at 31
[333] Franklin Parker, "Quantifying downside risk in goal-based portfolios" (2014) 17:3. The Journal of Wealth Management 68-77
[334] *Ibid* at 69
[335] For a different theory of downside risk, see Frank Sortino, The Sortino Framework for Constructing Portfolios, (Elseiver, 2010). This model is similar in theory to the Sharpe ratio. For a comprehensive review of downside risk, see Victoria V. Dobrynskaya, Downside Risk in Stock and Currency Markets, (September 2014) PhD Dissertation, London School of Economics, unpublished manuscript online at: http://etheses.lse.ac.uk/1031/1/Dobrynskaya_Downside_Risk_in_Stock_and_Currency_Markets.pdf
[336] That is, almost no one worries about making "too much money."
[337] Ross & Modigliani, s*upra* n 323 at 30
[338] *Ibid* at 30

more volatile than the market.[339] If a fund portfolio's beta is 1.2, it's theoretically 20% more volatile than the market.[340] Assets with high betas are thought to be more risky as their volatility will be higher.[341] Certain industries are more risky (such technology companies), while others are inherently less volatile, (such as utilities).[342] Beta is useful for comparing industries, but does not take into account the actual underlying risk of the company itself.

Company level risk includes a firm's cost of capital.[343] This formula adds both the cost of equity and the cost of debt to determine an overall cost of capital for a firm.[344] The higher the cost of capital, the lower the profit a company should show. An implied ESG cost of capital would have financial lenders charge more interest for companies with environmental or social concerns.[345] Any new paradigm should mandate the inclusion of the cost of environmental harms, such climate change to the cost of capital. Adding an internal price on carbon, for example, would raise the cost of capital for firm. This is the most straightforward in jurisdictions that enact carbon pricing mechanisms as the cost of carbon is known.[346] Sustainalytics, featured below, has created such a carbon risk score. The inclusion of improved environmental risks would lead to a decrease in the cost of

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339 *Ibid*

340 Investopedia, "5 Ways To Measure Mutual Fund Risk" Investopedia online Dictionary, available at: http://www.investopedia.com/articles/mutualfund/112002.asp#ixzz4Fdm39CKq accessed May 29, 2018

341 *Ibid*

342 For a list of US industries and their betas, see *Aswath Damodaran, "Betas by Sector (US)", (January 2018), Stern School of Business, online at: http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/Betas.html*

343 Ross & Modigliani, *supra* n 323 at Ch. 13

344 *Ibid*

345 Sudheer Chava, "Environmental Externalities and Cost of Capital" (2014) 60:9 Management Science 2223-2247

346 Max R. Sarinsky, "Discount Double-Check: An Analysis of the Discount Rate for Calculating the Social Costs of Carbon" (2016) 19 N.Y.U. Journal of Legislation & Public Policy 215-248

capital, which should lead to enhanced financial performance.[347] This would be especially pronounced during economic downturns,[348] which helps to explain RI investments conclusively outperforming non-RI funds during the 2008 financial crisis.

Other metrics are extremely difficult to quantify in practice, such that "the inability to design calculative devices that assign a market value to ESG criteria often leads to ESG issues being abandoned."[349] For example, reporting on human rights risks is weak.[350] ESG disclosures, focusing on broad CSR issues, such as indigenous rights, supply chain, and governance structures are also very qualitative.[351] Investor based duties on human rights are ambiguous.[352] Disclosure in a human rights context may be ineffective as the information may be "difficult to interpret because they are only proxies for the probability of human rights abuses; and the regimes ignore the considerable heterogeneity among companies with regard to the probability of risk, which complicates comparisons across disclosures."[353] There is debate about the construction and use of quantitative data on whether they fully reflect qualitative factors.[354] Data indicators that allow for comparisons could be defined through social phenomena by naming them and

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[347] Mark Sharfman & Chitru Fernando, "Environmental Risk Management and the Cost of Capital" (2008) 29:6 Strategic Management Journal 569-592 at 590; see also Trinks & Scholtens, *supra* n 35 at 197 See also Engen & Nylander, *supra* n 324 at 4

[348] Shan Xu, Dochi Liu, & Jianbal Huang, "Corporate social responsibility, the cost of equity capital and ownership structure: An analysis of Chinese listed firms" (2015) 40:2 Australian Journal of Management 245-276

[349] Diane-Laure Arjaliès & Pratima (Tima) Bansal, "Beyond numbers: How investment managers accommodate societal issues in financial decisions" (2018) 39:56 Organization Studies 691–719 at 710, also: I Huault & H Rainelli-Weiss, "A market for weather risk? Conflicting metrics, attempts at compromise and limits to commensuration" (2011) 32 Organization Studies 1395–1419

[350] Shift, *Human Rights Reporting Are Companies Telling Investors what they need to know*? (New York: Shift Project, 2017) at 30

[351] *Ibid* at 33

[352] Richardson & Cragg, *supra* n 26 at 32

[353] Adam Chilton & Galita Sarfaty, "The Limitations of Supply Chain Disclosure Regimes" (2017) 53:1 Stanford Journal of International Law 1-40 at 23

[354] Merry, *supra* n 305 at 15

attaching rights concepts to quantitative factors.[355] Thus, while difficult (and it is beyond the scope of this thesis to attempt such a feat), qualitative factors such as human rights can be converted into quantitative factors.

This lack of measurable ESG risk is a glaring defect in all RI analysis which may preclude any accurate ESG 'score'. This is especially true among fixed income (i.e. bond) managers.[356] Equity managers often use visuals (such as emoji's) to create a 'dissonance' from financial numbers.[357] This makes evaluating companies and assets extremely difficult, but it is not impossible to create quantitative data from qualitative factors.[358]

One model of risk used extensively is the Fama and French three factor model. The Fama and French model of risk adds size and value factors to market risk in the CAPM.[359] It posits that certain firms have excess business risk and are therefore mispriced.[360] The model values risk over a longer time horizon, stating that any short term disadvantage will be overcome by a longer term competitive advantage.[361] While this theory does not specifically posit to add environmental or other social risk factors, it does provide evidence to show that mispricing risk can lead to a mispriced asset.[362] If ESG factors (such as human rights) are not included, then the asset would be mispriced, according the Fama and French.

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[355] *Ibid* at 14
[356] Chilton & Sarfaty*, supra n 353* at 32
[357] Arjaliès & Bansal, *supra* n 349 at 711
[358] Merry, *supra* n 305 at 24
[359] EF Fama, & KR French, "Common risk factors in the returns on stocks and bonds" (1993) 33:1 J. Finan. Economics 3–56
[360] *Ibid*
[361] *Ibid*
[362] See Bertrand & Lapointe, *supra* n 324 at 177

On the return side of the equation, there are many different financial metrics that are used. These include concepts like payback period, internal rate of return, time value of money, net present value and others, and it is beyond the scope of this paper to detail them.[363] One valid exemplar is the discounted cash flow model ("DCF"), a concept used extensively in the world of finance.[364] DCF attempts to form a basis of valuing equities, by using free cash flow and the cost of equity to calculate an expected share price.[365] The greater the risk of a project, asset or firm, the lower the price or value it should have.[366] Adding material ESG risks to the DCF would lower the value of the company or project.

A commonly used measure that combines return and risk is the Sharpe Ratio.[367] This measure measures the return based per unit of risk.[368] This measure is important because rates of return cannot be compared equally. An investor does not usually try to compare rates of return for equities compared to fixed income funds, and rates of return for smaller companies are generally greater than larger, well established firms.[369] A Sharpe ratio normalizes returns and makes assets more comparable.

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[363] See Ross & Modigliani, *supra* n 323. See also Jean Tirole, *The Theory of Corporate Finance* (Princeton University Press, 2006)
[364] There are many authored textbooks on the subject. See Aswath Damodaran, *Damodaran on Valuation: Security Analysis for Investment and Corporate Finance* (Wiley, 2006), McKinsey, Valuation: Measuring and Managing the Value of Companies, 6th ed (Wiley, 2015) Lutz Kruschwitz, & Andreas Loeffler, *Discounted Cash Flow: A Theory of the Valuation of Firms* (Wiley: Wiley Finance Series, 2005)
[365] *Ibid*, Ch. 5
[366] Ross & Modigliani, *supra* n 323 at Ch. 4
[367] WF Sharpe, "Mutual fund performance" (1966) 39 Journal of Business 119–138
[368] This is different from MPT, which is a theoretical construct that attempts to obtain the maximize return per unit of risk, whereas measures such as the Sharpe Ratio are simple mathematical equations that calculate a ratio in real world terms. The real word calculations can then be used to compare one investment choice with others.
[369] See Indrani De, & Michelle Clayman, "The benefits of socially responsible investing: An active manager's perspective" (2015) 24:4 *Journal of Investing* 49-72

Alpha is defined as the measure of active return on an investment.[370] Alpha measures how well a portfolio manager does against a passive index. If the fund (or the portfolio manager) does not provide Alpha than an individual investor could obtain returns equal to (or better) compared to the portfolio manager they hired. The investor should invest in a simple index fund, which has lower costs than actively managed funds.[371] Research shows that 66-75% of all US active managers underperform the market, which is why portfolio managers fear the concept.[372] In Canada, the percentage soars to 91%.[373] This underperformance likely explains the rapid emergence and uptake of other product types, as will be discussed in the next chapter.[374] Many RI funds need active management during portfolio construction.[375] This active management uses diversification strategies, proxy voting, ESG analyses, and active shareholder dialogues and poses challenges for RI funds.

MPT is not a perfect model and has many disadvantages and detractors,[376] but is a useful theory to backstop an analysis of RI. There are two important reasons for this. Firstly, most portfolios mandate diversification. A Canadian equity fund will have a

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[370] Rob Russell, "ABCs of Investing, Alpha, Beta and Correlation" Release (14 July 2014) Forbes, online at: https://www.forbes.com/sites/robrussell/2014/07/15/abcs-of-investing-for-experienced-investors/#13077bc7393f ; For example, an alpha of 1% means the investment's return on investment over a selected period of time was 1% better than the market during that same period, an alpha of -1 means the investment underperformed the market

[371] Fees will be discussed in the next chapter. Fees contribute to the lack of RI uptake as they are correlated with advisors compensation.

[372] Jeff Cox, "Bad times for active managers: Almost none have beaten the market over the past 15 years" Press Releases (12 April 2017) CNBC news, online at: https://www.cnbc.com/2017/04/12/bad-times-for-active-managers-almost-none-have-beaten-the-market-over-the-past-15-years.html ; This number is different for the UK, where there is some limited alpha generated by active managers, see Owen Walker, "Active fund managers beat market by just 16p for every £100 invested" Press Release, (28 January 2018) accessed via ProQuest database May 29, 2018

[373] Aye Soe & Ryan Poirier, *SPIVA® Canada Scorecard* (S&P Global, 2016)

[374] Fees are one of the primary reasons, see Chapter 4. Together they form justification to move towards passive management to lower costs and yet achieve the same performance.

[375] De & Clayman, *supra* n 369 at 50

[376] See Sortino, *supra* n 335

broad diversification of Canadian equities. This will limit the potential of excluding major industries like the fossil fuel industry. Secondly, risk is conceptually misunderstood and improperly measured. It is doubtful that any broad based RI fund (i.e. the "plain vanilla" RI funds) could properly incorporate all ESG factors. This will be shown in Chapter 6.

3.2 Financializing ESG

Most portfolio managers have still not financially integrated returns or risks of ESG into their models. Currently, none of the global soft law transnational instruments necessitates a reconceptualization of risk.[377] The PRI creates tools to incorporate ESG factors, but does not create a fulsome operational model quantifying ESG risk.[378] The CDP contains quantitative data, and the GRI has CSR reporting standards. Other frameworks posit human rights issues which need to be part of the valuation process. The outcomes of these mechanisms require a further step to be financialized within a company's asset valuation. There is a glaring need to organize all of the necessary ESG data so that it can be materially financialized along with a firm's other financial metrics. This can reasonably be accomplished without standardization; however, true comparisons can only be made if the data, and therefore the financials are similar.[379]

If ESG factors become relevant factors that must be included in risk and return formulae, then an Environmental Benefit/Risk factor is mandated. This has been proposed, to very limited degrees in the past. For example, in 2007, Steuer et al.

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[377] The PRI attempts to aid in financialization but does not mandate it. See PRI, *supra* n 274
[378] *Ibid*
[379] Caplan, *supra* n 73 at 243

proposed a "suitable investor" portfolio.[380] This could either be in the form of a risk model, or could be added to the value of a project as the "portfolio social responsibility quotient."[381] A second approach would add an environmental premium to environmentally beneficial projects or companies. For example, a State Street Global Advisors Study provided early evidence of superiority of performance by environmental leaders.[382] It showed a 1.19% per year (119 basis points) performance improvement and an information ratio improvement from 0.86 to 1.22. This performance improvement became known as the 'Sustainability Premium'.[383] This premium could be included in a valuation calculation. Unfortunately, as will be shown in the context of green bonds, this does not currently occur. A third potential approach would be to add sustainability beta factors.[384] The UN PRI, as noted in the previous chapter, aids in adding beta financials.[385] Adding ESG as a beta factor would assist in RI fund construction and make company valuations more accurate.

Regardless of which option is chosen, it is necessary to construct weighted score of the various ESG components. Not all companies behave equally. Some companies have better environmental records than human rights records. Any fund/stock may rate low on one ESG factor, and high on another.[386] An ESG Benefit/Risk factor would encapsulate many ESG factors, rather than using one or two factors current used today.

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[380] Ralph E. Steuer, Yue Qi & Markus Hirschberger, "Suitable-portfolio investors, nondominated frontier sensitivity, and the effect of multiple objectives on standard portfolio selection" (2007) 152 Ann Oper Res 297–317 at 298
[381] *Ibid* at 309
[382] K. Gluck & Y. Becker, "Can Environmental Factors Improve Stock Selection" (2004) 5 Journal of Asset Management 220- 222
[383] *Ibid* at 222
[384] Meir Statman & Denys Glushkov, "Classifying and Measuring the Performance of Socially Responsible Mutual Funds" (2016) 42:2 Journal of Portfolio Management 140-151
[385] PRI, *supra* n 274
[386] Joan Junkus, & Thomas Berry, "Socially responsible investing: a review of the critical issues" (2015) 41:11 Managerial Finance 1176-1201 at 1195

This would provide a more accurate representation of a firm's value. ESG factors should not only be considered qualitative risks noted in disclosure documents as per Chapter 2. Rather the mathematical equations need to incorporate environmental, social and governance risks. This would increase the cost of capital for debt projects that have a negative environmental impact and decrease the cost of capital for projects that have positive environmental impacts.

It is difficult to make straight comparisons because risk is not developed and the ratios used to compare (for example the Sharpe ratio) will not be accurate. This will help to explain why there have been so many differing results for previous performance studies for RI.

3.3 Performance Studies

There are many problems with investment performance studies. It is extremely difficult to conduct a proper analytical study using scientific methods as a researcher cannot separate the variables that constitute an investment portfolio. These variables include proper comparison funds, management style of the fund, the influence of alpha, the amount of risk a fund is permitted to take, the size of the fund, transaction costs, geographic limitations, minimum (or maximum) allowable company capitalization, industry/sector restrictions, and many other influences.[387]

One critical problem with comparison studies for RI deals with the person or firm ESG research. Many portfolio managers (and academics) attempt to conduct in-house RI research, but many others would commission the services of third party experts. Established third-party ESG report and ratings providers include:

[387] A properly valued portfolio model would be constructed in conjunction with a portfolio manager and finance team.

(1) Bloomberg ESG Data Service
(2) Corporate Knights
(3) Dow Jones Sustainability Index (DJSI)
(4) Institutional Shareholder Services (ISS)
(5) MSCI ESG Research
(6) RepRisk
(7) Sustainalytics
(8) Thomson Reuters ESG Research[388]

Many of the authors of the performance studies used one or several of the above firms to assist with their research. Sustainalytics is a global responsible investment research firm. Founded over 25 years ago, it provides investors with tools to analyze firms and externalities that lead to improved ESG insights.[389]

> "Our philosophy is that our cooperation and interaction with investors is a partnership that yields mutual benefits. As our organization is fully dedicated to providing ESG research and services for our clients, our service offering allows for a large degree of flexibility."[390]

The firm was chosen as a representative example for three reasons. First, it recently released a carbon risk rating system; measuring a firm's exposure and management of carbon risks.[391] This carbon score and ratings system would assist in the examination of low carbon solutions, fossil fuel involvement/divestment, carbon intensity research, and carbon risk exposure.[392] Sustainalytics partnered with Morningstar Inc., the online database of securities and funds.[393] Morningstar uses Sustainalytics carbon risk

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388 Betty Huber and Michael Comstock, "ESG Reports and Ratings: What They Are, Why They Matter?" (2017) 25:5 The Corporate Governance Advisor 1-13
389 Sustainalytics, *About Us*, online at:
390 Sustainalytics, *Solutions*, online at: http://www.sustainalytics.com/solutions
391 Sustainalytics, "Sustainalytics Launches its New Carbon Risk Ratings", Press Release (May 1, 2018) online at: https://www.sustainalytics.com/press-release/sustainalytics-launches-its-new-carbon-risk-ratings/ accessed May 8, 2018
392 Sustainalytics, *Carbon Risk Rating*, online at: https://www.sustainalytics.com/carbon-risk-rating/ accessed May 30, 2018
393 Morningstar, *About Us*, online at: https://www.morningstar.com/company/about-us?cid=RED_GLB0014 accessed July 27, 2018

rating to create a Portfolio Carbon Risk Score.[394] This will provide greater carbon scores for companies. This is only one single metric, not a holistic ESG score.

Second, Sustainalytics highlights additional problems with screens. Identifying appropriate screening criteria is a challenge. Sustainalytics created the *Jantzi Social Index* (JSI).[395] This index uses two exclusionary criteria as screens: "product involvement" and "major negative ESG impact."[396] These criteria exclude firms engaged in environmental pollution, nuclear energy, military and tobacco production.[397] There is no consensus of which screens to use and what ESG factors to then use to value the assets that remain in the portfolio.

Third, using Sustainalytics highlights the fact that there is no theoretical model to help determine the optimal tradeoff between risk, return, and the amount of 'responsibility.'[398] Each portfolio manager creates their own tradeoff. Sustainalytics assists portfolio managers with determine the optimum point by providing expected returns, discount/risk rate, and variability scores.[399] Most research firms incorporate ESG only after all financial and non-financial metrics have been included.[400] Sustainalytics, identifies ESG in the research due diligence process, and incorporates these factors at relevant stages of valuation analysis and portfolio construction.[401] Sustainalytics notes

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394 Jon Hale, "New Tools to Assess Carbon Risk in a Portfolio" Press Release (1 May 2018) Morningstar Inc., online at: http://www.morningstar.com/articles/862383/new-tools-to-assess-carbon-risk-in-a-portfolio.html

395 Sustainalytics is a major ESG ratings firm. See Sustainalytics, online at: https://www.sustainalytics.com/ accessed February 27, 2018; for a review of various rating agencies, see Benjamin Auer, "Green, greener, greenest: Identifying ecological trends and leading entities by means of environmental ratings" (2018) 32:2 International Review of Applied Economics 139-162 at 142-143

396 Sustainalytics, *Jantzi Social Index Methodology* (Toronto: Sustainalytics, March 2016) at 3

397 *Ibid* at 5

398 Berry & Junkus, *supra* n 31 at 708

399 UN PRI, *Responsible investment in infrastructure, A compendium of case studies*, (UNEP FI, 2011) at 24

400 *Ibid* at 23

401 *Ibid* at 26

risk is more than volatility; it also includes information asymmetries and changing notions of risk.[402] But even Sustainalytics does not fully integrate all ESG factors. What is needed is the measurement of ESG factors throughout the valuation cycle. In other words, a new financialization model is required.

3.4 Summary Conclusions

This chapter described certain aspects of MPT and the concepts of risk. It is difficult to envision a publically available retail mutual fund that properly incorporates all ESG factors to create a robust RI product. The answer to RQ2 is yes, portfolio managers need to create new financial models to more accurately incorporate ESG factors into valuation analyses. If the data provided by each of the international normative frameworks was aggregated, and standardized per domestic securities laws, then a proper financialization model could be created. It is beyond the scope of this thesis to create such a model, as it would require the collaboration of a licensed portfolio manager or integrated with a large ESG ratings firm like Sustainalytics. An ESG risk would encapsulate many ESG factors, rather than using one or two factors current used today. This would provide a more accurate representation of a firm's value.

Measuring, disclosing, and then financializing ESG risk is the only way to construct RI portfolios. As Junkus & Berry noted that "many of these performance studies have data problems. Measures of socially responsible behavior are generally qualitative, only annually reported, and often based on self-reporting by firms."[403] Having a verified, audited system would solve many of these issues and allow proper valuations of companies. There is also a need to conduct further research on specific ranking schemes

[402] *Ibid* at 27

[403] Junkus & Berry (2015), *supra* n 386 at 1195

and techniques.[404] Despite this lack of fulsome RI valuation models; there are currently RI products for retail investors on the market. These products need to be reviewed. Issues of construction, in addition to issues of valuation, contribute to the RI problem.

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404 *Ibid* at 1196

CHAPTER 4 – FUNDS AND PRODUCTS AVAILABLE TO RETAIL INVESTOR

The first three chapters provided the background on RI and fund construction. Investment services, including portfolio management, are available to both institutional and retail investors. The nature of the services and their regulatory treatment differ.[405] This Chapter introduces the product structures available to the retail investor. It will show that issues of construction contribute to RI problems. Advantages and disadvantages of each investment vehicle will be described, noting that some of these structures are not available to the Mass Affluent retail investor.

4.1 Securities

Individual securities are important for some Mass Affluent investors, however, only institutional, High Net Worth, and Accredited Investors have any significant holdings in individual Securities.[406] A Security is very broadly defined in securities legislation. The *OSA* defines a security to include not only documents, instruments and writings commonly known as securities but also a great number of other items.[407] This very broad definition will be important to RI as a Security is more than just stocks and

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[405] Iain MacNeil, *An Introduction to the Law on Financial Investment*, 2nd ed (Oregon: Hart Publishing, 2012) at 203

[406] However, much of the individual stock wealth is concentrated in the hands of just a few investors. See: Time, "The Richest 10% of Americans Now Own 84% of All Stocks" *Time Magazine,* online at: http://time.com/money/5054009/stock-ownership-10-percent-richest/ See also Chicago Tribune, "Dow 22,000? Most Americans don't benefit from record stock market gains" (3 August 2017) at http://www.chicagotribune.com/business/ct-americans-dow-22000-investing-20170803-story.html accessed March 12, 2018; In Canada, the number of Canadians owning individual securities outside registered accounts is 7.3%, yet the top 10% of Canadians possess 60% of the wealth. See Statistics Canada, Table 2 Assets, debts and net worth held by all families in Canada, online at: https://www150.statcan.gc.ca/n1/daily-quotidien/171207/t002b-eng.htm
See also Andrew Jackson, "Extreme Wealth inequality persists" Press Release (10 December 2017) online at: http://www.progressive-economics.ca/2017/12/10/extreme-wealth-inequality-persists/

[407] *OSA*, s. 1

bonds.[408] It may also apply to other environment securities, like carbon offset credits[409] and green and social bonds.[410] Securities are similarly defined in both the *Securities Act of 1933* ("1933 Act") and the *Investment Company Act of 1940*. ("ICA")[411] The Mass Affluent retail investor relies heavily on investment funds for their portfolios.

4.2 Investment Funds

4.2.1 Mutual Funds

In 2015, over thirty-three percent (33%) of Canadians owned mutual funds, accounting for 31% of their financial wealth.[412] Approximately 43% of US households invest in mutual funds,[413] translating to over 55 million households owning these

[408] They may be considered securities, derivatives, both or neither. See Matthew F. Kluchenek, "The Status of Environmental Commodities under the Commodity Exchange Act" (2015) Harvard Business Law Review Online 39-52; Tyler McNish, "Carbon Offsets Are a Bridge Too Far in the Tradable Property Rights Revolution" (2012) 36 Harvard Environmental Law Review 388-442 at 408 and 432.; Barbara Hendrickson, "Today's New and Developing Carbon Markets" Barbara Hendrickson's speaking notes June 3, 2016 (BAX Securities Law, 2016)

[409] See also, James Munro "Trade in Carbon Units as a Financial Service under International Trade Law: Recent Developments, Future Challenges" (2014) 8:2 Carbon & Climate Law Review 106 -114 at 108; Jessie S. Lotay, Subprime Carbon: Fashioning an Appropriate Regulatory and Legislative Response to the Emerging U.S. Carbon Market to Avoid a Repeat of History in Carbon Structured Finance and Derivative Instruments, 32 Hous. J. Int'l L. 459 (2010)

[410] In NS, the *NSSA*, s. 30A (1) states: The Commission may, if the Commission considers that it would not be prejudicial to the public interest to do so, make an order designating (a) a good, article, service, right or interest, or a class of those, as a commodity; (b) a contract or instrument or a class of contracts or instruments to be, or not to be, a derivative; (ba) a contract or instrument or a class of contracts or instruments to be, or not to be, a security;

[411] *Ibid*, s. 2. A security is defined for US purposes in the *Investment Company Act of 1940, title 15 of the United States Code, 15 U.S.C. §§ 80a-1–80a-64.*("ICA") s. 2(36) as any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ''security'', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant.

[412] Investment Funds Institute of Canada, *Statistics and Facts*, online at: https://www.ific.ca/en/info/stats-and-facts/ accessed April 18, 2018

[413] Investment Company Institute, *a Review of Trends and Activities in the Investment Company Industry*, (2017 Investment Company Fact Book, ICI, 2017)

funds.[414] This proves the importance of mutual funds to North Americans, and helps to explain why most of the RI literature has focused on mutual funds.[415]

The governing legislation in the USA for investment funds is the *Investment Company Act of 1940, ("ICA")*[416] while in Canada (Ontario) the *OSA*, NI 81-101[417] and NI 81-102 govern.[418] Investment Funds are defined in the *OSA* as "a mutual fund or a non-redeemable investment fund."[419] Mutual Funds are defined as an

> "issuer whose primary purpose is to invest money provided by its security holders and whose securities entitle the holder to receive on demand, or within a specified period after demand, an amount computed by reference to the value of a proportionate interest in the whole or in part of the net assets, including a separate fund or trust account, of the issuer."[420]

In other words, a mutual fund is an investment vehicle that is made up of a pool of assets collected from many investors for investing in securities such as stocks, bonds, money market instruments and other securities.[421] A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its Prospectus and has similar continuing disclosure obligation as Securities.[422]

Mutual funds are operated by money managers, who invest the fund's capital and attempt to produce capital gains, dividends and interest income for the fund's investors.[423] For example, RBC Global Asset Management, a subsidiary company of the Royal Bank

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[414] Sarah Holden, *ICI Study: 55 Million US Households Own Mutual Funds* (Investment Company Institute, 2017) online at: https://www.ici.org/viewpoints/view_17_household_fund_investing
[415] For example, see Richardson, 2008, *supra n 11*
[416] *Investment Company Act of 1940*, 15 U.S.C. §§ 80a-1–80a-64
[417] *Mutual Fund Prospectus Disclosure Rule*, OSC NI 81-101 (17 November 2015)
[418] *Investment Funds*, OSC NI 81-102 (14 November 2017) Rule NI 81-102 governs the majority of the rules around mutual fund practices
[419] *OSA*, s. 1
[420] *Ibid*
[421] LL Gremillion, *Mutual fund industry handbook: a comprehensive guide for investment professionals* (Hoboken, N.J.: John Wiley & Sons, Inc., 2005)
[422] NI 81-101*, supra* n 417 at Part 2, see also: I*nvestment Fund Continuous Disclosure, OSC* NI 81-106 (8 March 2017)
[423] Lewis D. Johnson & Wayne Yu, "An analysis of the use of derivatives by the Canadian mutual fund industry" (2004) 23 Journal of International Money and Finance 947–970 at 948

of Canada, performs the banks duties of professional asset management.[424] Securities laws serve to align investment decisions with the interests of fund members.[425] These money managers have a fiduciary best interest standard, and shall exercise "the degree of care, diligence and skill that a reasonably prudent person would exercise."[426]

Mutual funds are legally structured in a number of ways, with mutual fund trusts being the most common form.[427] The main advantage of mutual funds is that they allow investors to access securities that would otherwise be unattainable.[428] An investor obtains instant diversification and access to a broad type and array of underlying investment vehicles.[429] Mutual fund managers can take an activist investor approach consistent with the Listed Equity Active Ownership principles under the PRI.[430] Mutual Funds can be rebalanced easily,[431] and in registered accounts can be rebalanced without any tax consequences.[432] Some "fund of fund" mutual funds offer enhanced

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[424] RBC, RBC Global Asset Management is a business name used by RBC Global Asset Management Inc. and RBC Global Asset Management (U.S.) Inc. (collectively, "RBC Global Asset Management Companies"). These companies are separate corporate entities which are affiliated. Phillips, Hager & North Investment Management is an operating division of RBC Global Asset Management Inc. The RBC Global Asset Management website has been prepared to publicize the products and services offered by RBC Global Asset Management Companies.

[425] *OSA*, s. 116(a)

[426] *OSA*, s. 116(b)

[427] John Haslam, *Mutual Funds Portfolio Structures, Analysis, Management, and Stewardship* (Hoboken, N.J.: Wiley, 2010)

[428] See the Globe and Mail, *Mutual funds: A good place to start*, Newspaper (29 November 2016) https://www.theglobeandmail.com/globe-investor/investor-education/mutual-funds-a-good-place-to-start/article4306620/ accessed March 12, 2018

[429] Statistica, *Mutual Funds, Statistics and Facts*, (December 2016) Available at: https://www.statista.com/topics/1441/mutual-funds/ accessed March 12, 2018

[430] UN PRI, *supra* n 274, Principle 2

[431] For example, see Kent Thune, "How and When to Rebalance your Portfolio" (5 April 2018) the Balance online at: https://www.thebalance.com/how-and-when-to-rebalance-your-portfolio-2466529 ; see also Preet Banerjee, "Portfolio rebalancing: Why, when and how much" (19 June 2014) MoneySense, online at: http://www.moneysense.ca/invest/portfolio-rebalancing-why-when-and-how-much/

[432] Government of Canada, *Registered Retirement Savings Plan (RRSP,* Available at: https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/rrsps-related-plans.html. See also: Shaun Pfeiffer, "Tax Efficiency of Mutual Funds and Exchange-Traded Funds" (2016) Journal of Financial Services Professionals 19-23

diversification and cost efficiencies.[433] Fund of fund mutual funds have as underlying assets other mutual funds, rather than individual securities. The greatest advantage of mutual funds is their availability and accessibility as all licensed advisors in Canada and the USA can sell mutual funds.[434]

There are many drawbacks to mutual funds. First, there are substantial restrictions on the underlying investments, done to protect the retail investor.[435] These include concentration restrictions,[436] the purchase of real property,[437] use of certain derivatives,[438] and purchasing illiquid assets.[439] Second, relative to other investments, they have higher fees.[440] Third, many 'active' mutual funds have both explicit and 'closet' indexing, which means that they claim to actively examine investments before purchase but in fact result in a portfolio that closely mirrors an index.[441] Active managed funds have larger fees than index (or "passive") funds which lowers returns.

All of these traits (positive and negative) have implications for RI. Mutual funds may not be the best vehicles to construct RI portfolios; however, they have been the default product for retail investors, especially the Mass Affluent.

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[433] William Bertin & Laurie Prather, "Management structure and the performance of funds of mutual funds" (2009) 62 Journal of Business Research 1364–1369 at 1367
[434] This will be shown to be vitally important in chapter 6.
[435] NI 81-102, *supra* n 418, Part 2.3
[436] *Ibid* part 2.1
[437] *Ibid* part 2.3
[438] *Ibid*, part 2.7, which may preclude the purchase of offsets, RECs, and other environmental derivatives.
[439] *Ibid*, part 2.4, This could include infrastructure investments
[440] John C. Adams, Sattar A. Mansi & Takeshi Nishikawa, "Are mutual fund fees excessive?" (2012) 36 Journal of Banking & Finance 2245–2259 at 2258; See also: James Cox & John Payne, Mutual Fund Expense Disclosures: A Behavioral Perspective, (2005) 83 Wash University Law Quarterly 907
[441] Martijn Cremers, Miguel A. Ferreira et al., "Indexing and active fund management: International evidence" (2016) 120 Journal of Financial Economics 539–560

4.2.2 Exchange Traded Funds

An exchange traded fund ("ETF") is a marketable security that tracks an index, a commodity, a set of bonds, or a basket of assets.[442] Unlike a mutual fund, an ETF trades like a common stock on a stock exchange.[443] ETFs experience price changes throughout the day as they are bought and sold.[444] ETFs typically have higher daily liquidity and lower fees than mutual funds, making them attractive to individual investors.[445]

ETFs are a recent market invention, yet are outpacing sales of mutual funds and often have a greater selection of investment strategies.[446] Fixed income ETFs were created in 2002.[447] ETFs are an important innovation and have played a major role in the development of passive investing.[448] Investors have a wide variety of ETFs from which to choose, from those that track a major market index to ETFs that track a basket of foreign currencies.[449] 'Green ETFs' are a newer type of ETF, focusing on companies that are directly involved with environmentally responsible technologies, such as water,[450]

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442 Martin Lettau & Ananth Madhaven, "Exchange-Traded Funds 101 for Economists" (2018) 32:1 Journal of Economic Perspectives 135–154

443 Azhar Mohamad, Aziz Jaafar & John Goddard "Short selling and exchange-traded funds returns: evidence from the London Stock Exchange" (2016) 48:2 Applied Economics 152–164

444 Antti Petajisto, "Inefficiencies in the Pricing of Exchange-Traded Funds" (2017) Financial Analysts Journal 24-54 at 26

445 Investopedia, *Exchange-Traded Fund (ETF) Definition,* http://www.investopedia.com/terms/e/etf.asp#ixzz4EPEVUWki Available at: accessed March 6, 2018 See also: James Chong, Monica Hussein, & Michael Phillips, ``S&P 500 ETFs and Index Funds: Are Fees All There Is to It" (2011) 14:2 The Journal of Wealth Management at 59

446 Cremers et al, *supra* n 441 at 540

447 Caitlin D. Dannhauser, "The impact of innovation: Evidence from corporate bond exchange-traded funds (ETFs)" (2017) 125 Journal of Financial Economics 537–560

448 Ananth Madhaven, *Exchange Traded Funds and the New Dynamics of Investing* (Oxford Scholarship Online, 2016)

449 Gary Gastineau, *The Exchange-Traded Funds Manual*, 2nd ed. (Hoboken, NJ: John Wiley & Sons. 2010)

450 Gerasimos Grompotis, *supra* n 87

development of alternative energy, or the manufacturing of green technology equipment.[451]

ETFs have several major advantages over traditional mutual funds. They are generally less expensive to own as they have lower fees.[452] They have a wider range of investing strategies and have made investing in bonds and fixing income easier.[453] ETFs can short stocks, lend shares, use leverage and use more complex derivative strategies that mutual funds cannot.[454] Third, (and more relevant for US investors), they can have certain tax advantages.[455] US investors can defer capital gains tax until the entire ETF is sold, whereas with mutual funds, they must claim capital gains tax every time assets in the fund are sold.[456] It is this wide range of strategies and low cost which may make ETFs better suited for RI purposes than traditional mutual funds.

Licensing restrictions limit the availability of green ETFs, which may help explain their lack of widespread use. ETFs require the same prospectus disclosure as

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451 Investopedia, *Going Green with Exchange Traded Funds*, Available at: http://www.investopedia.com/articles/exchangetradedfunds/11/going-green-with-etfs.asp#ixzz4Eu5X0yXO accessed March 12, 2018; Green ETFs will be detailed in Chapter 5

452 Petajisto, *supra* n 444 at 26

453 Joanne Hill, "The Evolution and Success of Index Strategies in ETFs" (2016) 72:5 Financial Analysts Journal 8-13

454 Azhar Mohamad, Aziz Jaafar, & John Goddard, *supra* n 443, short selling is used when an investor believes a stock will decline in value. It involves selling a Security that the investor does not own. There are several types of short selling, and there are market rules around the practice. Short selling is a risky endeavor and has many drawbacks. See Joseph Engleberg, Adam Reed & Mathew Ringgenberg, "Short-selling Risk" (2018) LXXIII:2 Journal of Finance 755-786. Professional portfolio managers often use the practice to hedge against other risks
Derivatives are instruments whose value is derived from a underlying investment. See MacNeil, *supra* n 405 at 154-155. Derivative strategies use options, futures and other contracts to hedge against risks. For example, a portfolio manager may use a futures contract to lock in a foreign exchange rate on a foreign stock. Derivatives are extremely complex and potentially very risky. See Christopher Nicholls, Corporate Finance and Canadian Law, 2nd ed (Toronto: Carswell, 2013) chapter 5

455 Madhaven, *supra* n 448

456 Mark Kennedy, ETF Tax Advantages over Mutual Funds, Blog (16 June 2018) The Balance, online at: https://www.thebalance.com/etf-tax-advantages-over-mutual-funds-1215121 see also Fidelity Investments LLC, Benefits of ETFs, online at: https://www.fidelity.com/learning-center/investment-products/etf/benefits-of-etfs accessed July 25, 2018

publicly traded companies, with some minor differences.[457] ETFs evolved from using complex structures, including bull/bear structures that allowed the fund to have a net positive return in many market conditions.[458] They are thought of as more complex (not necessarily riskier) than mutual funds, even if most ETFs created today are simple index structures.

4.2.3 Index Funds

Index Funds are funds that match (or track) the components of a market index.[459] This may be the TSX60[460] or some other type of index.[461] Index Funds may be structured as mutual funds or ETFs. Index funds provide broad diversification, market exposure, and low fees.[462] Most index funds are passively managed.[463] Research shows index investing outperforms active management.[464] Canadian mutual fund investors are more highly invested in actively managed funds relative to fund investors in other jurisdictions.

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[457] *OSA*, s.1.1; NI 41-101, *supra* n 122. On February 16, 2017, NI 41-101 was amended to include more ETF disclosures. See *Amendments to National Instrument 81-101 Mutual Fund Prospectus Disclosure, OSC NI 81-101 (*16 February 2017)

[458] Hill *supra* n 454

[459] Index Funds are structured either as a mutual fund or an ETF. Thus, while not an independent type of legal structure, they are sufficiently different from both to warrant a full discussion. Chapter 3 will explain the licensing and sales concerns around the differences.

[460] TMX, *S&P/TSX 60 Index (CAD*) Overview; the S&P/TSX 60 Index is designed to represent leading companies in leading industries. Its 60 stocks make it ideal for coverage of companies with large market capitalizations and a cost-efficient way to achieve Canadian equity exposure. Available at: https://web.tmxmoney.com/indices.php?section=tsx&index=^TX60#indexInfo accessed March 12, 2018

[461] E.g. RBC, *RBC Canadian Index Fund*, Fund Facts, (31 December 2017) (Toronto: RBC Global Asset Management, 2017)

[462] Michael Boldin & Gjergji Cici, "The index fund rationality paradox" (2010) 34 Journal of Banking & Finance 33–43 at 33

[463] Blake Phillips, Kuntara Pukthuanthong & Raghavendra Rau, "Size does not matter: Diseconomies of scale in the mutual fund industry revisited" (2018) 88 Journal of Banking and Finance 357–365 at 365

[464] Burton Malkiel, "Efficient Markets and Mutual Fund Investing through the Advantages of Index Funds", in *Mutual Funds, Portfolio Structures, Analysis, Management & Stewardship,* John Salam (ed) (John Wiley & Sons, 2011) at Ch. 7

This difference is decreasing as fund flows into index funds are greater than regular mutual funds.[465]

Newer index funds have followed the pattern of ETFs and have become more active, and have created artificial indexes to track a basket of securities, or a subset of an index, which means that Index Fund managers can create an ESG/RI 'friendly' index.[466] This includes RI indices like S&P/TSX 60 Carbon Efficient Index, and the S&P/TSX 60 Fossil Fuel Free Index.[467]

Mutual funds and ETFs are similar, in that they are funds that hold a diverse array of underlying assets. The temptation is to believe that they are equivalent (i.e. substitute) products. The evidence shows that investors segregate the vehicles into different market niches.[468] That is, investors treat mutual funds as a different investment type than ETFs. Retail investors need access to both investment types of funds. Yet, access to ETFs is more difficult than access to mutual funds for Mass Affluent retail investors.

4.2.4 Bonds

The global bond market is substantially larger than the stock market, yet is not as well-known.[469] A bond or fixed income instrument is an obligation to pay in which the

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[465] Reuters, *Index funds to surpass active fund assets in U.S. by 2024: Moody's* (2 February 2017) (New York: Reuters, 2017)
[466] E.G the TSX Jantzi Social Index, *supra*, or the Vanguard FTSE Social Index Fund, *Vanguard FTSE Social Index Fund Summary Prospectus* (31 December 2017) (PA: Vanguard Group Inc., 2017)
[467] S&P Dow Jones Indices, *S&P/TSX 60 Carbon Efficient Index*, online at: https://ca.spindices.com/indices/equity/sp-tsx-60-carbon-efficient-index ; see also S&P Dow Jones Indices, *S&P/TSX 60 Fossil Fuel Free Index, online* at: https://eu.spindices.com/indices/equity/sp-tsx-60-fossil-fuel-free-index accessed August 2, 2018
[468] Anna Agapova, "Conventional Mutual index funds versus Exchange Traded Funds" (2011) 14 Journal of Financial Markets 323–343 at 324
[469] Securities Industry and Financial Markets Association, *2017 FACT BOOK* (New York: SIFMA Research Department, 2017) at 4. This report put the global bond markets outstanding value to $92.2 trillion and global equity market capitalization increased to $70.0 trillion.

borrower agrees to pay the amount borrowed plus any interest for a period of time.[470] More specifically,

> it is a contract by specialty to pay a certain sum of money; being a deed or instrument under seal, by which the maker or obligor promises, and thereto binds himself, his heirs, executors, and administrators, to pay a designated sum of money to another; usually with a clause to the effect that upon performance of a certain condition (as to pay another and smaller sum) the obligation shall be void.[471]

The bond holder is a creditor of the investment, whereas a shareholder is an owner of that corporation.[472] There are many different types of bonds, including federal, provincial, municipal, corporate, and high yield.[473] A federal bond is one underwritten by the national government of a country (Canada, for instance); provincial bonds are underwritten by a province or state; while municipal bonds are allowed by statute (example the *Municipal Government Act*.)[474] A corporate bond is one issued by a corporation with a more positive rating, whereas a high yield bond is a type of corporate bond that is from a lower rated company.[475] Retail investors use bonds as part of their fixed income component of their portfolio. Mass Affluent can only use bond mutual funds as part of their fixed income. High Net Worth clients can access individual bonds.

Green bonds are generally defined as debt instruments that pass a certification process to ensure that the projects funded have positive environmental or climate change

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[470] Vasile Dedu & Dan Costin Niţescu, "Use of fixed income products within a company's portfolio" (2012) 10:10 *Theoretical and Applied Economics* 5 – 14 at 7

[471] Black's Law Dictionary, 7th ed, sub verdo: "What is a BOND?"

[472] Dedu & Niţescu *supra n 470* at 14

[473] There is very little actual difference between the types of bonds labelled here: federal bonds are backed by the taxation powers of the federal government, provincial bonds are backed by the province that issued the bond, and municipals are backed by the municipality. Corporate bonds are rated based on the rating of the underlying company. High yield bonds are corporate bonds that have a lower rating and thus a higher coupon and yield to maturity.

[474] For example, in NS, the *Municipal Government Act*, SNS 1998 c. 18 s. 66(1) states: "A municipality may borrow to carry out an authority to expend funds for capital purposes conferred by this Act or another Act of the Legislature"

[475] Ratings agencies such as DBRS and Moody's rate bonds. See Lotay, Subprime Carbon, *supra* n 409 at 494

benefits (such as renewable energy, sustainable water, waste management and energy efficiency.) [476] The green bond market is growing quickly, with over $36.6 billion issued in 2014.[477] Mark Carney notes "…the transition to an environmentally sustainable future in the coming decades provides an annual opportunity worth trillions of dollars for companies and financiers."[478]

Legally and structurally speaking, there is nothing unique about a green bond compared to other types of bonds.[479] Most green bonds are "asset-linked" instruments, in that the risk of the bond is linked to the risk of the project. The project determines the cost of capital, which determines the interest rate (and corresponding yield to maturity) and price of the bond.[480] Green bonds are issued for specific environmental projects [481] and their terms can be more flexibility structured.[482] "The socially responsible investors are not only looking at these bonds from a returns angle…when we talked to investors last week, our meetings weren't focused on the credit aspect, but on the actual bonds themselves and what they were funding."[483]

There are potential issues with labelling a project as "green." One of the concerns about green bonds is whether they produce meaningful, measurable, and quantitative

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[476] Amelie Labbe, "PRIMER: green bonds" (2017) International Financial Law Review London 1-9
[477] Climate Bonds, *Explaining Green Bonds*, (date) Available at: https://www.climatebonds.net/market/explaining-green-bonds accessed March 2, 2018; the Climate Bond initiative is a not for profit initiative used to track global issuances of green and climate related bonds. The set of standards is called the Taxonomy.
[478] CTV *News, Companies need to come clean about climate change risk, Mark Carney sa*ys, Press Release, (15 July 2016) CTV News, online at:http://www.ctvnews.ca/business/companies-need-to-come-clean-about-climate-change-risk-mark-carney-says-1.2987976 accessed March 13, 2018
[479] Michael Flaherty, Arkady Gevorkyan, et al., "Financing climate policies through climate bonds – A three stage model and empirics" (2017) 42 Research in International Business and Finance 468–479 at 471
[480] *Ibid* at 472
[481] Thomas Hale, "Banks help to bring climate change for green bonds" Financial Times (15 November 2017) (London: FT.com, 2017)
[482] Thiam Hee Ng & Jacqueline Tao, "Bond financing for renewable energy in Asia" (2016) 95 Energy Policy 509–517 at 514
[483] Tyler Davies, "Hunger for green funding unabated ahead of Paris talks" (2015) Global Capital 1-2

environmental and climate change benefits.[484] The Green Bond Principles ("GBP") are a set of voluntary process guidelines that recommend transparency, disclosure and integrity in the market by clarifying the approach for issuance of a green bond.[485] The GBP were created by International Capital Markets Association ("ICMA"), and focuses on the regulatory, market practices and other functions of debt markets.[486] The GBP emphasize the transparency, accuracy and integrity of disclosures by issuers.[487] There are four components, including the use of proceeds, processes for project evaluation and selection, management of proceeds, and reporting.[488]

To complement the GBP, the Climate Bonds Initiative developed the Climate Bonds Standard and Certification Scheme ("Standard").[489] This Standard adopts the GBP, and is developed to use as a screening tool for investors to "prioritize climate and green bonds with confidence that the funds are being used to deliver climate change solutions."[490] The Standard sets out and verifies whether or not a bond is a green bond. While most green bonds are structured like regular bonds, there are several instrument

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[484] Scott Breen & Catherine Campbell, "Legal Considerations for a Skyrocketing Green Bond Market" (2017) 31:3 Natural Resources & Environment 16-20
As previously mentioned, misrepresentation is a serious offence, and there are potential liabilities to green bond issuers for improperly labelling a bond as a green bond.

[485] ICMA, Green Bond Principles, https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/GreenBondsBrochure-JUNE2017.pdf Accessed March 6, 2018.

[486] ICMA, *About ICMA*, Available at: https://www.icmagroup.org/About-ICMA/ Accessed March 6, 2018. International Capital Market Association (ICMA) is an association (Verein) pursuant to articles 60 to 79 of the *Swiss Civil Code*

[487] ICMA, *Green, Social and Sustainability Bonds Brochure*, (date) Available at: https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/green-social-and-sustainability-bonds/green-bond-principles-gbp/ accessed March 6, 2018; see also Tom Young, "DEAL: Poland's first sovereign green bond" (2017) *International Financial Law Review*, 1-5

[488] ICMA, *Green Bonds*, online at: https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/GreenBondsBrochure-JUNE2017.pdf Accessed March 6, 2018

[489] Climate Bonds Group, *Climate Bonds Standard and Certification*, (January 2017) https://www.climatebonds.net/files/files/Climate%20Bonds%20Standard%20v2_1%20-%20January_2017(1).pdf
accessed March 6, 2018

[490] *Ibid, see also* Climate Bonds Standard, *Climate Bonds Standard*, (date) available at: https://www.climatebonds.net/standards/standard_download Accessed March 6, 2018.

types specifically listed in the Standard; including a Use of Proceeds Bond, Proceeds Revenue Bond, Project Bond, Securitized Bond, and "Approved Other Debt Instrument."[491] A Norwegian based firm, the Center for International Climate and Environmental Research provides opinions on the veracity of eligible projects.[492]

Sustainability Bonds are those that combine both environmental and social projects.[493] Social Bonds are any type of bond instrument where the proceeds will be exclusively applied to finance or re-finance in part or in full new and/or existing eligible Social Projects.[494] Proceeds from social bond issuances fund projects that have specific social benefits, including (but not limited to) affordable infrastructure, (drinking water, sewers), access to essential services (healthcare, education), housing, employment, food security, and socioeconomic advancement and empowerment.[495] Being debt securities,

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[491] ICMA, *Green Bonds, supra n 488*. Types of Bonds include:

- Use of Proceeds Bond: a standard recourse-to-the-issuer debt obligation for which the proceeds shall be credited to a sub-account, moved to a sub-portfolio or otherwise tracked by the issuer and attested to by a formal internal process that will be linked to the issuer's lending and investment operations for Eligible Projects & Assets.
- Use of Proceeds Revenue Bond: a non-recourse debt obligation in which the credit exposure in the bond is to the pledged cash flows of the revenue streams, fees, taxes etc., and the use of proceeds of the bond goes to related or unrelated Eligible Projects & Assets. The proceeds shall be credited to a sub-account, moved to a sub-portfolio or otherwise tracked by the issuer and attested to by a formal internal process that will be linked to the issuer's lending and investment operations for Eligible Projects and Assets.
- Project Bond: a project bond for a single or multiple Eligible Projects & Assets for which the investor has direct exposure to the risk of the project(s) with or without potential recourse to the issuer.
- Securitized Bond: a bond collateralized by one or more specific Eligible Projects & Assets, including but not limited to covered bonds, Asset Backed Securities ("ABS"), Mortgage Backed Securities ("MBS"), and other structures. The first source of repayment is generally the cash flows of the assets.
- Other Debt Instrument: other forms of debt instruments as per the latest version of the List of Debt Instruments on the Climate Bonds Initiative website at http://www.climatebonds.net/standards/certification/types-of-bonds.

[492] Bernard Simon, "Green Bonds" (2015) 14:1 *Corporate Knights* 48-54 at 49

[493] Breen & Campbell, *supra* n 484 at 18

[494] International Capital Markets Association, *Social Bonds Principles* (June 2018) online at: https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/SocialBondsBrochure-JUNE2017.pdf accessed July 6, 2018

[495] *Ibid,* There are four types of social bonds:

- Standard Social Use of Proceeds Bond: a standard recourse-to-the-issuer debt obligation aligned with the SBP investors in bonds are limited in their abilities to influence companies.[496] In practice, impact investments tend to be fixed income solutions, like green and social bonds.

The main drawback, at least from the Mass Affluent perspective, is that green and social bonds are generally not available to the public, and those that are, have very limited accessibility.[497] Thus, while green bonds may be the 'best' fixed income RI solution for the Mass Affluent investor, they cannot purchase such investments.

4.2.5 Hedge Funds

Hedge funds are not an asset class but an investment vehicle.[498] Hedge funds were originally designed to make money in both 'up' and 'down' markets and use a wide range of techniques and instruments, including short selling, leverage, derivatives and high frequency trading.[499] Hedge funds are largely unregulated,[500] although as per 2004, hedge funds in the USA must register under the *ICA*.[501] Hedge Funds, in Canada and the USA are only open to Accredited Investors, 'qualified purchasers' and institutional

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- Social Revenue Bond: a non-recourse-to-the-issuer debt obligation aligned with the SBP in which the credit exposure in the bond is to the pledged cash flows of the revenue streams, fees, taxes etc., and whose use of proceeds go to related or unrelated Social Project(s).
- Social Project Bond: a project bond for a single or multiple Social Project(s) for which the investor has direct exposure to the risk of the project(s) with or without potential recourse to the issuer, and that is aligned with the SBP.
- Social Securitized Bond: a bond collateralised by one or more specific Social Project(s), including but not limited to covered bonds, ABS, MBS, and other structures; and aligned with the SBP. The first source of repayment is generally the cash flows of the assets.

[496] Park, *supra* n 19 at 20

[497] Chapters 6 & 7 delve into accessing the green bond market.

[498] UN PRI, *Responsible Investment and Hedge Funds* (New York: UN PRI, 2016) at 8

[499] For a list of various strategies, see François-Éric Racicot & Raymond Théoret, "Macroeconomic shocks, forward-looking dynamics, and the behavior of Hedge Funds" (2016) 62 Journal of Banking and Finance 41-61 at 47

[500] D. Stafylas et al., "Recent advances in hedge fund performance attribution: Performance persistence and fundamental factors" (2016) 43 International Review of Financial Analysis 48 –61 at 49. For a broad list of regulatory issues the hedge fund industry faces, see AIMA, ``Regulation, Key Topics`` AIMA website, online at https://www.aima.org/regulation/key-topics.html accessed March 13, 2018

[501] *Registration of Certain Hedge Fund Advisers*, SEC, Investment Advisers Release No, 2333, 69 Fed, Reg, 72,054 (Dec, 10, 2004) (codified at 17 C,F,R, pts, 275, 279 (2006))
See also: Administrative Law – Judicial Review of Agency Rulemaking – District of Columbia Circuit Vacates Securities and Exchange Commission's "Hedge Fund Rule"." — *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006 120:1394 Harvard Law Review 1394-1401

managers.[502] Hedge funds are structured as limited partnerships, with a corporate general partner and one or more corporate limited partners.[503] This allows one general partner to control the day to day aspects of the fund, while each limited partner invests the capital.[504]

Shareholder activism is a key way in which hedge funds could potentially play an important role in RI.[505] Shareholder activism is any action by the group for a change within a public company and not for corporate control.[506] Other hedge funds use screening tools to eliminate companies.[507] The PRI, noting that hedge funds could play a vital role in RI, issued a due diligence questionnaire for hedge funds ("PRI DDQ").[508] The PRI DDQ contains 14 questions split evenly between qualitative and quantitative questions, and is divided into four sections: policy, governance, investment process and monitoring & reporting.[509] The investment process section, for example, asks managers to describe what ESG data, research, third-party consultants, resources, tools and practices the investment manager uses.[510]

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[502] Andrew McGarva "Keeping up with the Joneses: A Model Systemic Risk Reporting Regime for the Canadian Hedge Fund Industry" (2016) 174 The Dalhousie Law Journal 174-204 at 185. For the USA, Qualified Purchasers are defined in the ICA as having more than $5million investable assets. See also, Nova D. Harb, David H. Pankey, & David L. Ronn, "The SEC Considers Updating the Accredited Investor Definition" (2015) 29:6 INSIGHTS: The Corporate & Securities Law Advisor 10-16 at 14
[503] Vincent Glode & Richard C. Green, "Information spillovers and performance persistence for hedge funds" (2011) 101 Journal of Financial Economics 1–17
[504] Henry Ordower, *The Regulation of Private Equity, Hedge Funds, and State Funds, (201) 58* Am. J. Comp. L. *295;* Keith Black, "Defining Liquid Alternative Investments" (2015) 17:3 the Journal of Alternative Investments 6-25
[505] Lucian Bebchuk, Alon Brav, & Wei Jiang, "The Long Term Effects of Hedge Fund Activism" (2015) 115:5 Columbia Law Review 1085-1155
[506] Bernard S. Sharfman, "The Tension between Hedge Fund Activism and Corporate Law" (2016) 12 Journal of Law Economics & Policy 251 -277 at 255
[507] Jessica Papini, "Responsible Returns? It's not always easy being virtuous, but hedge funds are trying" (2017) the Investment Dealers Digest 1
[508] UN PRI, *The Limited Partners' Responsible Investment Due Diligence Questionnaire and How to Use It* (New York, PRI, 2017)
[509] Alternative Investment Management Association, *Illustrative Questionnaire for the Due Diligence of Practices for Responsible Investment*, (London, AIMA, 2017)
[510] Susan Barreto, "UN issues responsible investment DDQ for hedge funds" (2017) InvestHEDGE, via Factiva (6 June 2017) accessed March 3, 2018

Mass Affluent retail investors have no access to hedge funds mainly due to their complexity.[511] Hedge funds have also faced serious governance and fraud cases.[512] They still pose a systemic risk to the economy due to a fragmented (and often non-existent) regulatory oversight process.[513] Shelby notes: "standardizing risk disclosures for hedge fund investors and counterparties would provide these market participants with the necessary tools to better protect themselves against systemically harmful funds. Developing appropriate disclosures would require experts from a range of fields such as economic, quantitative analysis, and finance.[514] Even for hedge funds, material disclosures are important.

4.2.6 Private Equity

Private Equity ("PE") is similar to hedge funds in the structures used.[515] PE is probably the most suited for RI due to its long term strategic time horizon and ability to understand risk.[516] The Institutional Limited Partners Association also has a due diligence ("PE DDQ") ESG questionnaire.[517] One of the advantages of PE and other institutional investors is their ability to access over the counter "OTC" securities, the most common types of securities.[518] These securities are traded between parties without the use of an exchange or dealer network.[519] OTC securities can be structured in whichever way the

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[511] Glode & Green, *supra* n 503, see also Nicolls, *supra* n 103 & MacNeil, *supra* n 405 at 495

[512] PRI, *supra* n 274 at 9; Peter Isakoff, "Agents of Change: The Fiduciary Duties of Forwarding Market Professionals" (2012) 61 Duke Law Journal 1563-1598 at 1565, 1593

[513] Cary Martin Shelby, "Closing the Hedge Fund Loophole: The SEC as the Primary Regulator of Systemic Risk" (2017) 58:639 Boston College Law Review 639-701 at 646

[514] *Ibid* at 701

[515] S. Kaplan & A Schoar, "Private equity performance: returns, persistence, and capital flows" (2005) 60 Journal of Finance 1791–1823, see also Keith Black, *supra* n 504 at 8

[516] UN PRI, *Integrating ESG in Private Equity: A Guide for General Partners* (New York, PRI, 2014)

[517] ILPA, *Due Diligence Questionnaire v 1.1* (Washington DC: ILPA 2016) section 10 ESG

[518] OTC is estimate to be about 100x the volume of exchange based

[519] Rainer Jankowitsch, et al. "Price Dispersion in OTC Markets: A New Measure of Liquidity." (2011) 35:2 Journal of Banking and Finance 343–357 at 344; see also Daniel Marcus and Liévin Tshikall "Some misconceptions about OTC markets" (2010) 4:3 Law and Financial Markets Review 263--268

parties and their lawyers agree as they are formed as contractual obligations.[520] The Mass Affluent retail investor cannot access the OTC market. PE, hedge funds and infrastructure are important to the institutional investor, but have limited direct impact on the retail investor (with the exception for Accredited Investors). These structures could be transformed into investment vehicles for the Mass Affluent as often they underlying holdings are no riskier or more complex than ordinary Securities.

4.2.7 CEDIF

The Community Economic Development Investment Fund structure ("CEDIF")[521] allows for raising capital to invest in not for profit entities within a defined community.[522] Social enterprises often emerge in geographies where the market and the state have failed to provide adequate responses to social, economic, and environmental challenges.[523] One of the primary advantages of a CEDIF is favorable tax treatment. The Equity Tax Credit (ETC) was designed to assist Nova Scotia small businesses, co-operatives and community economic development initiatives in obtaining equity financing by offering a personal income tax credit to individuals investing in eligible businesses.[524] A "community economic-development corporation" must meet criteria prescribed by the *Equity Tax*

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[520] FINRA, *Unraveling the Mystery of Over-the-Counter Trading*, online at: https://www.finra.org/investors/unraveling-mystery-over-counter-trading see also Daniel Marcus & Liévin Tshikali, *supra* n 519

[521] *Community Economic-Development Corporations Regulations*, SNS , Schedule A
While the CEDIF structure is a Nova Scotia invention, there are similar concepts, namely Labour Sponsored Venture Capital Fund ("LSVCF") See Michael Friedman, *Budget 2016: Labour-Sponsored Venture Capital Corporations Tax Credit Re-Introduced (*Toronto: *McMillan LLP,* 2016) Other types include B-Corps, Community Interest Corporations and others.

[522] Nova Scotia Securities Commission, *Community Economic-Development Investment Funds (CEDIFs)* https://nssc.novascotia.ca/corporate-finance/community-economic-development-Investment-funds accessed March 3, 2018

[523] Douglas Lionais, "Social Enterprise in Atlantic Canada Canadian" (2015) 6:1 Journal of Nonprofit and Social Economy Research 25 – 41

[524] Government of Nova Scotia, *Equity Tax Credit, Equity Tax Credit Application*, online at: https://www.novascotia.ca/finance/en/home/taxation/tax101/personalincometax/equitytaxcredit/default.aspx

Credit Regulations[525] and registered as a community economic-development corporation under the *Equity Tax Credit Act*.[526] There is also a special green energy CEDIF for companies applying for a certificate under the Community Feed-in Tariff Program.[527]

A CEDIF is small by nature,[528] yet must raise a minimum capital and have at least 25 initial investors.[529] Local communities are unlikely to have many locally based investors who are both sophisticated and locally focused, and those who are sophisticated are likely using their networks to look outside the area for high-yield investment opportunities.[530] While there is no prospectus requirement, there are obligations for continuous disclosure under NI 51-102.[531]

In Nova Scotia, the principal reasons to invest in a CEDIF are twofold. First, the investor is investing locally in a local small business.[532] Second, the investor gets a deduction under the *Equity Tax Credit Act*.[533] Given their local focus, CEDIFs should be a valuable tool to use for RI and could be structured to provide tangible ESG benefits. For example, certain wind farms are structured as CEDIFs.[534] Jurisdictions like Nova Scotia could use this as a true model of a unique legal structure to 'incent' investors to incorporate using this structure. There are some the regulatory drawbacks to investing in a

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525 *Equity Tax Credit Act*, SNS 1993, c 3 s. 11 *Equity Tax Credit Regulations* N.S. Reg. 18/94
526 CEDIF Regs, s. 2(1)
527 *Community Economic Development Investment Funds*, NSSC Policy 45-601 (17 January 2014)
528 CEDIF Regs, s. 12. The current maximum is $3,000,000.
529 *Ibid*, ss 10(1) & (3)
530 Harvey Johnstone, "Business model innovation: a case study of venture capital in a depleted community" (2013) 15:1 Venture Capital 77-90
531 CEDIF Regs., S. 17
532 Equity Tax Act, *supra* n 525, s. 2
533 *Ibid* ss. 8 & 20
534 Scotian Wind Inc., Wind4All Communities are two examples of wind based CEDIFs. Unfortunately, the offering memoranda exemption found in the CEDIF Regs preclude public access to their documents that would be found for public companies on websites such as SEDAR. See NSSC, *PRNS Issuers*, online at: https://nssc.novascotia.ca/corporate-finance/reporting-issuers-prns

CEDIF (described in next Chapter) which precludes accessibility by most Mass Affluent investors.[535]

4.3 Summary Conclusions

There are many legal structures in which a retail investor could, in theory, invest. These include stocks, mutual funds, ETFs, index funds, bonds, hedge funds, private equity and CEDIFs/LSVCC. Each structure has its own unique characteristics and challenges. Mass Affluent investors do not have access to all of these vehicles.

Securities laws are designed to "protect" Mass Affluent investors against loss due to complex structures. Perhaps, by not requiring a full integration of ESG into risk (by not fully financializing ESG risks), securities laws as currently designed do not in fact protect investors from risks. In addition, by precluding investors from accessing investment vehicles simply due to their structure, they also fail to protect investors from risk. An individual security, like a stock, can lose 100% of its value. Mutual funds and ETFs reduce this risk by diversifying assets. Mutual funds are often equally complex as ETFs. ETFs do have certain characteristics that could make them more complex. However, this does not mean that they are more risky. The primary difference, as explained in the next chapter, is that ETFs trade on an exchange, and are thus unavailable to most financial advisors.

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[535] The author created a CEDIF in 2003, the BCA Investment Cooperative Ltd. see cedif.ca, Community Economic Development Investment Funds, *BCA Investment Cooperative Ltd,* online at: http://cedif.ca/funds/bca-investment-co-operative-limited/

CHAPTER 5 – REGULATION OF RETAIL ADVISORS

Elon Musk, the CEO of Tesla, "claimed that traditional dealers lack incentives to sell EVs that compete with their gasoline-powered inventory and lack specialized knowledge about everything from battery service to tax breaks for EVs."[536] These factors are also problems for retail RI. Advisors need education, incentives, and most importantly, the ability to sell RI funds. The primary goal of this chapter is to prove that the licensing provisions themselves may prevent advisors from accessing, advocating, recommending, advising or even being informed about RI investment vehicles. This chapter will detail four concepts: advisor duties, advertising, licensing, fee structures and accessibility to investment vehicles. The chapter reviews the registration criteria for Canada, the USA and Australia. Canada is the author's home country. The US has the largest stock market with the largest mutual fund market. Australia is a developed, wealthy nation, with a large stock market, chosen to ensure that North American licensing criteria are comparable to another jurisdiction.

The current fund distribution system poses challenges for RI.[537] Bollen notes that "actively managed mutual funds may be more promoted and advisers may have an incentive to recommend these products that provide them with better remuneration."[538] Investor protection depends on the unique relationship between financial advisor and client. A great deal of securities legislation was enacted in response to fraud perpetuated

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[536] Eric Biber, S. Light, et al., "Regulating business innovation as policy disruption: From the model T to Airbnb" (2017) 70:5 *Vanderbilt Law Review* 1561-1626 at 1601

[537] The systems are separated into the asset management network, i.e. those who build and construct the funds, and the broker-dealer market, who distribute these funds to end users.

[538] Rhys Bollen, *supra* n 88 at 227

by unethical dealers and brokers.[539] Canada has had its share of securities issues.[540] A fiduciary duty is a standard that provides the beneficiary with a heightened sense of loyalty and fidelity.[541] Fiduciary duties require that fiduciaries make complete disclosure of all relevant material information.[542] Any fee arrangements that 'disincent' advisors to provide alternative investment choices for their clients should be curtailed.

5.1 Canada

In Canada, provincial securities commissions license advisors.[543] In Ontario, to trade securities, a person must be licensed as a dealer or dealing representative acting on behalf of the dealer.[544] Similarly, an adviser must be registered as such, or registered as an associate acting on behalf of the registered adviser.[545] In each province, there is a duty of every registered dealer, (and adviser), to act fairly, honestly and in good faith with their clients.[546] In the case of retail investment advisors in Canada, this duty does not amount to a fiduciary duty (although in some circumstances, it may).[547] Some retail Investment Advisors can register as retail portfolio managers. There are limited circumstances where these advisors can hold "discretionary" investment accounts. That

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[539] For a review of the Bernie Madoff saga, see Peter D. Isakoff, "Agents of Change: The Fiduciary Duties of Forwarding Market Professionals (2012) 61 Duke L.J. 1563-1598

[540] *National Bank Financial Ltd. v. Potter* [2013] N.S.J. No. 401 Locus Para 240; R. v. *Colpitts*, [2018] N.S.J. No. 78; *Kerr v. Danier Leather Inc*., [2007] 3 S.C.R. 331, 2007 SCC 44, [2007] 3 R.C.S. 331, [2007] S.C.J. No. 44, [2007] A.C.S. no 44

[541] Mark Vincent Ellis, *Fiduciary Duties in Canada,* loose-leaf (Toronto: Carswell, 1988) at Ch. 1, s 4 Leonard Rotman, "Understanding Fiduciary Duties and Relationship Fiduciarity" (2017) 62:4 McGill Law Journal 1-67 at 10

[542] *Ibid* at 16

[543] While there are certain nuanced differences between the various securities legislation across the Canadian provinces, all of the relevant provisions governing licensing are uniform across Canada. Thus, Ontario will be highlighted as it is the largest jurisdiction in Canada, and home of the TSX. However, any other province could have been as easily chosen. The spelling used in the OSA is adviser, as is done with the SEC. In Canadian financial planning, the term is spelled advisor.

[544] *OSA*, s. 25(1)

[545] *Ibid*

[546] For example, see the *OSA*, s. 36(1), NSSC, s. 39A, ASA, s. 75.2

[547] *Hunt v. TD Securities Inc*. (2003), 2003 CarswellOnt 3141 (Ont. C.A.); *Varcoe v. Sterling* (1992), 7 O.R. (3d) 204 (Gen. Div.); however, see *Andrews v. Keybase Financial Group Inc*., [2014] N.S.J. No. 48, and *Industrial Alliance Insurance and Financial Services Inc. v. Brine*, [2015] N.S.J. No. 486

means that the advisor can make investment decisions and trades without the clients consent.[548] When this type of relationship occurs, i.e. when there is full trust and confidence and discretion, then there may be fiduciary duties attached to the advisor.[549]

Many advisors are considered "order-takers." The Supreme Court of Canada ruled that fiduciary duties do not attach to order takers, who offer little to no advice.[550] In *Hodgkinson,* the plaintiffs claimed that they suffered a loss due to material non-disclosure from the alleged breach of fiduciary duty from the defendant.[551] The Court ruled that there was a fiduciary duty owed.[552] However, the defendant was an accountant, not an investment advisor and the breach of a fiduciary duty was from non-disclosure of a material pecuniary interest with a developer.[553] The circumstances do not fit with normal advisor practices.

National Instrument 31-103 ("NI 31-103") governs the majority of duty provisions for financial advisors.[554] The Know your Client ("KYC") rule is one of the most important rules an individual financial advisor must follow to protect their clients.[555] KYC obligations do not amount to a fiduciary duty.[556] KYC obligations mandate that advisors select investments that are suitable for their client's investment

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[548] Eric Dolden & Tom Newnham, *Legal Liability for Financial Advisors in Canada (Vancouver: Dolden, Wallace , Folick LLP, 2015) at 19*
[549] *Kent v. May* (2001), 298 AR 71 (QB) at para 51-53, aff'd (2002), 317 AR 381 (CA). The court ruled that no fiduciary duty existed in the circumstances, see para 55; *Varcoe v. Sterling*, *supra* n 547 at para 234-236
[550] *Hodgkinson v. Simms*, [1994] 3 S.C.R. 377, at para 33, Leonard Rotman, "Fiduciary Law's Holy Grail: Reconciling Theory and Practice in Fiduciary Jurisprudence" (2011) 91:921 Boston University Law Review 921-971 at 965-966
[551] *Ibid* at para 1
[552] *Ibid* at 70
[553] *Ibid* at 70
[554] *Registration Requirements, Exemptions, and Ongoing Registrant Obligations*, OSC NI 31-103 (4 December 2017)
[555] Section 13.2 of NI 31-103 is commonly known as the Know Your Client ("KYC") rule. KYC poses the greatest risk for advisors as it relates to recommendations for RI investments.
[556] Kent v. May, *supra* n 549 at para 65, Dolden & Newnham, *supra* n 548 at 22-25

needs, time horizons, purpose of investment, and risk tolerances.[557] Suitability and diversification are necessary components of a client's investment portfolio. Breaches of KYC and suitability obligations, while not amounting to a breach of fiduciary duties, do amount to breach of contract and potentially negligence.[558]

RI may pose diversification risks due to negative screens limiting the number of companies available for investment.[559] On the other hand, RI may be more suitable for clients as ESG factors may limit downsize risk, (the potential fall in asset values) in which case they would lower the risk on a client's portfolio.[560] The greater risk to retail investors is the lack of clear, meaningful, and timely disclosures (both in quality and quantity). To that end, the Responsible Investment Association ("RIA") drafted a memorandum seeking to enhance the obligations of advisers by adding ESG factors to the KYC.[561] A client cannot make informed, meaningful investment choices unless they obtain all necessary and material information. ESG factors are very important to the global institutional investing community. It should follow that retail investors must have the same level of access to products and information as their institutional counterparts. To date, there has been no implementation to the RIA request.

Advertising issues complement the problems with disclosures. Advertising includes both "television and radio commercials, newspaper and magazine

[557] *Suitability Obligation and Know Your Product,* CSA Staff Notice 33-315, *Notices* / News Releases OSC, (September 4, 2009)
[558] Kent v. May, *supra* n 549 at 65
[559] Ick Jin, "Is ESG a systemic risk factor for US equity mutual funds" (2018) 8:1 Journal of Sustainable Finance and Investment 72-93 at 73
[560] *Ibid* at 75
[561] RIA, *Comments Regarding CSA Consultation Paper 33-404: Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives toward their Clients,* (September 26, 2016) online at: http://www.osc.gov.on.ca/documents/en/Securities-Category3-Comments/com_20160926_33-404_abbeyd.pdf ; This would presumably apply not just to the ASC, but if adopted would become a National Instrument applying to all jurisdictions in the country.

advertisements and all other sales material generally disseminated through the communications media", and sales literature which includes "audio and visual recordings in any media, written matter and all other material designed for use in a presentation to a purchaser, whether such material is given or shown to the purchaser."[562] The most relevant disclosure/advertising document is the Fund Facts document, mandated to be provided to clients for any sales of mutual funds.[563] Primarily a sales tool, the Fund Facts describes relevant fund elements, including historical rates of return, fees, top holdings, investment mix, and risk rating. The Fund Facts contains the description of the purpose of the fund and the appropriate investor, which will incorporate whether the fund is intended to be an RI fund.[564] Limits to material disclosures shown in Chapter 2 means that Fund Facts documents would not have all material information disclosed to retail investors. Thus the 'marketing pitch' from this document needs to be credible in that it should better illustrate how and why the underlying companies and assets are included.

The provincial securities commissions delegate responsibility to Self-Regulatory Organizations ("SROs") to provide retail advisor licensing requirements.[565] The OSA defines an SRO as a "person or company that is organized for the purpose of regulating the operations and the standards of practice and business conduct of its members and their representatives with a view to promoting the protection of investors and the public

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[562] *OSA*, s. 50(2)

[563] *Mutual Fund Prospectus Disclosure OSC NI 81-101 (13 June 2013), see also Point of Sale for mutual funds and segregated funds*, OSC Framework 81-406 (24 October 2008) and *ETF Facts: Filing and Delivery Requirements for a Summary Disclosure Document for Exchange-Traded Mutual Funds*, OSC Framework (8 December 2016) CSA Notice of Amendments to National Instrument 41-101 General Prospectus Requirements Form 41-101F4 *Information Required in an ETF Facts Document* (Form 41-101F4) (8 December 2016) ; It was precisely the review of a Fund Facts document that stimulated the origin of this thesis.

[564] *Ibid*

[565] OSA, s. 21.1; see also Gary L. Gassman & Perry S. Granof, "Global Issues Affecting Securities Claims at the Beginning of the Twenty-First Century" (2007) 43 Tort Trial & Ins. Prac. L.J. 85-111 at 88

interest."[566] SROs set out the education requirements of their members and advisers.[567] There is an important distinction in the legislation of Canada that separates the two main types of advisor SROs. Para 7.1 of NI 31-103 differentiates categories of dealer registration between (a) investment dealers and (b) mutual fund dealers.[568] The representatives of each category are limited in terms of the products about which they can provide advice. A person or company registered in the category of investment dealer may act as a dealer or an underwriter in respect of any security; whereas a mutual fund dealer may act as a dealer in respect of any security of a mutual fund.[569] The two SROs that provide licenses are the Mutual Fund Dealers Association (the "MFDA")[570] and the Investment Industry Regulatory Organization of Canada ("IIROC").[571]

5.1.1 MFDA and IIROC

Mutual funds are regulated by the MFDA and most bank financial advisors are mutual fund licensed.[572] There are currently approximately 79,800 licensed mutual fund advisors in Canada.[573] Mutual funds are the most commonly and widely available type of fund structure available to all retail investors in Canada. High Net Worth retail investors also use mutual funds extensively. Mutual fund representatives can only advise and sell on mutual funds and mutual fund based index funds.[574] They cannot provide advice on

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566 *Ibid,*
567 *OSA*, s. 21.1(3)
568 NI 31-103, *supra* n 554, para 7.1(1)
569 *Ibid*, para 7.2
570 *Ibid*, para 9.2
571 *Ibid*, para 9.1
572 MFDA, *Membership statistics*, online at: http://mfda.ca/members/membership-statistics/ accessed March 29, 2018
573 *Ibid*
574 NI 31-103, *supra* n 554

stocks, bonds, ETFs and non-mutual fund based index funds.[575] There is a potential for a higher market penetration of mutual funds than ETFs. Any investment not structured as a mutual fund has accessibility issues.

NI 81-105 governs allowable sales practices for mutual funds.[576] It provides for permitted compensation structures, marketing practices, and other concerns.[577] Many RI funds are 'more expensive' (that is they have higher fees) than non-RI funds.[578] Fees are usually taken as a percentage of assets, and so the higher the fees, the lower the returns. Fees are thus directly related to performance. Fees are also tied to commissions via trailer revenue, which impacts advisor behaviour.[579] Advisors will often sell to clients the product that gives them the largest commission payment, whether or not this is in a client's best interest.[580] For example, if an advisor is paid 60 bps on a "fund of fund" mutual fund, but only 50 bps on a standalone fund, there is a disincentive to provide advice on that standalone fund, especially if it is an RI fund.[581] Advisors will sell what is easy to sell, not necessarily what is in the client's long term best interests.

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[575] The issue with ETFs and licensing is that MFDA advisors cannot access a stock exchange to trade or provide advice. Index funds, depending on the fund manager, can be either MFDA or IIROC.
[576] *Mutual Fund Sales Practices*, OSC NS 81-105 (27 March 2013)
[577] *Ibid*
[578] See Chapter 5
[579] The Management Expense Ratio "MER" is the fee charged on the mutual fund. It encompasses the management fee, paid to the portfolio management firm to design and manage the fund, the operating expenses (which includes marketing, legal, auditing, customer service, office supplies and filing and other administrative costs) taxes, and the trailer fee paid to the distribution dealer. See also NI 81-106, *supra* n 429, ss. 15.1, 17.1
[580] Edwin Weinstein, *Mutual Fund Fee Research*, Paper submitted to CSA per RFP OSC 201314M -93 (OSC/Brondesbury Group, 2015)
[581] The author experienced this reality as an investment advisor for one of the large financial institutions. Many independent advisors are commission based, and during the time when they are beginning their practices they are likely not making much money. This provides an even larger incentive to sell the fund of fund rather than the standalone funds. Bps, or basis points, are hundredths of a percentage point and are used extensively in finance.

The CSA is currently investigating the need to amend fee arrangement structures.[582] In 2013, the CSA commissioned a third party study of fees.[583] This study found that funds that pay commission underperform other funds (for example a fee based product), with distribution costs raising expenses and lowering investment returns.[584] It also found that advisors push investors into riskier funds, with compensation influencing the flow of money into mutual funds. [585] Larger embedded commissions stimulate sales, with advisor recommendations being sometimes biased in favour of products that generate more commission for the advisor. [586]

The CSA, on April 28, 2016 released Consultation Paper 33-404 for public comment.[587] Its purpose is to seek comment on proposed regulatory action aimed at enhancing the obligations of advisers, dealers and representatives toward their clients. All of the CSA jurisdictions, except the British Columbia Securities Commission (BCSC), are currently consulting on a regulatory best interest standard, accompanied by guidance, that would form both an over-arching standard and the governing principle against which all other client-related obligations would be interpreted.

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[582] *Review of Practices Firms Use to Compensate and Provide Incentives to their Representatives*, OSC CSA Staff Notice 33-318 (15 December 2016)
On December 13, 2012, the Canadian Securities Administrators (CSA) published CSA Discussion Paper and Request for Comment 81-407 *Mutual Fund Fees* which identified potential investor protection and fairness issues that may arise from Canada's current mutual fund fee structure. In particular, the Paper examined how embedded advisor compensation and other forms of tied compensation could give rise to actual or perceived conflicts of interests.
[583] Edwin Weinstein, *supra* n 580 at 9
[584] *Ibid* at 15
[585] *Ibid* at 25
[586] *Ibid* at 17
[587] OSC, Consultation Paper OSC 33-404, (28 April 2016) online at:
http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20160428_33-404_proposals-enhance-obligations-advisers-dealers-representatives.htm

Through the Fund Facts delivery (Point of Sale)[588] and Client Relationship Model Phase 2 (CRM2)[589] initiatives, the CSA have introduced regulatory reforms to make mutual fund fees, registrants' compensation (and related conflicts), and clients' investment performance, more transparent.[590] Adding a best interest standard and 'leveling the playing field' by equalizing compensation structures would be a positive step to all mutual funds. RI may be an unintended beneficiary.

Commission is only one form of inducement that influences sales. Other inducements (e.g., advancement, recognition, etc.) can also influence sales.[591] Compensation affects the effort made by advisors to overcome investor behavioral biases, including biases that may lead to sub-optimal returns. It is not yet known if banning commission based products in favour of asset or fee-based structures will result in a net improvement in the overall return to the investor.[592]

While banning embedded commissions may reduce some fees, there are drawbacks to fee based solutions. In jurisdictions that have moved to fee-based compensation, people with less wealth and less income find it harder to get advisory service than others.[593] Selling investments based on an improper match between risk propensity and the risk of the investment will not be eradicated by a change of

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588 See *Implementation of the Final Stage of Point of Sale Disclosure for Mutual Funds: Pre-Sale Delivery of Fund Facts* -- CSA Notice of Amendments to NI 81-101 Mutual Fund Prospectus Disclosure and to Companion Policy 81-101CP Mutual Fund Prospectus Disclosure (December 11, 2014). The publication is available on the websites of members of the CSA.

589 See CSA *Notice of Amendments to National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations* and to Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations (Cost Disclosure, Performance Reporting and Client Statements*) (March 28, 2013). The publication is available on the websites of members of the CSA.

590 Morningstar, "The days are numbered for embedded fund commissions" Release, online at: http://cawidgets.morningstar.ca/ArticleTemplate/ArticleGL.aspx?id=758402&culture=en-CA

591 Weinstein, *supra* 580 at 26

592 *Ibid* at 6

593 *Consultation on the Option of Discontinuing Embedded Commissions*, CSA Consultation Paper 81-408, (10 January 2017) at 76; IFIC, *IFIC Submission Re: Consultation Paper 81-408*, (9 June 2017) at 4

compensation regime, but it will likely be diminished.[594] The evidence is clear: fee structures impact advice and product recommendations.

While commission and compensation are issues with all mutual fund products, not just RI, a more serious concern prejudicing RI uptake is the lack of knowledge of the advisor on RI. The educational requirements to be licensed under MFDA are simple and straightforward. There is only one required course, the Investment Funds of Canada ("IFIC") course and exam.[595] There are no current educational requirements dealing with either ESG or RI issues. This poses a problem given the volume of MFDA advisors relative to other advisors. It is difficult to understand how MFDA representatives can accurately and materially recommend (or not recommend given a client's KYC) RI investments if they have no education or knowledge on the subject.[596]

Investment advisors are regulated by the IIROC.[597] There are fewer IIROC licensed financial advisors than MFDA advisors, with approximately 25,000 'approved persons' currently IIROC licensed.[598] These approved persons include associates of licensed advisors (who do not meet clients directly) and telephone advisors who take client orders for self-directed investment accounts. A recent update lists approximately 7,400 advisors at the Big Six banks, and another 800 at the four major independent

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594 Weinstein, s*upra* n 580 at 7

595 Investment Funds Institute of Canada, *IFIC exam*, (Course list, 2017) online available at: https://www.ifse.ca/courselist/canadian-investment-funds-course-cifc/
There is a similar exam provided by the Canadian Securities Institute called the Investment Funds of Canada exam. See CSI, *Investment Funds in Canada*, (Course, CSI, 2017) online: https://www.csi.ca/student/en_ca/courses/csi/ifc_info.xhtml ; A passing score under the Canadian Securities Course will also suffice for MFDA licensing.

596 This is but one conceptual issue with lack of education and training on mutual fund licensed personnel. Unlike law, medicine, accounting and other professions, there is no mandated standard that must be achieved. The certified financial planner ("CFP") is a designation only. It does not confer any abilities or privileges above the level of a financial advisor. However, there is movement among the CSA to provide enhanced regulation for the CFP designation.

597 IIROC, *About IIROC, Know Your Advisor*, online at: http://www.iiroc.ca/about/Pages/default.aspx accessed March 28, 2018

598 *Ibid*

firms.[599] There are fewer IIROC brokers than MFDA. IIROC advisors also have higher minimum investment thresholds. Scotiabank's Scotia McLeod IIROC division has a $250,000 investment minimum, but in personally speaking with several brokers, the actual minimum is closer to $500,000.[600] Seasoned IIROC advisors generally have minimums of $750,000-$1 million or more.[601]

These minimums stem from the fee structure of IIROC brokers. Most IIROC brokers are not employees (i.e. salary based) but are compensated via sales commissions and trailer revenue. These issues have been dealt with above. Thus, only investors with $500,000 (or more likely $1 million) of investable assets can access an IIROC broker.[602] As most Mass Affluent investors will not meet these minimum thresholds, they will not be able to access an IIROC broker, and will be limited to accessing only mutual fund products.

Current RI mutual funds are no-different from their non-RI counterparts which poses an accessibility problem for Canadian Mass Affluent retail investors. Bank licensed advisors and independent MFDA licensed representatives are precluded from providing advice on ETFs, stocks, or alternative structures. If a retail investor wishes to purchase

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[599] Staff Report, "The Firms with the Biggest Books, the Most Assets and the Largest Rosters" (4 May 2016) Advisor Magazine, online at: http://www.advisor.ca/news/industry-news/the-firms-with-the-biggest-books-the-most-assets-and-the-largest-rosters-205346

[600] For example, the Schultz Group, a Scotia McLeod group of IAs, has a minimum threshold of $500,000 for IA service and $250,000 for a client to see an associate portfolio manager. See, Scotia Wealth Management, The Schultz Group, Fee Based Investing, online at: http://www.schultzgroup.ca/Services/Fee-Based-Investing.html accessed March 27, 2018

[601] Mathieu Storrier, Scotia McLeod, http://crescoadvisorygroup.ca/second-opinion/ accessed March 27, 2018 See also David Aston, A Perfect Fit, (12 May 2011) Article: MoneySense, online at: http://www.moneysense.ca/magazine-archive/a-perfect-fit/

[602] Weinstein/Brondesbury Group, *supra* n 580 at 49

an RI ETF they must either use an IIROC broker, or use an online brokerage and trade themselves.[603]

Individual bonds are only available via an IIROC Investment Advisor, while green bonds and other Impact Investments are generally not available to any retail investor.[604] Green bonds are generally sold by way of private placement as a type of mezzanine debt. They do not generally form part of the fixed income component of fixed income or balanced mutual funds. An investor would need to either invest in bonds directly, which is rarely done in the real marketplace or invest in a fixed income mutual fund.[605] Fixed income fund managers need to start investing in green bonds as part of their investment mandate. CEDIFs, while exempt from prospectus requirements, do require an offering memorandum which is considered a public offering. Practically speaking then, the only way to purchase a CEDIF is through an IIROC advisor.[606]

Like MFDA advisor education, the importance of advisor education on IIROC advisors cannot be understated. The Canadian Securities Course ("CSC") is currently the mandatory course to become an IIROC licensed advisor.[607] Like the mutual funds exam,

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[603] Online brokers are for the do-it yourself investor. These channels do not provide any advice or guidance on product suitability, nor require a duty of care or KYC requirements. Thus, if the client requires advice, the only channel for ETFs or stocks is the broker/IIROC channel.

[604] For example, see Ontario, *Ontario Green Bond Q&A's* (26 January 2017) online at: http://www.ofina.on.ca/greenbonds/. The primary distribution of Ontario Green Bonds is made to institutional investors. "Retail investors in Canada can contact their registered investment dealer if they are interested in purchasing Ontario Green Bonds on the secondary market. "Ontario may examine opportunities to sell Green Bonds directly to retail investors in Canada if it can be undertaken in a cost effective manner, and only once the domestic market for Green Bonds has had time to develop sufficiently."

[605] There have been several US bond fund issuances, such as Calvert Green Bond Fund, however, green bond funds do not yet exist in Canada. There are several balanced RI funds that have a green bond in them. See Calvert Investments, *Calvert Green Bond Fund* (A), online at: https://www.calvert.com/Calvert-Green-Bond-Fund-CGAFX.php accessed August 2, 2018

[606] See *CEDC Regulations*, s. 3(4). See also NSSC, *CEDIF Application Process FAQs*, para 12. , Moreover, the operator of a CEDIF must be an investment fund manager licensed under the NSSC. See: *Community Economic Development Investment Funds*, NSSC CP 45-601 (17 January 2014) s. 1.2

[607] Canadian Securities Institute, *Canadian Securities Course*,(Course, CSI, 2018) online at: https://www.csi.ca/student/en_ca/courses/csi/csc.xhtml accessed March 28, 2018

the CSC does not have an RI/ESG education component. It is thus doubtful that IIROC advisors have the knowledge to understand and recommend RI products.

Some retail IIROC advisors are licensed to be retail portfolio managers. Section 25(4) of the OSA states: "Unless a person or company is exempt under Ontario securities law from the requirement to comply with this subsection, the person or company shall not act as an investment fund manager unless the person or company is registered in accordance with Ontario securities law as an investment fund manager."[608] Unlike retail investment/financial advisors in Canada, portfolio/investment fund managers have a fiduciary duty to their clients.[609] The CFA Institute manages the Chartered Financial Analyst ("CFA") designation.[610] The CFA Institute is a global program for portfolio managers.[611] The CFA designation is not required to be a securities representative in Canada, although possessing it will qualify an individual.[612] It is required to have either the CFA designation of a Certified Investment Manager designation in order to become a portfolio manager, in Canada.[613]

5.1.2. Movement to Best Interest

The current standard, the good faith standard, is facing scrutiny as not being strict enough to protect client interests, and there is a movement in Canada towards a 'best interests' standard for advisers.[614] The UK, EU and Australia already mandate a best

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608 *OSA* s. 25(4)
609 *OSA*, s. 116
610 CFA Institute, *CFA Program,* (Course, CFA, 2018) online at: https://www.cfainstitute.org/programs/cfaprogram/Pages/index.aspx?WPID=Programs&PageName=Homepage accessed March 28, 2018
611 *Ibid*
612 NI 31-103, *supra* n 554, s. 3.5
613 *Ibid*, s. 3.11
614 *Status Report on CSA Consultation Paper 33-404 Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients,* CSA Staff Notice 33-319 (June 1, 2017)

interest standard.[615] The CSA has identified five issues that could be solved by a best interest standard, including rates of returns and fees (i.e. value for money), misplaced trust, conflicts of interest, information asymmetry, and outcomes based on the regulatory regime.[616] Moving to a best interest standard would alleviate (at least in theory) some of these issues as advisors would need better skill sets to meet their duties.

The best interest standard would elevate the obligations of all advisors. The fear by advisors is that the best interest standard may be interpreted to be a fiduciary standard.[617] In the CSA proposal, the best interest standard would elevate an advisors standard of care beyond the simple suitability (the Know your Client) requirement but would not amount to a fiduciary duty.[618] Unfortunately, the CSA is backtracking on its reforms.[619] The June 2018 proposal would put the client's interest first when making a suitability determination.[620] It is inconceivable that an advisor can recommend the proper products for their clients without understanding either the client or the product.[621]

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615 *The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients*, OSC CSA Consultation Paper 33-403 (25 October 2012) at 3
616 *Ibid at* para i
617 Michelle Schriever, "Best Interest Standard Could be Fiduciary Duty in Disguise: Expert" Post (3 October 2016) Advisor.ca, online at: http://www.advisor.ca/news/industry-news/best-interest-standard-could-be-fiduciary-duty-in-disguise-expert-212984 accessed August 1, 2018
618 David Hodges, "Provincial Regulators Raise concerns about best interest standard for advisers" Press Release (11 May 2017) Canadian Press
619 *Proposed Amendments to National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations*, CSA Notice and Request for Comment, (21 June 2018); Barbara Schecter, "OSC drops push for 'best interest' standard as regulators propose narrower reforms" (21 June 2018) online at: https://business.financialpost.com/news/fp-street/osc-drops-push-for-best-interest-standard-as-regulators-propose-narrower-reforms
620 CSA, Canadian securities regulators align to publish harmonized response to concerns with the client-registrant relationship, Release (21 June 2018) online at: https://mailchi.mp/osc/canadian-securities-regulators-publish-harmonized-response-to-concerns-with-the-client-registrant-relationship?e=dcff75c17d
621 See FINRA, Rule 2111, discussed below; Lawrence Ritcie, Louis Tsilivis & Marleigh Dick, "CSA publishes harmonized response to concerns regarding client-registrant relationship" Blog (22 June 2018) Osler LLP, online at: https://www.osler.com/en/blogs/risk/june-2018/csa-publishes-harmonized-response-to-concerns-regarding-client-registrant-relationship

The current KYC duties, for both IIROC and MFDA, only require a bare minimum of information to pass the suitability requirements, including age of client, timeframe to invest and risk tolerance. Fee structures that bias advice towards a current product or class of products can derail these duties. The Mass Affluent, generally speaking only can access MFDA advisors. IIROC advisors focus on High New Worth and Accredited Investors, mainly due to fee and commission structures.[622] Clients of IIROC advisors can access a broad range of products. Clients of MFDA advisors cannot. As shown in Chapter 4, products like ETFs, and individual bonds, which are not necessarily more complex than mutual funds, are unavailable to the Mass Affluent. The next chapter will show the effect of this denial of access to clients that desire RI funds.

5.2 USA

In the US, the SEC, FINRA, and state securities commissions[623] provide the criteria for adviser licensing.[624] Regulation of advisers falls under the *Investment Advisers Act of 1940 ("IAA")*.[625] Investment adviser is defined as any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.[626]

[622] Weinstein/Brondesbury, *supra* n 580 at 74
[623] For the purpose of this paper, it is not necessary to canvass any differences among the various states, as most requirements have become uniform, as will be described below.
[624] The USA uses the spelling adviser, while Canada uses the spelling advisor
[625] *Investment Advisers Act of 1940 15 U.S.C. § 80b-1 through 15 U.S.C. § 80b-21*
[626] *IAA*, s. (11) There are exemptions for banks, professionals, media, statistical rating agencies whose performance of such services is solely incidental to the practice of his profession;

Canadian and US licensing are similar in that both separate the two roles of investment adviser and, in the US case, a limited service adviser.[627] The duty of care, on the other hand, differs in the USA from Canada. Under s. 206 and 207 of the IAA, it is unlawful for any investment adviser to directly or indirectly defraud, deceive, or engage in a deceptive or manipulative practice.[628] It is also illegal for any person willfully to make any untrue statement of a material fact in any registration application or willfully to omit to state in any such application or report any material fact which is required to be stated therein.[629] In the United States, the above legislation has been interpreted to be a fiduciary duty standard, and would pose greater obligations on the adviser than their Canadian counterparts.[630]

Like the CSA, the SEC is mandating increased reforms and disclosures for advisers.[631] The financial crisis has caused a dramatic debate on the reforms on diverse standards that professionals provide to their clients. This debate is characterized as the 'fiduciary duty' versus suitability standard of care.[632] As fiduciaries, investment advisers owe their clients a duty to provide only suitable advice, which takes into account the client's financial situation, investment experience, and investment objectives.[633] The crisis of 2008 prompted the passage of the *Dodd-Frank Act*.[634] While much of the debate

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627 *Ibid*

628 IAA, s. 206 SEC. 206 ø80b–6¿

629 IAA, SEC. 207. ø80b–7¿

630 *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180 (1963)

631 SEC, *Commission Guidance on Disclosures*, Securities Act Release No. 33-9106, Exchange Act Release No. 34-61469, 75 Fed. Reg. 6289 (Feb. 2, 2010).

632 James Wrona, "The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection" (2012) 68:1 The Business Lawyer 1-56

633 SEC, Investment Advisers Act Release No. 1406 (March 16, 1994).

634 *The Dodd–Frank Wall Street Reform and Consumer Protection Act* (Pub.L. 111–203, H.R. 4173

has been sparked around fraud and deceit,[635] the relevance to RI is more subtle. The disclosures or lack thereof, and the lack of training around RI may not amount to a breach of fiduciary duty, but it could impact a client's purchasing decision, especially if a best interest standard was imposed.[636] Presumably, this fiduciary duty standard should lead to increased and more complete disclosures of RI materials in USA than in Canada. Unfortunately, the legislation seems doomed for repeal.[637]

5.2.1 FINRA

The Financial Industry Regulatory Authority ("FINRA") is authorized by the SEC to protect investors and ensure the fair and honest operation of markets.[638] It, like IIROC and the MFDA, does not regulate mutual funds but regulates the broker-dealers and registered representatives that sell mutual funds.[639] This organization is a new institution, created in 2007.[640] FINRA currently oversees approximately 629,525 registered securities representatives.[641] There was movement by Congress to separate the regulatory environment for mutual funds and investment advisers, similar to the Canadian experience; however, this has not yet come to pass.[642]

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[635] Wrona, *supra n 632* at 4

[636] Joseph Goertz, Swarn Chatterjee & Brenda Cude, "Suitability vs Fiduciary Standard: The perceived impacts of changing one's standard of care" (2014) 27:2 Journal of Financial Planning 20-25

[637] *Financial Choice Act* (USA), H.R.10 — 115th Congress (2017-2018)

[638] "Self-regulatory organization" is a defied term in *the Securities Exchange Act of 1934* Pub. L. No. 94-29, sec. 3(6), § 3(a)(26), 89 Stat. 97, 100 (1975) (codified as amended at 15 U.S.C. § 78c(a)(26) (2012)), and includes a national securities association registered under 15 U.S.C. § 78o-3. Barbara Black, "Punishing Bad Brokers: Self-Regulation and FINRA Sanctions" (2013) 8 BROOK. J. CORP. FIN. & COM. L. 23-55

[639] FINRA, *About Us*, online at: http://www.finra.org/about accessed March 29, 2018

[640] In 2007, the member firm regulation and enforcement functions of the New York Stock Exchange and NASD were consolidated, and the NASD changed its name to FINRA. The consolidation was intended to "streamline the broker-dealer regulatory system, combine technologies, and permit the establishment of a single set of rules within a single SRO." *Exchange Act Release No*. 55,495, 2007 WL 1260858 (20 March 2007) at 9

[641] FINRA, *Statistics*, online at: https://www.finra.org/newsroom/statistics

[642] Barbara Black, "Are Retail Investors Better Off Today?" (2008) 2 Brooklyn Journal of Corporate Finance and Commercial Law 303-338 at 319-20 & 13-14

One of the objectives to advisor licensing is to ensure that the investment advice is suitable for a client. FINRA Rule 2111 states that a "member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile."[643] Rule 2111 lists the three main suitability obligations for firms and associated persons:[644]

- Reasonable-basis suitability requires a broker to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. Reasonable diligence must provide the firm or associated person with an understanding of the potential risks and rewards of the recommended security or strategy.
- Customer-specific suitability requires that a broker, based on a particular customer's investment profile, has a reasonable basis to believe that the recommendation is suitable for that customer. The broker must attempt to obtain and analyze a broad array of customer-specific factors to support this determination.
- Quantitative suitability requires a broker with actual or de facto control over a customer's account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, is not excessive and unsuitable for the customer when taken together in light of the customer's investment profile.

Suitability should, based on this suitability standard, encompass a client's willingness, desire, aptitude and appetite for RI investments.[645] Yet, there are certain intrinsic and extrinsic forces that may dissuade an advisor from discussing these investment vehicles. Of note are fee structures, advertising, and educational requirements, the same forces that affect advice in Canada. Like the CSA, FINRA has noted that the

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[643] FINRA, *Suitability* Rule 2111. This rule is known as the Know your product (KYP) rule, and complements the KYC rule. Advisers in the US also have stringent KYC obligations. See *Know your Customer*, FINRA Rule 2090, R-FINRA-2010-039 and amended by SR-FINRA-2011-016 eff. July 9, 2012.

[644] *Ibid*

[645] FINRA, *Suitability: What Investors Need to Know*, online at: http://www.finra.org/investors/suitability-what-investors-need-know

fee structure of certain products may provide for a risk that incents advisers to increase their sales.[646] Lipton notes, "sharing sustainability information, corporate responsibility initiatives and progress publicly on the company's website and bringing them to these investors' attention are significant actions in the new paradigm."[647]

Advisors employed by firms with proprietary funds tend to sell a higher proportion of their most profitable fund classes. Captive advisors are more likely to recommend in-house products.[648] Underlying licensure shapes the focus of advice.[649] Commission only advisors sell individual equities in greater numbers and asset sizes than others; while ETFs are sold more by fee-only advisors.[650] Similar to the Canadian experience, there is an inherent potential conflict of interest for suitability of investments due to compensation structures. This has repercussions for the entire industry, but could have profound implications for RI products.

Advertising regulations in the USA is a second potential issue of RI misrepresentation. FINRA Rule 2210 governs US rules around advertising and client communications.[651] RI is manifestly misunderstood in general, so it is not improbable that adviser communications may not reflect the true nature, intent and performance of

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646 FINRA, *Report on Examination Findings* (6 December 2017) online at http://www.finra.org/industry/2017-report-exam-findings/product-suitability, accessed June 30, 2018 at 6

647 *Martin Lipton, Wachtell, Lipton et al., "*Engagement—Succeeding in the New Paradigm for Corporate Governance" (2018) Harvard Law School Forum on Corporate Governance and Financial Regulation, *Online:* https://corpgov.law.harvard.edu/2018/01/23/engagement-succeeding-in-the-new-paradigm-for-corporate-governance/ *accessed March 26, 2018*

648 Weinstein/Brondesbury, *supra* n 580 at 35

649 *Ibid* at 34

650 *Ibid* at 38

This study does not break down mutual fund fees, but does state that the sale of ETFs vs. mutual funds is not just a compensation issue. Despite lower cost and typically higher net return, there are at least three other reasons for lower ETF sales.

1. Many financial advisors are not allowed to sell ETFs.
2. Some clients and advisors view "stock - picking" as the focus of their relationship.
3. Advisors may not be willing to expend the time and effort to get clients comfortable with a new product

651 FINRA, Rule 2210 – *Advertising Regulation* (9 January 2017)

RI. More importantly though is the lack of communication and advertising for RI. A dearth of communication may be seen as indifference, or apathy towards RI.

The third topic of access deals with advisor education. A broker-dealer agent ("Agent") must complete the Series 7,[652] Series 63,[653] or Series 66[654] exams. The Agent must then register with the Central Registration Depository maintained by FINRA.[655] Series 7 exams are known as the General Securities Representative Exam, and is mandated for all Registered Representatives.[656] A candidate who passes the Series 7 exam is qualified for the solicitation, purchase and/or sale of all securities products, including corporate securities, municipal fund securities, options, direct participation programs, investment company products and variable contracts.[657] Thus, this includes stocks, bonds, mutual funds, ETFs. Series 7 is an equivalent to the CSC, and licensing would be similar to that of IIROC.[658] Series 65[659] are necessary to become a full independent Investment Advisor.

Series 6 exams, on the other hand, are similar to MFDA requirements, in that the Series 6 exam assesses the competency of an entry-level representative to perform his or

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[652] FINRA, *Series 7 Exam - General Securities Representative Exam (GS)*. However, as of October 1, 2018, this requirement will be changed.
[653] FINRA, *Series 63 - Uniform Securities Agent State Law Examination,* (Course, FINRA, 2018) online at:
[654] FINRA, *Series 66 – Uniform Combined State Law Examination* (Course, FINRA, 2018) online at: http://www.finra.org/industry/series66
[655] *New Hampshire Act*, at (B)9; this is the equivalent of the NRD in Canada.
[656] See FINRA, *EC Approves Consolidated FINRA Registration Rules, Restructured Representative-Level Qualification Examinations and Changes to Continuing Education Requirements,* Regulatory Notice 17-30 (October 2017) changing this requirement. This will create a new Securities Industry Essentials Exam. See FINRA, Securities Industry Essentials Exam, (Course, FINRA, 2018) online at: http://www.finra.org/industry/essentials-exam
[657] FINRA, Series 7, *supra n 659*
[658] Financial Planner World, online, available at: https://www.financialplannerworld.com/canadian-advisor/
[659] FINRA, *Series 65 - Uniform Investment Adviser Law Examination* (Course, FINRA, 2018) online at: http://www.finra.org/industry/series65

her job as an investment company and variable contracts products representative.[660] There is no mention of ESG criteria in either the Series 6 or series 7 exams, nor any educative requirements on RI. Completing levels 1 and 2 of the CFA exam permits an applicant to request an exemption from Series 86 exams.[661]

5.2.2 State Licensing

In addition to the SEC, states can regulate licensing of advisers.[662] In New Hampshire[663] for example, an Investment Adviser ("IA") is defined as a

> "person that, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or the advisability of investing in, purchasing, or selling securities or that, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities."[664]

The term includes a financial planner or other person that, as an integral component of other financially related services, provides investment advice to others for compensation as part of a business or that holds itself out as providing investment advice to others for compensation.[665] The Investment Adviser Representative ("IAR") is an individual employed by or associated with an investment adviser who

[660] FINRA, *Series 6 Investment Company and Variable Contracts Products Representative Exam (IR)* (date) online; http://www.finra.org/industry/series6 accessed March 28, 2018.
Like the Series 7, this rule will be amended October 1, 2018 and replaced by FINRA Rule 1210.03 and the Securities Industry Essentials Exam.
[661] FINRA, Series 86 and 87 - Research Analyst Examination (RS), online at: http://www.finra.org/industry/series86-87
[662] *IAA*, s. 203A. ø80b–3a & SEC. 222 ø80b–18a¿
[663] New Hampshire was selected to be a representative state example. There does not appear to be any unique states with varying levels of obligations, however, a complete analysis was not attempted.
[664] New Hampshire, *Uniform Securities Act*, Title XXXVIII Securities Ch. 421-B s. 26
[665] Like the federal counterpart, there is a carve out for several categories. The term does not include: (A) an investment adviser representative; a lawyer, accountant, engineer, or teacher whose performance of investment advice is solely incidental to the practice of the person's profession; a broker-dealer or its agents whose performance of investment advice is solely incidental to the conduct of business as a broker-dealer and that does not receive special compensation for the investment advice; (D) a publisher of a bona fide newspaper, news magazine, or business or financial publication of general and regular circulation; (E) a federal covered investment adviser; (F) a bank; (G) any other person that is excluded by the *Investment Advisers Act of 1940* from the definition of investment adviser; (H) a person whose advice, analyses or

> "makes any recommendations or otherwise gives investment advice regarding securities, manages accounts or portfolios of clients, determines which recommendation or advice regarding securities should be given, provides investment advice or holds herself or himself out as providing investment advice, receives compensation to solicit, offer, or negotiate for the sale of or for selling investment advice, or supervises employees who perform any of the foregoing."[666]

Like in Canada, there is a difference in licensing for advisers and representatives of advisers. This distinction is important as many clients do not ultimately meet with their adviser, either due to size, time, or perceived needs. IAR representatives may not have the fiduciary requirements and thus may not have the experience and knowledge and expertise in RI and ESG criteria. This is a potential hazard for client best interests.

The key takeaway is that US advisors have a fiduciary standard. Suitability requirements are similar to Canada. US advisors, like their Canadian counterparts may conflicts due to compensation structures, and also like Canadian advisors, do not have the training required to provide advice on RI.

5.3 Australia

The Australian Securities and Investment Commission ("ASIC") regulates the fund industry in Australia.[667] Australia has moved to a centralized federal government securities regulatory regime, like the US.[668] There are approximately 25,379 financial advisers in Australia.[669] Australia and Canada are similar in that retail investors are more likely to retain the services of a financial advisor/financial planner rather than a stockbroker or Investment Advisor, which means that mutual funds will be the more

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reports relate only to securities exempted under RSA 421-B:2-201(1); (J) a person who transacts business in the field of insurance, provided such business is solely and exclusively in the field of insurance;

[666] NH Act, (26) 27. This is similar to the "associate" role in the Canadian context.

[667] Australia, *Corporations Act of 2001 (Cth) No. 50, 2001*, Part 7.6

[668] Pamela Hanrahan & Ian Ramsay, "Regulation of mutual funds in Australia" To be published in *Research Handbook on Mutual Funds,* William Birdthistle and John Morley, [eds] (Edward Elgar Publishing, 2017)

[669] ASIC, *Annual Report 2016-2017* (Sydney: ASIC, 2017)

prominent products being sold.[670] This section will conduct a comparison of key topics, notably fiduciary/best interest standards, advertising/disclosure obligations, fee structures, and education requirements.

The responsible entities that operate as advisors must be licensed under the Australian Financial Services (AFS) licensing regime.[671] Section 916A of the Australian *Corporations Act* provides a that "A financial services licensee may give a person (the authorised representative) a written notice authorising the person, for the purposes of this Chapter, to provide a specified financial service or financial services on behalf of the licensee."[672] The financial services specified may be some or all of the financial services covered by the licensee's license.[673] Thus, not all licensed individuals will deal in both securities and mutual funds. All three countries separate mutual fund advisors from the broader securities brokers. The treatment of mutual funds as distinct from other securities creates a potential for systemic bias, and suggests a need for a more extensive regulatory review. This separation would affect Australians in much the same manner as Canadians. Dealer and advisors in Australia have a fiduciary duty to their clients. A duty of care, diligence and honesty includes a "best interests" standard.[674] This is akin to US standards but is more onerous than Canadian requirements.

Continuous disclosure obligations are conducted via a Product Disclosure Statement, much like the Fund Facts in Canada.[675] Like in Canada, this is a disclosure

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[670] *Ibid* at 8; Stockbrokers are equivalent to Investment Advisors, with stockbroker being a historical term.
[671] Hanrahan & Ramsay, *supra* n 6668 at 12
[672] *Corporations Act supra* n 667, s. 916
[673] *Ibid,* s. 921B (2) to (4).
[674] *Ibid*, section 601FC(1). This section provides that advisors act in the best interests of the members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests
[675] *Ibid*. part 7.9. The PDS is limited to 8 pages, while the Fund Facts are limited to four. The headings require information about the responsible entity, the fund, the approach to investment taken by the fund,

document but is used as a marketing document. The regulations contain "Good Disclosure Principles" which state that: (a) disclosure should be timely; (b) disclosure should be relevant and complete; (c) disclosure should promote product understanding; (d) disclosure should promote product comparison; (e) disclosure should highlight important information; and (f) disclosure should have regard to consumers' needs.[676] Content requirements include "fees payable in respect of a financial product; risks of a financial product; benefits of a financial product; and significant characteristics of a financial product."[677]

Fee structures have been studied in Australia.[678] Unlike Canada and the US, Australia has made the proactive choice to regulate commission structures. These regulations could curtail the potentially conflicting methods advisors use to artificially inflate their commission payments. Unfortunately, a recent amendment rolls back many of these amendments.[679] The ban on embedded commissions remains.[680]

ASIC has set the minimum training standards for all financial product advisers, not just investment advisers.[681] The type of training depends upon which products are advised.[682] Like Canada and the USA, there is no educational requirement for RI. It is difficult to conclude that advisors are meeting their fiduciary obligations, as they will not necessarily be sufficiently knowledgeable to probe into a client's suitability as necessary.

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and the fees and costs payable. See ASIC, RG 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* (28 October 2011)

[676] *Ibid*, RG 168.4

[677] *Ibid*, RG 168.38

[678] Australia, *Corporations Amendment, (Future of Financial Advice Act) 2012*, No 67, 2012 and *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012*, No 68, 2012

[679] *Corporations Amendment (Financial Advice Measures) Bill, 2016*, No. 22, 2016

[680] Herbert Smith, "ASIC's new 'fees for service' model: impact on takeovers and schemes" Blog Lexology, online at: https://www.lexology.com/library/detail.aspx?g=828ba0b4-09ea-4715-bc27-c65a8862048f

[681] ASIC, *Regulatory Guide 46, Licensing: Training of financial product advisers* (July 2012)

[682] *Ibid*, para RG 146.7

In summation, Australia's structure is much like that in Canada and the US, in that the separation of mutual fund advisors from stock brokers poses similar RI access issues. Australia has moved to a best interest standard, unlike Canada, and has already mandated fee structure changes to limit compensation conflicts.

5.4 The Accredited Investor

The Accredited Investor exemption exempts certain investors from disclosure obligations.[683] An Accredited Investor is defined as an individual with financial assets greater than $ 1 Million (CAD), or who either beneficially owns assets greater than $5 million, or whose net income is greater than $200,000 (or combined with the spouse $300,000).[684] A similar threshold exists in the USA.[685] For Australia, the "Sophisticated" investor (the equivalent to Accredited Investor) has thresholds of net assets of $2.5 million and/or income in excess of $250,000 (AUS).[686] Accredited Investors are those high net worth individual investors for whom prospectus disclosures are not required.

There is no actual test of investment knowledge or competency to become an Accredited Investor. Accredited Investors are not to be confused with competent or knowledgeable investors.[687] The exemption is an artificial, arbitrary threshold that deems accredited investors to have the financial capabilities to not require full disclosure documents. Recently, both the CSA and SEC are reviewing these thresholds as being too

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683 *OSA*, s. 73.3, *Prospectus and Registration Exemptions*, OSC NI 45-106 (1 April 2017) Part 2.3
684 *Ibid* s. 1.1
685 For US investors, the thresholds of the $1,000,000 (USD) financial asset base, $200,000 income, and $300,000 spousal income are the same. See *Securities Act of 1933, supra n 270,* Regulation D
686 Corporations Act 2001, Cth, Ch. 6D. See, ASIC, *Certificates issued by a qualified accountant*, online at: https://asic.gov.au/regulatory-resources/financial-services/financial-product-disclosure/certificates-issued-by-a-qualified-accountant/
687 Greg Oguss, "Should Size or Wealth Equal Sophistication in Federal Securities Laws?" (2012) 107:1 Northwestern University Law Review 285-320

low.[688] The ASIC is also concerned with practices that allow non-sophisticated investors to get the Sophisticated Investor exemption.[689] Principal criticisms of the Accredited Investor exemption rely on two, (somewhat contradictory) arguments, that securities laws are overprotective of Mass Affluent retail investors and under protective of large or High Net Worth investors, and thus need to be adjusted.[690] The underlying theory is that wealthy people are either smart, or wealthy enough to hire someone is who smart still exists, as is the theory that the wealthy can better tolerate losses.[691] Yet, "even sophisticated investors may not be able to protect their own interests if they do not have the information they need or want about the issuer or cannot feasibly understand it."[692]

The relevance to this thesis is simple. An arbitrary wealth threshold determines whether or not an investor requires a prospectus or other publically available securities document. It allows these investors access to vehicles that Mass Affluent retail investors cannot access. This thesis does not imply or suggest that Mass Affluent retail investors be granted access to extremely complex investment strategies, such as certain derivative products or hedge funds; however, it does suggest that the law is mistaken over the role of less complex structures such as ETFs. It also puts investors just above a threshold at risk. Imagine, a well-educated professional that wants to invest $980,000 cannot access certain vehicles, but a lottery winner who just won $1.2 million could be an Accredited Investor.

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688 Nova D. Harb, David H. Pankey, & David L. Ronn, *supra* n 502 at 11; CSA, *Review of Minimum Amount and Accredited Investor Exemptions, Prospectus and Registration Exemptions*, BCSC NI 45-106 (19 February 2015)

689 FINSIA, "Sophisticated Investor ruling begs need for review", Release (12 July 2017) online at: https://www.finsia.com/insights/news/news-article/2017/07/12/sophisticated-investor-ruling-begs-need-for-review

690 Oguss, *supra* n 687 at 289-290

691 Ibid at 294

692 *Ibid* at 298

Academics often argue a workaround this financial threshold is to create an exam testing an investor's financial knowledge.[693] This would overcome an obstacle that financial adept but "poor" investors can participate in some of these investment vehicles.[694] This is not suggesting we allow Mass Affluent access to extremely risk and complex strategies. Rather MFDA advisors should have access to a slightly wider array of potential investment options.

5.5 Summary Conclusions

Canadian securities licensing requirements offer a significant and potential limiting source of RI investments. Canada, the US and Australia divide mutual fund dealers from advisors who can offer the full range of investment products. As there are more mutual fund advisors as compared to Investment Advisors, access is a major issue.

Fee structures, duties of care, advertising and education requirements all limit RI access and uptake. Canada should implement Australia's enhanced duty of care standards and limits on fee compensation. Suitability and KYC requirements need to incorporate ESG issues to ensure clients are aware that RI products exist.

RI requires a deep understanding of the issues, risks and theories surrounding ESG. Advisors in Canada, the USA and Australia do not have the education or training to provide advice on RI. Updating the KYC requirements without updating education requirements would be ill advised, as advisors would not be able to provide the advice to satisfy their duty of care. Mandating ESG factors as part of both a mutual fund and an investment advisor's education requirements would aid in RI uptake. Enhancing

[693] *Ibid* at 310
[694] *Ibid* at 311

education requirements of MFDA advisors would overcome any objection to broadening their ability to access certain other investment vehicles.

The advertising documents do not by themselves cause problems with RI in Canada, the USA or Australia. The underlying information contained in these documents is incomplete, as was shown in Chapter 2. This incomplete information causes a misunderstanding of RI, as shown in the next chapter.

Poor investment decisions by investors around type and style of investment products appears to be the result of a "lack of financial awareness and education, better advertising of active styled products, and more enthusiastic promotion of actively managed funds by intermediaries (perhaps due to sales commissions, and overconfidence biases of investors and advisers and fund managers."[695]

To conclude, the answer to RQ3 is yes, MFDA licensed advisors should be granted access to provide advice on certain other investment structures such as ETFs, but not extremely complex products like hedge funds.

[695] Bollen, *supra* n 88 at 234. This article also provides a useful overview of some of the behavioural finance issues surrounding investor decisions, determining that it is not simply adding more disclosures, but adding better and more cognitively useful disclosures, the "bounded rationality" approach.

CHAPTER 6 – FUND ANALYSIS

Approximately thirty-eight (38%) percent of Canadian investments have some RI component.[696] This chapter provides an analysis of real world funds that focus on RI for retail investors. There are six generally accepted classifications of RI investments, as illustrated in Chapter 1. The classifications include positive screens, negative screens, ESG integration, specialty/niche sustainability themes, impact investments and activist investments. This chapter will investigate the implementation of these theoretical RI classifications, based upon the types of funds available to the retail investor.

Chapter 1 showed the issues and problems with screens and the dichotomy between negative screens and activist investing. Chapter 2 and 3 explained the potential disclosure and valuation issues with ESG integration funds. This chapter shows that real world funds that attempt to integrate ESG appear to include the same underlying holdings as equivalent non-RI funds. This would indicate that portfolio managers do not value ESG properly, as indicated in Chapter 3. This chapter will also show that impact investments are implemented in the form of fixed income products, such as green and SDG bonds, and infrastructure investments, which are inaccessible to the Mass Affluent retail investor. This chapter will show that activist funds are also largely inaccessible to the Mass Affluent retail investor. The only funds that properly show RI are the niche sustainability themed funds. A fund does not need to focus on all three aspects of ESG to qualify as RI.[697] Unfortunately, sustainability themed funds are primarily constructed in as ETFs, which cannot be sold by MFDA advisors and are thus largely unattainable by the Mass Affluent.

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[696] Responsible Investment Association, *RIA Trends Report 2016* (Toronto: Responsible Investment Association, 2017). Available at: https://www.riacanada.ca/trendsreport/ accessed February 27, 2018
[697] Global Sustainable Investment Alliance, *supra* n 13 at 7

6.1 Mutual Funds

Generally speaking, Canadian investors only have access to Canadian mutual funds, and US investors have access to US funds. The two countries will be analyzed separately.

6.1.1 Canada

Each quarter the Responsible Investment Association publishes a list of all of the RI funds available to retail investors.[698] This list includes segregated funds, which were not reviewed as they are insurance products. Each fund has multiple series ("A", "E", "F", "L", etc.)[699] A funds series does not change the purpose of the fund or the underlying assets; rather it only changes the fees and tax structures. For example, the "F" series is generally a fee-based series, which eliminates part of the embedded commission in the MER, and charges the client directly for services rendered. Series "I" is generally the institutional version of the retail series, normally used for defined contribution pension plans. The "A" Series was used in the analysis for this chapter, as this is the most common series available to investors and including other series would duplicate analysis of one single fund.[700] Several of the funds listed in the RIA report are known as 'fund of fund' structures. Fund of fund structures have, as underlying assets, other mutual funds, rather than individual securities. For example, the IA Clarington Inhance Growth Fund is comprised of the IA Clarington Inhance Canadian Equity Class, IA

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[698] RIA, *Responsible Investment Funds in Canada*, (31 December 2017) (Toronto: RIA, 2018) Report generated by Fundata Canada Inc.

[699] Only the "A" Series was used in the analysis for this chapter, as this is the most common series available to investors.

[700] Morningstar is a service that lists all available mutual funds, ETFs, and stocks for sale in Canada and USA. As of April 26, 2018, there are over 18,600 mutual funds alone. As a back check to ensure that no RI fund was missed in the RIA report, the author went through each of the funds to ensure that all were covered. The first step was to filter all the "fee based" products, which left 10,600 funds.

Clarington Inhance Bond Fund, and other RI funds.[701] Fund of fund structures were eliminated, as this would be double counting the number of RI funds.[702] Several of the funds are only available in Quebec. Governance issues for women on boards will be investigated in follow up research.[703]

After this preliminary canvassing of the potential available funds, the result was approximately thirty (30) unique RI mutual funds available to retail advisors. By way of comparison, there are well in excess of 2,000 unique mutual funds in Canada.[704] Thirty (30) unique RI Funds are immaterial to the overall mutual fund lineup.

Of the "Big Six" banks, only the Royal Bank of Canada ("RBC") and the Bank of Montreal ("BMO") offer RI products.[705] The RBC Vision Canadian Equity Fund is a closeted index fund.[706] This does not mean, necessarily, that it is not a proper RI fund. Rather, it means that the underlying holdings are very similar to an index fund, and thus the argument could be made that the broad TSX index is also responsible. The RBC Vision Bond Fund does not have any green bonds or any underlying green assets and invests only in government bonds.[707] Chapter 3 noted that fixed income funds do not value ESG factors well, so this fund would not constitute a valid RI fund. Saying this Vision Bond fund is a valid RI fund would also mean that every Canadian bond fund

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[701] Industrial Alliance, *IA Clarington Funds*, online at: https://iaclarington.com/products-services/mutual-funds

[702] Also eliminated were funds that contained 30% or more of another fund. For example, the Social Housing Canadian Equity Fund contained 30% of the RBC Vision Equity Fund. This also would be double counting.

[703] For example, State Street Advisors, SPDR SSGA Gender Diversity Index ETF, online at: https://www.bloomberg.com/quote/SHE:US , *BMO, "Invest with Impact, Invest in Women, Release (16 February 2017), online at: https://bmoforwomen.bmo.com/invest-with-impact-invest-in-women/, BMO, Women in Leadership* Fund, Fund Facts at: https://www.bmo.com/gam/ca/investor/products/mutual-funds/product?fundId=37646#

[704] Morningstar, *supra* n 700

[705] RIA, *supra* n 698

[706] RBC Global Asset Management, *RBC Vision Canadian Equity Fund*, Fund Facts (Toronto, RBC, 2018)

[707] RBC Global Asset Management, *RBC Vision Bond Fund*, Fund Facts (Toronto, RBC, 2018)

would qualify as an RI bond fund, as they have the same holdings. The RBC Vision Fossil Fuel Free Global Equity Fund follows the negative screen/divestment mandate of eliminating companies that derive a substantial portion of their income from oil and gas activities.[708] In reality then, RBC has only one valid RI fund. BMO has only two RI offerings. The BMO Women in leadership fund uses a positive screen, and focuses on the importance of women in senior leadership positions.[709] The BMO Fossil Fuel Free Fund follows the negative screen/divestment mandate of eliminating companies that derive a substantial portion of their income from oil and gas activities. [710]

It is easy to see that there is a lack of accessibility to RI for clients of the Bank of Nova Scotia, CIBC, the Toronto-Dominion Bank ("TD"), and National Bank, as they have no funds with RI mandates. As mutual fund sales representatives must, generally, exclusively sell proprietary products of their financial institution, their clients will not be able to access RI funds. TD Bank published its Sustainable Investing Approach stating:

> We believe incorporating sustainability criteria within the investment framework is compatible with our goal of maximizing long-term financial returns. More specifically, we believe that considering environmental, social and governance (ESG) factors provides us with a more robust view of potential risks and opportunities. Based on our fiduciary duty to clients, we focus on ESG issues that are likely to influence the value of an investment.[711]

TD states that its analysis incorporates the six principles of the PRI by integrating ESG factors directly into investment analysis, maintaining active ownership by voting its proxies and engaging with management of the companies in which it invests, disclosing ESG in plain language, advocating for sustainable investing, collaborating with groups

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708 RBC Global Asset Management, *RBC Vision Fossil Fuel Free Global Equity Fund*, Fund Facts (Toronto, RBC, 2018)
709 BMO, *supra* n 703
710 BMO Asset Management Inc., *BMO Fossil Fuel Free Fund*, Fund Facts (Toronto: BMO, 2018)
711 TD Asset Management, *Sustainable Investing Approach,* (April 2015)

such as CDP and reporting.[712] While it may do this analysis for institutional financing, it does not currently have a publicly available fund in which a retail investor could invest. This seems counterintuitive for an institution exposing its RI credentials to not make available any retail RI fund.

Offerings by independent investment managers,[713] (Investors Group, Manulife, Sun Life, and Industrial-Alliance) were examined.[714] These were chosen as they would have the greatest number of Mass Affluent clients, after the big banks. Manulife and Sun Life do not have RI offerings. Investors Group's Summa Fund is akin to the RBC Vision Canadian Equity, although it appears to exhibit more active management. There are newer funds, launched late 2017 and early 2018. These funds are managed by MacKenzie Investments (a sister company to Investors Group). MacKenzie offers the MacKenzie Global Sustainability and Impact Balanced Fund and the Mackenzie Global Leadership Impact Fund.[715] These funds were created only recently, and thus outside the analysis for this thesis. The IA-Clarington INHANCE Canadian Equity Class appears to

[712] At the outset of this thesis, TD's responsible fund was going to be case studied, as the author was colleagues with the portfolio manager. However, since the thesis began, the portfolio manager left the company and the fund was dissolved. This shows more evidence of a lack of RI availability in the marketplace as TD now has no RI funds to compare.
[713] Due to ownership structures, most of these "independent" they are large insurance companies are not actually independent. They are called "independent" as they are not owned by the big six banks. Both offer segregated funds, however, segregated funds will be excluded as they are technically an insurance product and are sold for reasons other than just investing. See Investors Group, *Socially Responsible Investing*, online at: https://www.investorsgroup.com/en/investments/products/socially-responsible-investing-sri accessed May 30, 2018; Manulife, http://www.manulifeam.com/ca/About-Us/Responsible-Investment-at-Manulife-Asset-Management/
[714] Desjardins, online at: https://www.desjardins.com/ca/personal/wealth-management/our-solutions/responsible-investement/index.jsp accessed May 30, 2018
[715] MacKenzie Investments, *Mackenzie Global Leadership Impact Fund – Series A Fund Facts* (London ON: Mackenzie Global Leadership Impact Fund – Series A, 2017), online at: https://www.mackenzieinvestments.com/en/products/mutual-funds/mackenzie-global-leadership-impact-fund-f accessed February 5, 2018; see also, MacKenzie Investments, "Investing with Impact" Press Release (10 October 2017) online at: https://www.mackenzieinvestments.com/en/about/press-releases/2017-october-10-investing-with-impact-mackenzie-investments-announces-two-new-products

benefit from negative screens and activist investing.[716] Perhaps the greatest advantage is that IA-Clarington uses Vancity Investment Management, a specialized niche portfolio management company, to construct its portfolios.[717] On the downside, the remaining holdings are still the extremely large Canadian corporations that can be found in every Canadian equity fund. This once again, shows that in a small stock market like the TSX, it may be impossible to build a broadly diversified responsible mutual fund of Canadian equities that satisfied diversification mandates. It may also mean that large Canadian companies have adopted ESG practices and thus are responsible. Without enhanced, standardized information, it is difficult to make a determination, one way or another.

The final financial institution that serves Mass Affluent clients are the credit unions. NEI Investments is a wholly owned Canadian company, 50% owned by Desjardin Securities Inc. and 50% by the Provincial Credit Unions.[718] NEI is also the only Canadian asset manager to exclusively use third party money managers to construct its portfolios.[719] NEI Investments Environmental Leaders fund does show RI characteristics. This shows that sustainability themed investing may be the valid RI fund available. Broad based ESG integration funds do not, as again evidenced by the NEI Canadian Equity Fund RS (formerly Ethical Canadian Fund A), which holds the same equities as a non-RI fund (in different quantities). It would still qualify as valid RI as the

[716] IA Clarington Investments, *IA Clarington Inhance Canadian Equity SRI Class, Manager commentary*, (31 March 2018) online at: https://iaclarington.com/activeinsights/quarterly-commentaries/q1-2018/ia-clarington-inhance-canadian-equity-sri-class
[717] Vancity Investment Management, *IA Clarington Inhance SRI Funds RIA Conference 2014* (12 May 2014) Presentation to the RIA Annual 2014 conference
[718] NEI Investments, *About NEI Investments*, online at: https://www.neiinvestments.com/pages/about-nei/ accessed May 8, 2018
[719] NEI Investments, *The NEI Investments Portfolio Manager Selection and Monitoring Process: Committed to Exceptional Portfolio Management* (Toronto: NEI, 2016)

fund takes an active investing approach.[720] The same holds true for Desjardins and their lineup of SocieTerra funds. All but two of SocieTerra funds are fund of funds, and therefore not analyzed. The two that show RI characteristics, the Desjardins SocieTerra Cleantech Fund and the Desjardins SocieTerra Environment Fund, are specialized niche funds that focus on sustainability investing.[721]

Overall, most broad based RI funds are not materially different from non-RI funds or the broader index, confirming research by others.[722] This makes intuitive sense, as the public market is small and there are very few large tradable liquid companies. Canada is a resource based economy, with 1/3 of its public companies in the extractive and/or fossil fuel industries. In summation, there is a paucity of funds available to most Canadians. The big six bank offerings do not provide the RI access an investor would expect, and most of the other funds are derivative offerings, with high fees. Only specialized cleantech/environmental funds (of which there are only three funds), divestment funds (of which there are two funds) and active investor funds (again only two) show true RI characteristics.

6.1.2 US Mutual Funds

US funds offer the potential to be more diversified than Canadian funds, given the larger number of companies based in the USA and its more diversified economy. Thus it is theoretically 'easier' to construct a US equity fund that complies with the tenets of RI

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[720] NEI Investments, *NEI Canadian Equity RS Fund, Fund Facts* (12 July 2018). They stated: "Corporate Engagement Suncor's board and management recommended that investors should vote for our shareholder proposal on strategic resilience in a carbon-constrained future - a first in North America. We met with Telus to discuss corporate governance matters in advance of the 2016 AGM, including director independence, diversity and executive compensation." As a major drawback, one that would preclude large uptake, it has an extremely large MER at 2.51%.

[721] Desjardins Funds, *Desjardins SocieTerra Cleantech Fund,* Fund Facts, online at: https://www.fondsdesjardins.com/information/00168_adf_a_en.pdf accessed August 5, 2018

[722] This confirms Hawken, *supra* n 81

and MPT. However, there is still a tendency for funds to either closet index, or mirror closely one of the non-RI fund products.

The US mutual fund data principally originated from the Social Investment Forum.[723] It listed approximately two hundred (204) funds, several of which are the same fund but different series. Several of these funds had minimum investment amounts of $100,000 or greater, so these were eliminated as these would cater to the Accredited Investor, and thus outside the mass affluent market.[724] Other funds eliminated are the SRI funds that promote a "Christian or Catholic lifestyle."[725] Others eliminate a 'LBTQ" lifestyle.[726] These types of screens and funds do not currently exist in Canada. Some funds eliminate 'sin stocks' such as alcohol or gambling, as these funds promote ethics over profit. [727] These were eliminated from review. There are other non-RI problems with "Chinese" or foreign government owned enterprises, which preclude analysis.[728]

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723 US SIF, *Sustainable, Responsible and Impact Mutual Fund and ETF Chart*, online at https://charts.ussif.org/mfpc/ data current as of May 3, 2018

724 MPT would not allow a person with $300,000 to invest all their money in one or two funds.

725 Global X Funds, *S&P 500 Catholic Values ETF*, online at: https://www.globalxfunds.com/funds/cath/, for a list of funds, see Chris Taylor, "Gotta have faith: The rise of religious ETFs" (31 August 2017) Reuters, online at: https://www.reuters.com/article/us-religion-etf/gotta-have-faith-the-rise-of-religious-etfs-idUSKCN1BB2JI; yet, despite any incorrect academic misgivings about these funds having potential humans rights issues; the top holdings are no different from any non-RI fund. The top ten holdings for example are Apple, Microsoft, Amazon, Facebook, Berkshire Hathaway, JP Morgan Chase, Exxon Mobil, Alphabet, Abbvie and Bank of America. This also proves that RI and SRI funds are not statistically different from their non-responsible counterparts. For a full list of holdings, a reader can download the Excel file on the Global X fund page. It shows that there is no difference from Hawken's conclusions that names are misleading, see n 87

726 For example, see the Inspire Global, *Hope Large Cap ETF*, at http://www.etf.com/BLES For comparison, see Workplace Equality Portfolio, at http://www.etf.com/EQLT

727 See Trinks & Scholtens, *supra* n 34, Richardson, *supra n 11; a*lcohol is an example of an industry that could be considered SRI or RI. Alcohol eliminated solely for being a "sin stock" and for no other reason becomes SRI. Alcohol can be RI as it is very profitable, yet may have ESG problems. Alcohol needs vast quantities of water and farming practices may be environmentally destructive. Farming practices may have human rights issues, for example, Mexican farmers harvesting agave for tequila need to be treated and paid fairly. Large international alcohol companies may or may not have problems with women in leadership.

728 WisdomTree *China ex-State-Owned-Enterprises Fund* (CXSE) and the WisdomTree Emerging Markets ex-State-Owned Enterprises Fund (XSOE), online at: https://www.wisdomtree.com/etfs/equity/cxse

From this data, again, none of the major US financial institutions (for example Wells Fargo[729] or JP Morgan Chase) or the large investment firms (such as Fidelity) create RI mutual fund products.[730] For US mutual fund investors, there is both a construction and an access issue. Wells Fargo, like TD Bank in Canada, states that they are actively engaged in ESG.[731] Only Wells Fargo Private Bank offer custom RI solutions, but this is only available to Accredited Investors.[732] There a few funds that specialize in water issues[733] or in women's rights[734] but, like in Canadian context, they are small niche funds. There is a construction issue with RI mutual funds in the USA.

6.2 ETFs

ETFs offer a unique perspective on RI. The data for the ETF analysis is derived from the Morningstar database[735] and the ETF Database.[736] The types and variety of offerings offer potential to enhance environmental finance. For example, Blackrock Inc., the portfolio manager of the iShares ETF series, has a number of ETFs that focus on ESG and RI issues.[737] Several examples that address environmental issues will be explored.

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[729] A search of the Wells Fargo mutual fund site, screening for Wells Fargo Product resulted in 0 results. See Wells Fargo, "Mutual Fund Screener", online at: https://mutualfunds.wellsfargo.com/mutual-fund-center/mfScreener.aspx?#:L=NT:AF=T:SO=T:MRC=0:p=1:c=NM:d=up

[730] SIF, *supra* n 723

[731] Wells Fargo, *Environmental, Social, and Governance Guide*, (Wells Fargo, 2017) online at: https://www.wellsfargo.com/about/investor-relations/environmental-social-governance-guide/

[732] Wells Fargo, *Social Impact Investing*, online at: https://www.wellsfargo.com/the-private-bank/solutions/social-impact-investing/

[733] Calvert Research and Managements, *Calvert Water Fund* at: https://www.calvert.com/Calvert-Global-Water-Fund-CFWAX.php

[734] Impax Asset Management LLC, *Pax Ellevate Global Women's Leadership Fund* at: https://paxworld.com/pax-ellevate/

[735] Morningstar, *ETF Screener*, online at: http://screen.morningstar.com/etfselector/etf_screener_version1.aspx

[736] ETF Database, *Social Responsible ETFs*, online at: http://etfdb.com/type/investment-style/socially-responsible/

[737] Blackrock Inc., *iShares Sustainable ETFs Investing for a Sustainable Futu*re, online at: https://www.ishares.com/us/strategies/sustainable-investing/sustainable-etfs-product-overview. In Canada, they manage the iShares Jantzi Social Index ETF, see https://www.blackrock.com/ca/individual/en/products/239574/ishares-jantzi-social-index-etf

These include unique offerings that focus on water, alternative energy and low carbon technologies, and even nuclear.

Water is the basis for all life on earth, yet in very few countries is water considered to be a human right despite UN General Assembly endorsement of the idea.[738] Global water demand is increasing due to population growth and better diets and water use has doubled in the past forty years.[739] More than a billion people cannot even get access to clean water, billions more without proper sanitation.[740] Large regions of major countries, such as the USA and China, are in drought or have questionable long-term access to a water supply.[741] The most disadvantaged peoples today are poised to be even more at risk.[742] The world may only have 60% of its required water by 2030.[743]

Certain industries, such as farming and mining, require vast amounts of water.[744] There are many problems with water infrastructure including underinvestment, corruption, and disputes over whether public or private actors should own water

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[738] UN GA, *The Human Right to Water and Sanitation*, Resolution adopted by the General Assembly, (28 July 2010) UN Res 64/292

[739] United Nations Educational, Scientific and Cultural Organization, *The United Nations World Water Development Report 2015 Water for a Sustainable World* (France: UN, 2015)

[740] UN GA, *Report of the Special Rapporteur on the human right to safe drinking water and sanitation, Catarina de Albuquerque* (11 July 2013) A/HRC/24/44

[741] E.g. Charles Parton, "China's acute water shortage imperils economic future" (27 February 2018) News Release, Financial Times online at: https://www.ft.com/content/3ee05452-1801-11e8-9376-4a6390addb44 accessed April 20, 2018; For a real time look at droughts, see The National Drought Mitigation Center University of Nebraska-Lincoln, *US Drought Monitor*, online at : http://droughtmonitor.unl.edu/ accessed April 18, 2018; see also National Weather Service, *Climate Prediction Center*, at http://www.cpc.ncep.noaa.gov/products/Drought/ accessed April 18, 2018 & Center for Climate and Energy Solutions, https://www.c2es.org/content/drought-and-climate-change/

[742] M Jakob, & J Steckel, "How climate change mitigation could harm development in poor countries" (2014) *5*:2 Wiley Interdisciplinary Reviews: Climate Change 161-168; see also R Wolf, "Why wealthy countries must not drop nuclear energy: Coal power, climate change and the fate of the global poor" (2015) 91:2. International Affairs 287-301

[743] UNESCO, *supra* n 739 at 11

[744] Deanna Kemp, et al., "Mining, water and human rights: Making the connection" (2010) 18:15 Journal of Cleaner Production 1553-1562 at 1554

resources and deliver services.[745] Columbia has challenges with potable drinking water.[746] Bolivia had issues with privatization of water resources.[747]

A greater role needs to be placed on FIs to ensure human rights clauses are contained in their financing instruments.[748] The SDGs mandate access to water and sanitation.[749] The SDGs set out eight water related targets by 2030, including universal access to safe drinking water, equitable sanitation, reduction of pollution, international cooperation of large projects and others.[750] Investors should prepare for a complete overhaul of water management and pricing practices and an outlay of up to $25 trillion (USD) in water infrastructure spending.[751] The private actors will be the firms actually doing the work, from the design, construction to the supply chain.[752] "Government funds alone will never be enough to build resilience to extreme weather and deal with the

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[745] Fabrizio Marrella, "On the Changing Structure of International Investment Law: The Human Right to Water and ICSID Arbitration" (2010) 12 International Community Law Review *335–359* at 336

[746] J.D. González Ruiz, C.A. Arboleda, & S. Botero, "A Proposal for Green Financing as a Mechanism to Increase Private Participation in Sustainable Water Infrastructure Systems: The Colombian Case" (2016) 145 Procedia Engineering 180 – 187

[747] Pierre Thielborger, "Re-Conceptualizing the Human Right to Water: A Pledge for a Hybrid Approach" (2015) 15 Human Rights Law Review 225–249; Solon, "Intervention of the Permanent Representative of the Plurinational State of Bolivia: "The Human Right to Water and Sanitation" Speech (28 July 2010) available at: pwccc.wordpress.-com/2010/07/28/speech-the-human-right-to-water-and-sanitation/

[748] Marrella, *supra* n 745 at 358

[749] SDGs, *supra* n 219, SDG 6, Ensure availability and sustainable management of water and sanitation for all, online at: https://sustainabledevelopment.un.org/sdg6

[750] RT Hon Lady Justice Arden, "Water for all? Developing a Human Right to Water in National and International Law" (2016) 65 International and Comparative Law Quarterly 771-789 at 787

[751] Jantzi Sustainalytics, *Water Scarcity: Will Investors Be Left High and Dry?* Special Report (Toronto: Jantzi Sustainalytics, April 2016)

[752] There is a tremendous amount of research on public private partnerships and other models to back this claim. A valid example can be found in the deep sea bed mining context, whereby small island nations such as Papua New Guinea, Tonga and Nauru, according to the 'common heritage of mankind' are sponsoring states, yet contract to large multinationals like Nautilus Minerals Inc. to do the work. See Keith MacMaster, "Environmental Liability for Deep Seabed Mining in the Area – An urgent case for a robust Strict Liability regime" (2018) Ocean's Yearbook (Forthcoming) at 10

threats to energy, water, and food supplies – the private sector and institutional investors must be involved."[753]

Retail investors have limited options for water investments. An investor could make an equity investment in companies such as Coca-Cola.[754] These companies often have environmental and human rights issues, so a thorough company level ESG analysis is required for any specific investment. Again, without fulsome disclosures, it is arguable that this is not possible. Green and social bonds are the most relevant potential financing mechanism as they are sufficiently robust to provide for the necessary infrastructure. Few green bonds are available to the retail public. It is thus the author's view and opinion that any fund that is mandated to invest in clean water and sanitation investments would constitute a valid RI fund. That being said, the fund itself may be valid RI, each company, project, bond or asset would need a thorough ESG analysis to ensure that it qualifies to become a portfolio asset.

There are no Canadian mutual funds that invest in water or water infrastructure, and only one US mutual fund. There is one Canadian ETF that focuses on water, the iShares Global Water Index ETF.[755] There were two US based ETFs that focus on water including the *Criterion Water Infrastructure Fund* and the Guggenheim S&P Global

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[753] World Bank, "Growing the Green Bond Market to Finance a Cleaner, Resilient World" Article (4 March 2014) online at: http://www.worldbank.org/en/news/feature/2014/03/04/growing-green-bonds-market-climate-resilience

[754] For example, Coca Cola (Ticker, "KO") purchase an old municipal water drinking system in Atlanta and created the Dasani water plant. Dasani, See how is Dasani made? Online at: https://www.dasani.com/faq/ . This is another case of environment and humans rights coming together, see Mother Jones, "Bottled Water Comes From the Most Drought-Ridden Places in the Country" (August 2014) online at: https://www.motherjones.com/environment/2014/08/bottled-water-california-drought/

[755] Blackrock Inc., *iShares Global Water Index ETF, Fund Facts* at https://www.blackrock.com/ca/individual/en/products/239755/ishares-sp-global-water-index-fund

Water Index ETF.[756] The Global Water Index ETF is an equity fund, and invests in companies that focus on water, not on projects that focus on water.[757] There is still a duality investing in the companies versus investing in a project with direct benefits to humans.[758] More direct exposure to clean water/sanitation projects that benefit humankind would be preferable from an RI perspective. This, again, points to a greater need for retail investors to access infrastructure and green bonds.

The current consensus among climate scientists is that humanity must keep rising temperature change to below 2 degrees C.[759] SDG 13 mandates taking urgent action to combat climate change and its impacts.[760] SDG 7 mandates access to sustainable and modern energy for all.[761] All clean tech funds would qualify as RI.[762] There are ETFs that focus on low carbon technologies.[763] These include clean technologies[764]

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[756] Now managed by Invesco; see ETFDB.com, *Invesco S&P Global Water Index ETF online at:* http://etfdb.com/etf/CGW/

[757] See list of top holdings at: http://etfdb.com/etf/CGW/#holdings

[758] Even the analysis report on the fund notes this disparity, noting "this ETF likely doesn't belong in a long-term buy-and-hold portfolio due to the targeted nature of exposure, but may be appealing to those who believe that scarcity issues will prompt increased demand for water treatment companies. While this investment thesis may seem compelling, it is not clear how strong the link between water usage/scarcity trends and performance will be going forward. Given the complexity of the issues, as well as the various other business operations of component companies, we're skeptical of the ability of this ETF to accomplish the objective investors may be expecting of it" at http://etfdb.com/etf/CGW/#etf-holdings&sort_name=weight&sort_order=desc&page=3

[759] IPCC 2014, *Climate Change 2014: Synthesis Report. Contribution of Working Groups I, II and III to the Fifth Assessment Report of the Intergovernmental Panel on Climate Change* [Core Writing Team, R.K. Pachauri and L.A. Meyer (eds.)] (IPCC, Geneva, Switzerland. 2014) at 151, there is now a with a 90 percent probability range of 2.6_C to 4.8_C

[760] SDGs, *supra* n 219, SDG 13, see also, UN, Goal 13—Taking Urgent Action to Combat Climate Change—SDGs and the Paris Climate Agreement, Release (April 2015) UN Chronicle, online at: https://unchronicle.un.org/article/goal-13-taking-urgent-action-combat-climate-change-sdgs-and-paris-climate-agreement

[761] *Ibid*, SDG 7

[762] Global Sustainable Investment Alliance, *supra* n 13 at 7

[763] iShares MSCI *ACWI Low Carbon Target ETF* (CRBN), Blackrock Inc., Fund Facts, online at https://www.ishares.com/us/products/271054/ishares-msci-acwi-low-carbon-target-etf and the SPDR MSCI ACWI Low Carbon Target ETF (LOWC),

[764] E.g. PowerShares Cleantech Portfolio Fund, see Invesco, *Invesco Cleantech EFF, Fund Facts*, at https://www.invesco.com/portal/site/us/investors/etfs/product-detail?productId=PZD

infrastructure,[765] battery technologies,[766] and others. This is in sharp contrast to the mutual fund industry, which, save for NEI cleantech fund, offers no such opportunities.

Transportation accounts for 24% of Canada's carbon emissions, a similar number exists for most countries.[767] Automotive manufacturers are starting to make climate change a priority, as are the investors financing them. As of February 2018, Tesla Inc. ("Tesla") has a market capitalization of 59.16 Billion (USD).[768] This is currently greater than General Motors ("GM") at 54.6B and Ford at 47.55B.[769] Only Daimler-Benz and Toyota are larger in terms of market capitalizations and both manufacturers are developing low carbon transportation.[770] There are ETFs that focus on electric vehicles.[771] There are no mutual funds that focus on this important technology.

Nuclear energy represents a more controversial technology. Uranium can be converted to make nuclear weapons. It is also required to make many medical devices.[772] Thus there is enough justification, in the author's opinion, to continue allowing investors access to nuclear energy, and thus retail investors should have equal access. With proper

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765 First Trust Advisors LP, *First Trust NASDAQ Clean Edge Smart Grid Infrastructure Index Fund* (GRID), Fund Facts online at: https://www.ftportfolios.com/retail/etf/etfsummary.aspx?Ticker=GRID See also, NASDAQ OMX Clean edge Smart Grid Infrastructure at https://cleanedge.com/indexes/stock-index/qgrd

766 Global X Funds, *Lithium & Battery Tech ETF*, online at: https://www.globalxfunds.com/funds/lit/

767 Environment and Climate Change Canada, *National Inventory Report 1990-2016: Greenhouse Gas Sources and Sinks in Canada* (Ottawa: Environment Canada, 2018) online at: https://www.canada.ca/en/environment-climate-change/services/climate-change/greenhouse-gas-emissions/inventory.html accessed June 7, 2018

768 Google Finance, *Market Capitalization of Tesla Inc*., accessed February 27, 2018

769 *Ibid, Market Capitalizations of Ford and GM* accessed February 27, 2018

770 Danielle Muoio, "Mercedes will sell a hydrogen-powered SUV in the US in 2019 — here's a closer look" Press Release (12 September, 2017) online at: http://www.businessinsider.com/frankfurt-motor-show-mercedes-hydrogen-glc-2017-9; Toyota, Zero CO2 emissions. Operates on electricity alone, online at: http://www.toyota-global.com/innovation/environmental_technology/electric_vehicle/

771 Global X Funds, *Autonomous & Electric Vehicles ETF*, online at: https://www.globalxfunds.com/funds/driv/

772 William J. Nuttall, Peter Storey "Technology and policy issues relating to future developments in research and radioisotope production reactors" (2014) 77 Progress in Nuclear Energy 201-213 at 201; see also Cal Woodward, "United States scrambles for secure, safe isotope supply" (2010) 185:5 Canadian Medical Association Journal 427-428

disclosure potential investors could decide for themselves, after a careful financial and ESG risk analysis. There are no mutual funds that offer investors the opportunity to invest in nuclear energy. There are several nuclear ETFs currently on the market. The Global X Uranium Index provides investors access to uranium mining and production.[773] There are publicly available companies in which an investor could directly purchase stocks, such as, for example, Cameco.[774] Individual stocks, especially ones that have not performed well over the past number of years,[775] are not preferred for the Mass Affluent. A broad portfolio including other uranium producers such as Denison Mines, BHP Billiton, Rio Tinto (if these companies engaged in positive ESG/RI practices) could be included, as many are hailed as responsible companies.[776]

Finally, there are ETFs that focus on the SDGs.[777] Trucost, a leader in carbon and environmental data and risk analysis, has launched the Trucost SDG Evaluation Tool to help enable companies to identify business risks and opportunities aligned with the SDGs.[778] On September 25th 2015, countries adopted the goals to end poverty, protect the planet and ensure prosperity for all as part of a new sustainable development

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773 Global X Funds, *Uranium ETF*, online at: https://www.globalxfunds.com/funds/ura/
Fund performance has not been positive; rather the fund has lost 83% of its value.

774 (TSX "CCO"); for a complete list see: Mining Feeds, *Uranium Mining Companies Listed In All Countries*, online at: http://www.miningfeeds.com/uranium-mining-report-all-countries ; for a list of the uranium miners by percentage of world uranium, see Investing News, "Top Uranium-producing Companies in the World" Press Release (2 May 2017) online at: https://investingnews.com/daily/resource-investing/energy-investing/uranium-investing/uranium-producing-companies-bhp-rio-tinto-cameco-areva-paladin-ur-energy-uranium-one-energy-fuels-peninsula-uranium-resources/

775 Jonathan Ratner, "Cameco Corp. takes another hit, but production cuts positive for uranium market" Press Release (9 November 2017) Financial Post, online at: http://business.financialpost.com/investing/cameco-corp-takes-another-hit-but-production-cuts-positive-for-uranium-market

776 Julie Smith, "Canada's top 50 socially responsible corporations: 2015" Press Release (8 June 2015) MacLean's, online at: https://www.macleans.ca/economy/business/canadas-top-50-most-socially-responsible-companies/ Cameco ranks among the top 50.

777 *iShares MSCI Global Impact ETF* (MPCT), up 18.3% year-to-date, tracks an index of companies that "derive a majority of their revenue from products and services that address at least one of the world's major social and environmental challenges as identified by the United Nations Sustainable Development Goals."

778 Trucost is an ESG rating agency similar to Sustainalytics

agenda.[779] There are no mutual funds that invest in the SDGs or companies that promote the SDGs.

In short, ETFs offer a potential solution to the construction of RI. The paucity of available ETFs in Canada is a problem as is access to the Mass Affluent.

6.3 Bonds, Project Finance and RI

Green and social bonds offer the greatest opportunity for RI to get a better foothold on the retail market. TD is a signatory to the Green Bond Principles. Launched in 2014, the TD Green Bond was the first issuance by a commercial bank.[780] This bond financed renewable power generation, energy efficiency and management, and green infrastructure/land use.[781] $234 million of the bond was used for building efficiency projects, $130 million was invested in transportation efficiency and $59 million was invested in wind energy.[782] In 2017, TD issued a second green bond, this one a USD $1 billion offering.[783] This bond was to finance projects including renewable energy generation, energy efficiency and management, green infrastructure and sustainable land use.[784] TD also issued a five year bond non-green bond issuance at the same time.[785] Both bonds were oversubscribed and pricing was similar, indicating no premium for a

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[779] S&P Global, "SDG Evaluation Tool Launched by Trucost" Press Release (9 May 2018) Trucost/S&P Dow Jones Indices

[780] TD Bank, "Green Bonds" online at: https://www.td.com/investor-relations/ir-homepage/debt-information/green-bonds/green-bonds.jsp

[781] Climate Bonds Initiative, *TD Green Bond Term Sheet*, online at: https://www.climatebonds.net/2014/05/canada%E2%80%99s-first-corporate-green-bond-td-bank%E2%80%99s-3yr-aa-cad500m-usd454m-bond-was-15-x

[782] Barry Critchley, "TD raises US$1-billion in bank's first green bond issue south of border" Press Release (7 September 2017) online at: http://business.financialpost.com/news/fp-street/td-raises-us1-billion-in-banks-first-green-bond-issue-south-of-border

[783] TD Bank, *TD Bank Green Bond 2, DNV GL Eligibility Assessment*, online at: https://www.td.com/document/PDF/Verification_Statement.pdf

[784] *Ibid* at 3

[785] Climate Bonds Initiative, *supra* n 781

green bond.[786] This shows that the market still does not value ESG risk and that standardized metrics are required.

There are some concerns in the financial community over the TD Green Bond issuance. The definition of 'green' might be overly broad[787] and there may be a lack of external review.[788] Labelling a product as "green" or "responsible" does not mean that the product is green or responsible. A better understanding and proper valuation and risk analysis is required for each product to determine if they are green and responsible.

This green bond will be available to retail investors; however, it is only available through the TD Wealth Management network.[789] This means that only certain IIROC advisors can sell these bonds, eliminating access to the Mass Affluent. Given its oversubscription, this seems like a missed opportunity to have given the larger retail segment a chance to purchase this vehicle.

Ontario was the first province in Canada to launch a green bond.[790] The initial bond was a $500 million (CAD) offering in 2014.[791] A subsequent offering of $750 million was developed in 2016.[792] The Ontario bond is based by the credit rating of the province, with the first green bond being issued at a coupon rate of 1.75%, while the second was offered at 1.95%.[793] Structurally the Ontario green bonds are the same as Ontario government bonds, and rank *pari passu* with other bonds, which are highly used

[786] *Ibid*
[787] Climate Bonds, *First Corporate Green Bond*, online at: https://www.climatebonds.net/2014/05/canada%E2%80%99s-first-corporate-green-bond-td-bank%E2%80%99s-3yr-aa-cad500m-usd454m-bond-was-15-x
[788] *Ibid*
[789] *Ibid*
[790] Province of Ontario, *Green Bonds* online at: http://www.ofina.on.ca/greenbonds/
[791] *Ibid*
[792] Climate Bonds Initiative, Ontario issues long-awaited inaugural green bond, online at: https://www.climatebonds.net/2014/10/ontario-issues-long-awaited-inaugural-green-bond-cad-500m-4481m-175-4yrs-aa2e-mixed
[793] Because of oversubscription, the coupon rate was tightened by 5 bps to 38 bps over the 1.25% CAD September 2018 rate.

in the fixed income mutual fund market.[794] Pricing is similar to non-green bonds, showing again that ESG risk is not measured or valued. The Ontario green bonds have funded clean transportation, energy efficiency, clean energy, forestry, agriculture/land management, and climate adaptation/resilience.[795] Like other green bonds, this Ontario bond was issued via a prospectus, so only IIROC advisors could access these bonds.

Many issuers in the US fear a green bond issuance due to potential litigation due to claims of misrepresentation.[796] Issuers of green bonds in the USA are large government or quasi-governmental organizations, such as Fannie Mae.[797] Fannie Mae is the largest issuer of green bonds in the world, issuing $27.6 billion (USD) of green bonds.[798] Fannie Mae is also the mortgage lender that was bailed out during the 2008 financial crisis.[799] Bank of America issued three green bonds totalling $1 billion USD.[800] Projects funded included solar projects, wind projects, energy efficiency initiatives, and water conservation projects.[801] Mass Affluent retail investors do not have access to these bonds.

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[794] Ontario, *supra* n 790

[795] Province of Ontario, *Green Bond 2016 Newsletter*, online at: http://www.ofina.on.ca/pdf/2016_ontario_green_bond_newsletter_en.pdf

[796] Kate Allen, "Strict US market rules limit corporate sellers of green bonds" Press Release (20 February 2018) Financial Times, online at: https://www.ft.com/content/baa217c4-157c-11e8-9376-4a6390addb44 accessed July 24, 2018

[797] Cicero, '*Second Opinion' on Fannie Mae Multifamily Green Bond Framework*, (8 June 2018) online at: https://www.fanniemae.com/content/fact_sheet/green-bond-second-opinion.pdf

[798] Alicia Jones, "Fannie Mae Wins Recognition as Largest Issuer of Green Bond by the Climate Bonds Initiative" Press Release (20 March 2018), Fannie Mae, online at: http://www.fanniemae.com/portal/media/corporate-news/2018/green-bond-award-6680.html accessed July 25, 2018

[799] Kimberly Amadeo, "What was the Fannie Mae and Freddie Mac Bailout" Blog (30 December 2017) online at: https://www.thebalance.com/what-was-the-fannie-mae-and-freddie-mac-bailout-3305658

[800] Bank of America, "Bank of America Issues Its Third and Largest Green Bond" Press Release (10 November 2016)

[801] Bank of America, *Bank of America issues $1 billion Green Bond*, online at: https://about.bankofamerica.com/en-us/green-bond-overview.html#fbid=addsZ7Tfj_c

Access in Australia to green bonds is extremely limited. National Australia Bank launched the first Australia's first green mortgage bond in 2018.[802] It had pricing similar to a non-green bond, showing that there was no "greenium" yet the bond was oversubscribed, which shows an appetite for such a vehicle.[803] Overall, Australia has seven green bonds, valued at US$2.563 billion.[804] The largest investor class has been asset managers, who make up over half of all investors to date.[805] Superannuation funds are a main driver of this investment, as the majority of super funds hold green bonds through asset managers, rather than through direct investments.[806] There is a substantial market for green bonds, yet few will create a product or a market for it.

The UK is also noticeably silent on green bonds.[807] Barclays was the first UK bank to launch such a fund.[808] Green bonds are more readily available in the UK, as the London Stock Exchange ("LSE") has a specific trading platform for purchasers to procure green bonds.[809] This market is aligned with and has admission criteria based on the Green Bond Principles.[810] The year 2017 saw a 57% growth in green bonds listed on

[802] NAB, *NAB Climate Bonds*, online at: https://capital.nab.com.au/information/green-and-sri-bonds
[803] Paulina Duran, "Australia green bond market muzzled by policy uncertainty" Release (5 February 2018) Reuters, online at: https://www.reuters.com/article/us-australia-bonds-green/australia-green-bond-market-muzzled-by-policy-uncertainty-idUSKBN1FP0OS
[804] Cole Latimer, "Climate bonds market to hit a new benchmark in 2018", Press Release, (10 January 2018) Sydney Morning Herald, online at: https://www.smh.com.au/business/banking-and-finance/2018-the-year-of-the-green-bond-20180109-p4yycb.html
[805] *Ibid*
[806] Oliver Yates, "Australia's budding green bond market" (June 2015) Clean Energy Finance Corp. online at: https://www.cefc.com.au/media/feature-articles/files/australias-budding-green-bond-market/
[807] Climate Bonds Initiative, "Barclays issues Climate Bonds Certified Green Bond: €500m First for a UK Bank" Press Release, (6 November 2017) online at: https://www.climatebonds.net/2017/11/barclays-issues-climate-bonds-certified-green-bond-eur500m-first-uk-bank
[808] *Ibid*
[809] LSE, *Green Bonds Pricing*, online at: http://www.londonstockexchange.com/exchange/prices-and-markets/debt-securities/green-bonds-search.html#formAndResults
[810] LSE, *Global Sustainable Investment Centre*, online at: https://www.lseg.com/sustainable

LSE (from 14 to 22 new bonds listed) and a 58% increase in amount raised (USD 9bn in 2017 YTD vs. USD 5.7bn in 2016).[811] The issue in UK is one of construction.

The World Bank is the largest single issuer of green bonds. As of September 2017, the Bank has issued a total of 135 green bonds in 18 currencies totaling more than $10.2 billion equivalent and IFC had issued 90 bonds worth $7.25 billion across 12 currencies.[812] Projects funded include renewable energy, energy efficiency, water, wastewater & waste management, agriculture, land use, resilient infrastructure, and sustainable transportation.[813] Thirty-seven percent (37%) of these projects were located in Asia, 25% in Latin America, 16% in South Asia, and only 6% in Africa.[814] No projects are located in developed countries as green bond proceeds are used by the IBRD for their member countries.[815] Specific projects funded include rooftop solar in India[816], energy security in Jamaica, concentrated solar in Morocco,[817] water sanitation and public transport in Ecuador,[818] and sanitation and wastewater in Brazil.[819] All green bond issuances are reviewed by CICERO, ensuring that these projects are indeed "green."[820]

Investors in these bonds are solely institutional investors.[821] For example the November 2016 offering was a private placement offering for large pension funds. [822]

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[811] LSE, "A Steller Month for Green Bonds in November" (5 December 2017) online at: https://www.lseg.com/markets-products-and-services/our-markets/london-stock-exchange/fixed-income-markets/green-bonds/stellar-month-green-bonds-november
[812] World Bank, *Green Bonds*, online at: http://www.worldbank.org/en/results/2017/12/01/green-bonds
[813] World Bank, *Green Bond Impact Report (*Washington DC: World Bank Treasury, 2017), at 7
[814] *Ibid* at 8
[815] *Ibid* at 9
[816] *Ibid* at 16
[817] *Ibid* at 18
[818] *Ibid* at 22
[819] *Ibid* at 23
[820] *Ibid* at 10
[821] World Bank, "Green Bonds Attract Private Sector Climate Finance" Press Release (10 June 2015) online at: http://www.worldbank.org/en/topic/climatechange/brief/green-bonds-climate-finance ; see also World Bank, "Who buys Green Bonds?" online at: http://treasury.worldbank.org/cmd/htm/Chapter-2-Who-Buys-Green-Bonds.html

There are few issuances by the World Bank that are available to Accredited Investors. The June 2014, 1.375% offering was listed on the Luxembourg Stock Exchange.[823] The April 2014 3.5% "Kangaroo" Green bond, on the other hand, was launched on Austraclear[824], which is an OTC clearinghouse on the ASX.[825] The June 2011 offering was available solely to Bank of America Merrill Lynch Wealth Management investors.[826] The September 2014 offering was an equity-linked green bond.[827] An equity linked bond is a type of structured product that combines features of debt/fixed income and those of equities.[828] The World Bank bond was linked to the performance of the Ethical Europe Equity Index, an index that selects eligible sustainable companies.[829]

There are no World Bank green bonds constructed for the Mass Affluent. World Bank green bonds are initially attractive, and do fund legitimate green projects. The ability of any Mass Affluent retail investor to procure a green bond is extremely limited. A green bond mutual fund or ETF is the only method to invest in these vehicles. The launch of the Green Cornerstone Bond Fund[830] is a baby step in the right direction.

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822 World Bank, "World Bank USD 500 Million Green Bonds Support Global Climate Action", Press Release (3 November 2016)

823 World Bank, "World Bank Issues 1.5 billion Swedish Kronor Fixed Rate Green Bonds" Press Release (12 June 2014) http://treasury.worldbank.org/cmd/htm/SEK1_5BillionGreenBonds.html

824 World Bank, World Bank Launches First Kangaroo Green Bond, Press Release (16 April 2014) http://treasury.worldbank.org/cmd/htm/AUD300Million_First_Kangaroo_Green_Bond.html

825 ASX, *Austraclear*, online at: https://www.asx.com.au/services/settlement/austraclear.htm

826 World Bank, "The World Bank and Bank of America Merrill Lynch Announce World Bank Green Bonds for Merrill Lynch Wealth Management Investors" Press Release (8 June 2011) online at: http://treasury.worldbank.org/cmd/htm/GreenBonds_BoAML.html

Information is unavailable to the exact nature of these clients, but most likely, these are all Accredited Investors, and thus access to the Mass Affluent is extremely limited.

827 World Bank, "World Bank Issues its Second Equity Index-Linked Green Bond" Press Release (23 September 2014) online at: http://treasury.worldbank.org/cmd/htm/EURO10Million_Second_EquityIndexLinked_Green_Bond.html

828 Investopedia, *Equity Linked Note*, online at: https://www.investopedia.com/terms/e/equity-linkednote.asp

829 World Bank, s*upra* n 821

830 IFC, "IFC, Amundi to Create World's Largest Green-Bond Fund Dedicated to Emerging Markets" (21 April 2017) online at:

As previously described in Chapter 2, the GC and GRI have collaborated to form a platform entitled the "Business Reporting on the Sustainable Development Goals."[831] The creation of an SDG Bond was proposed from this collaboration.[832] These are green bond structures that finance projects and entities supporting the SDGs.[833] They broaden their focus from pure environmental issues to a wider array of sustainable assets.[834] These would include environmental issues such as renewable energy and energy efficiency, but also social issues such as education, affordable housing and healthcare.[835]

HSBC, a global bank based in the UK, was the first to issue an SDG bond.[836] The $1 billion (USD) bond offering will fund projects that improve access to education for boys and girls (equally), healthcare, fresh water, sanitation, and other environmental goals.[837] The World Bank has also issued an SDG Bond.[838] The bond funds projects that provide healthcare to women and children in Argentina, Swaziland, water and sanitation in India, and coral reef rehabilitation in Indonesia.[839] It is based on the principle "leave no one behind" to ensure that signatories to the SDGs live up to their commitments.[840]

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https://ifcextapps.ifc.org/IFCExt/pressroom/IFCPressRoom.nsf/0/2CC3EDA1AE8B9B558525810900546887

[831] UN GC, *Business Reporting on the SDGs, An Analysis of the Goals and Targets*, (New York, UN Global Compact, 2017)

[832] Lewis McLellan, "World bank SDG bond marks SRI broadening" Press Release (February 2018) Global Capital, Retrieved via ProQuest databased July 8, 2018. SDG Bonds are described in Chapter 6

[833] BBVA, *SDG Bond: DNV GL Eligibility Assessment* (BBBV, 2017) at 1

[834] Global Capital, "World Bank deal heads SDG bond trend" Press Release (14 February 2018) online at: https://www.globalcapital.com/article/b16xx52s5bvfbx/world-bank-deal-heads-sdg-bond-trend

[835] BBVA, *supra* n 833 at 7

[836] HSBC, "HSBC issues world's first corporate sustainable development bond" Press Release (23 November 2017) online at: https://www.hsbc.com/news-and-insight/media-resources/media-releases/2017/hsbc-issues-worlds-first-corporate-sustainable-development

[837] *Ibid*

[838] World Bank, "World Bank Bond Highlights Investor Focus on Sustainable Development Goals", Press Release (February 12, 2018) online at: http://www.worldbank.org/en/news/press-release/2018/02/12/world-bank-bond-highlights-investor-focus-on-sustainable-development-goals ; Global Capital, *supra* n 841

[839] *Ibid*

[840] Bond UK, *Sustainable Development Goals*, online at: https://www.bond.org.uk/advocacy/sdgs

There is no international framework, like the Green Bond Principles, for SDG Bonds.[841] Each FI is developing a set of standards. BBVA, an Argentinean bank, created, the SDG Bond Framework, modelled after the GBP and the Social Bond Principles.[842] HSBC developed its own framework.[843] These bonds are extremely new, available only to institutional investors, and do not have an internationally accepted framework. A unifying framework is required, but is beyond the scope of this thesis to develop one.

SDG bonds are not ready for the Mass Affluent retail investor. The potential to become a formidable RI investment vehicle is limitless. Large institutional pension funds are the only material investors of these funds. Given the oversubscription and the dire need of water infrastructure and other infrastructure, it is extremely unfortunate why there is not greater access. Even if specific projects were available to the public, most Mass Affluent investors would not have the time or ability to research each one. Professional retail fund managers are needed. Without a green or SDG bond mutual fund, access for the retail investor is limited.

To summarize, there is no green bond mutual fund in Canada. There is one green bond index ETF, the S&P Green Bond Index Fund.[844] There are generic ESG bond index ETFs[845], however these suffer from the same concerns of their generic ESG equity

[841] Green Bond Principles, *supra* n 485

[842] Sustainalytics, *Second Party Opinion ANZ Sustainable Development Goals (SDG) Bond*, (February 2018) online at: https://www.sustainalytics.com/wp-content/uploads/2018/02/ANZ-SDG-Bond-Opinion_final.pdf

[843] HSBC, *HSBC Sustainable Development Goal (SDG) Bond Framework* (London: HSBC, November 2017) online at: hsbc.com/171115-hsbc-sdg-bond-framework%20(1).pdf

[844] S&P Dow Jones, *A Look Inside Green Bonds: Combining Sustainability With Core Fixed Income* (May 2018), online at: https://ca.spindices.com/indices/fixed-income/sp-green-bond-index

[845] For example, the *iShares ESG USD Corporate Bond ETF*, see http://etfdb.com/etf/SUSC/ This fund tracks the Bloomberg Barclays MSCI US Corporate ESG Focus Index, which provides exposure to U.S. dollar-denominated, investment grade corporate bonds of all maturities issued by companies with positive

counterparts. This access for Mass Affluent individuals to access fixed income impact investments is severely limited.

6.3 Specialized Investment Vehicles/Private Equity

Private equity offers potential to be RI enhancing vehicles. Due to their private nature, it is difficult to assess what funds and underlying holdings make up these investments. One particular fund, the Greening Canada Fund, is available for review.[846] The Greening Greater Toronto initiative, part of the Toronto Summit Alliance project,[847] developed a unique fund that invested directly in carbon offset credits. Carbon credits may or may not be considered securities. An offset reduces an equivalent amount of CO2e from emissions elsewhere.[848] While there are controversies over the efficacy of offsets, there are valid offset providers.[849] A carbon offset must prove certain criteria in order to be a valid credit, including relevance, completeness, consistency, transparency, and conservativeness.[850] This thesis is not advocating that a carbon credit is a useful,

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environmental, social and governance (ESG) characteristics. http://etfdb.com/index/bloomberg-barclays-msci-us-corporate-esg-focus-index/

[846] This is available only due to the author being involved in the project.

[847] Greening Greater Toronto, online at: http://www.greeninggreatertoronto.ca/, Toronto City Summit Alliance, online at: http://www.torontocitysummit.ca/

[848] K. Kathy Dhanda & Laura P. Hartman, "The Ethics of Carbon Neutrality: A Critical Examination of Voluntary Carbon Offset Providers" (2011) 100 Journal of Business Ethics 119–149; David Suzuki Foundation, "Carbon Offsets" Release (5 October 2017) online at: https://davidsuzuki.org/what-you-can-do/carbon-offsets/

[849] *Ibid* at 122

[850] Michael Gillenwater, "How do you explain additionality" (12 January 2012) GHG Institute, online at: http://ghginstitute.org/2012/01/25/how-do-you-explain-additionality/ ; Brianne Riehl, Guangyu Wang, et al., "Lessons Learned in Mandatory Carbon Market Development" (2017) 10:3-4 International Review of Environmental and Resource Economics 227-268

- Relevance – Selecting GHG sources, sinks, reservoirs, data and methodologies appropriate to the needs of the user
- Completeness – including and addressing all relevant GHG emission and removals. Including all relevant information to support criteria and procedures;
- Consistency - enabling meaningful comparison in GHG related information;
- Transparency – discussion sufficient and appropriate GHG related information to allow intended users to make decisions with reasonable confidence;
- Conservativeness – using conservative assumptions values and provided to ensure that GHG emission reductions or removal enhancement are not overestimated;

pragmatic or positive tool to combat climate change. There are other studies showing the advantage and disadvantages of offsets.[851] Rather, this thesis shows that alternative structures, involving unique environmental attributes, can be used to create a distinctive RI product. That product is the Greening Canada Fund LP ("GCF").

The GCF was a truly unique structure at its time, in that it followed private equity model of investments, rather than the traditional mutual fund structure.[852] The asset created was called an "Instrument," purchasing carbon credits rather than shares of companies.[853] The performance of the fund depended on the pricing of the offsets. The purposes of the fund satisfy RI criteria. The purposes are set out in the preamble:

> • Acquisition of carbon offset credits for potential use in satisfying voluntary carbon emission reduction goals, at attractive prices, with the potential for financial returns on the disposition of excess credits. While the Fund will initially concentrate on credits in the voluntary markets, it is positioned to operate in any compliance scheme for carbon emissions.
> • Promotion of highly visible community benefits by using innovative technology and by sourcing, wherever reasonably possible, many of the carbon offset projects from local public sector and non-profit sites. These community benefits can provide reputational benefits for subscribers, as well as helping subscribers satisfy their corporate social responsibility goals[854]

The offering was by a private placement via an offering memorandum, rather than by prospectus, and was unavailable to the public.[855] The documentation of the fund consisted of an Offering Memorandum, a Limited Partnership Agreement, a Management Services Agreement, Executed Subscription Booklet, Delivery Schedule, and Emissions Reduction

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There are different standards which measure these requirements. For example see *The Gold Standards* at https://www.goldstandard.org/

[851] Dhanda, *supra* n 848, see also Shi-Ling Hsu, "International Market Mechanisms" in *The Oxford Handbook of International Climate Change Law*, Cinnamon P. Carlarne, Kevin R. Gray, and Richard Tarasofsky (eds) (Oxford University Press, 2016) at 249

[852] Greening Canada Fund LP, *Limited Partnership Interests, Confidential Offering Memorandum* (September 17, 2009) (Toronto: Torys LLP, 2009)

[853] Greening Canada Fund LP., *Amended and Restated Limited Partnership Agreement* (30 September 2009) S. 3.1

[854] *Ibid*, preamble

[855] *Ibid*

Purchase Agreement (or "ERPA").[856] Ironically, despite the lack of a prospectus, all investors had more information available to them prior to purchase than an investor would normally have. Securities law may have it wrong. It is perhaps not the complexity of the product that should warrant public access or not, rather it is the amount of information that could allow investors to make their informed decisions.

Unfortunately, the lack of a prospectus meant that there was a very limited market for the fund, with only TD Bank and BMO making contributions. The success of the fund (or lack thereof) is not the primary purpose of examining the fund in this thesis. Rather, it is an example of an alternative model based on a unique asset structure mandated to combat climate change. One of the key features of this fund is its replicability. Had a prospectus offering been made, then the fund could have been made available to IIROC based retail investors (whether accredited or not). Had the fund been constructed as an open ended mutual fund trust, then the fund could have been marketed to the Mass Affluent, which would have greatly expanded the client base of the fund. It would also have shown the potential of unique fund structures that retail investors could make as part of their portfolio. The GCF is one example, a CEDIF is another.

A representative CEDIF example is Wind4all Communities III Inc., formed in NS ("Wind4all").[857] Proceeds from the Wind4all CEDIF would invest in two wind farm developments in NS. As there is a Mi'kmaq partner in Wind4all, there are some positive

[856] An ERPA is an agreement for the purchase/sale of carbon credits see Marcelo Labbe & Colin Atkinson, "On the pricing of Emission Reduction Purchase Agreement contracts" (2010) 3:2 Journal of Energy Markets 69-VI
[857] In order to obtain the offering memorandum, as they are not publically available on www.sedar.com, it was necessary to register with Assante Investments, Hydrostone office. See Assante Wealth Management Hydrostone, *Invest in the Power of Wind Energy*, Wind4all Communities III Inc., online at: http://www.assantehydrostone.com/wind4all/

potential Indigenous human rights/economic development opportunities available.[858] One of these Mi'kmaq partners, the Pictou Landing First Nation,[859] is a historically disadvantaged community that has suffered human rights abuses from the construction and operation of a pulp mill in Nova Scotia.[860]

Wind4all should qualify as an RI product. Like the GCF, any specific investment must be reviewed to determine suitability, and this paper is not advocating for its use as a valid or 'good' investment option. For example, this vehicle, due to its tax advantages, is not redeemable or tradeable prior to a five year period.[861] Rather it shows a unique, local solution to climate change and human rights issues. It addresses an academic argument that large scale electric projects may have negative environmental and human rights impacts, and that local community economic development projects are needed. Assuming that Wind4all is a suitable investment, the issue is accessibility. NS CEDIFs require the use of an IIROC broker. Most CEDIFs, being small, means that not all IIROC advisors can access this vehicle.[862] Wind4all is only available through one (1) specific IIROC broker.[863] Any one specific CEDIF may not be appropriate to a Mass Affluent investor. A mutual fund of several CEDIF entities should be created to offer diversification to reduce the inherent risks in a CEDIF.[864]

Like their fixed-income counterparts, access to equity based impact investments is severely limited to the Mass Affluent retail investor.

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[858] *Ibid*, Glossary, s.28
[859] *Ibid* at 41
[860] Joan Baxter, *The Mill: Fifty Years of Pulp and Protest* (Pottersfield Press, 2017)
[861] *Ibid* at 3
[862] Wind4all Communities III Inc., *Offering Memorandum*, (14 January 2016) at 29
[863] Assante Hydrostone, *supra* n 857
[864] *Ibid* at 13; several risks are noted in the Offering Memorandum

6.4 Summary Conclusions

Any project, whether or not one project follows ESG and/or RI principles, needs to be investigated on a case by case basis. All water projects may not have positive ESG qualities and mining projects may not have negative ESG characteristics. Yet, given the vast challenges and opportunities of financing water projects, it is difficult to fathom why there are not more available projects accessible to retail investors.

Mutual funds can be structured to be RI funds. However, in practice this does not occur. Many broad based mutual funds are closeted index funds. New mutual funds that use negative screens and divestiture strategies, and positive screens such as women in leadership may alleviate RI access issues. There are many problems with screens as previously indicated, and there is no guarantee that the remaining holdings exhibit ESG characteristics. Even divestment strategies, discussed in the next chapter, have problems. The disclosure issues and valuations issues shown in Chapters 2 and 3 could be reasons why RI funds have the underlying holdings that they do. There is clearly an issue of construction of real world mutual funds. Thus, the answer to RQ4 is no, mutual fund RI is generally not significantly different from non-RI funds, save for sustainability themed investing and divestment strategies.

ETFs and infrastructure funds do have positive RI characteristics. ETFs tend to focus on niche sustainability issues, such as green energy. These types of ETFs are not more complex than mutual funds. Most of these green ETFs are simple index fund structures. There does not seem to be a solid justification for preventing greater access to these products.

Green and SDG bonds also hold great promise. These impact investments in practice tend to be fixed income products, and so are not made readily available to any retail investor, let alone Mass Affluent. Green bonds are not structurally different than other bonds, so there is no justification for why they are not part of a fixed income mutual fund. Unique structures offer unlimited RI potential. CEDIFs and LPs such as the Greening Canada fund could be structured to allow Mass Affluent retail investors to access these vehicles. These structures could be re-constructed as Impact Investments for the Mass Affluent. Thus, the answer to RQ5 is yes, there is a need to create additional green and SDG bonds, and other unique structures like CEDIFs, and to structure them in such a way that the Mass Affluent can gain access.

CHAPTER 7 – PORTFOLIO MANAGEMENT

> "Mutual funds tend not to rock the corporate boat steered by incumbent boards, but labor union and public sector pension funds often do."[865]

Corporate and governmental pension plans are potentially the most significant influencers of RI factors as they have the political profile, large asset base, and long term time horizon, to stimulate change.[866] Institutional investors control much of the global shareholdings and can actively engage management of the firms they invest to promote ESG within their companies.[867] This chapter will show that institutional investors have the ability and authority to access, influence and structure RI. The retail investor does not have these powers. Public sector pension funds and private defined benefit pension plans make up approximately 70% of a North American's retirement income.[868] Mass Affluent investors only recourse to RI may result from their government pension or their work pension. This is problematic when their work pension does not follow RI principles.

First, this chapter investigates duty of care obligations of institutional investors. Mass Affluent retail investors in North America have a significant portion of their savings invested in companies from Canada and the USA. The UK was chosen as the country has legislation for pension funds. Second, the chapter details ways in which institutional funds influence the RI market; namely proxy voting and divestiture strategies. A short case study on the Canadian Pension Plan Investment Board follows. The chapter concludes that institutional investors are the primary driving force of RI.

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[865] Eric Finseth, "Shareholder Activism by Public Pension Funds and the Rights of Dissenting Employees under the First Amendment" (2011) 34 Harvard Journal of Law & Public Policy 289-359 at 292
[866] Darlene Himick, & Sophie Audousset-Coulier, "Responsible Investing of Pension Assets: Links between Framing and Practices for Evaluation" (2016) 136 Journal of Business Ethics 539–556
[867] Joakim Sandberg, "Socially Responsible Investment and Fiduciary Duty: Putting the Freshfields Report into Perspective" (2011) 101 Journal of Business Ethics 143–162
[868] Sun Life, *supra* n 7

7.1 Duties of Institutional Fund Managers

Historically, pension and institutional funds did not want to give any weight to non-financial metrics in their investment decisions.[869] The shareholder primacy model was firmly entrenched.[870] This was due to their fiduciary duty which obligates the portfolio manager to focus solely on maximizing returns for their clients.[871] There was and, to a certain extent, still is a perceived conflict between a fund manager's fiduciary duties and the implementation of ESG guidelines in investment decisions.[872] This is true in Canada, the USA and Australia, as well as many other countries.[873]

A fiduciary relationship occurs when a "significant interaction of social and/or economic importance exists that creates an implicit dependency and peculiar vulnerability of the beneficiary to the fiduciary."[874] Fiduciary duty is a special measure of trust which raises specific obligations which must be kept by the Trustee.[875] The primary duty is to act in the best interest of their client.[876] There is no debate that pension funds owe a fiduciary duty to their plan members.[877] An inherent conflict of interest exists; the ethics of RI against the ethics of a fiduciary.[878]

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[869] Magnus Jansson, Joakim Sandberg, et al, "Should pension funds' fiduciary duty be extended to include social, ethical and environmental concerns? A study of beneficiaries' preferences" (2014) 4:3 Journal of Sustainable Finance & Investment, 213-229 at 214

[870] William Martin, "Socially Responsible Investing: Is Your Fiduciary Duty at Risk?" (2009) 90 Journal of Business Ethics 549–560 at 551

[871] Jansson et al, *supra* n 869 at 214

[872] William Ransome & Charles Samford, *Ethics and Socially Responsible Investment, A philosophical Approach* (Farnham: Ashgate, 2013)

[873] *Ibid* at 147

[874] Leonard Rotman, "Fiduciary Law's 'Holy Grail': *supra* n 550 at n 46 & 933

[875] Benjamin Richardson, "Fiduciary Relationships for Socially Responsible Investing: A Multinational Perspective" (2011) 48:3 American Business Law Journal Volume 597–640

[876] Martin, *supra* n 870 at 552

[877] *OSA*, s. 116(b), with other jurisdictions having similar provisions

[878] *Ibid* at 121

The 2005 Freshfield's Report ("Freshfield's") facilitated the integration and legal acceptability of ESG principles in investment analyses.[879] Freshfield's was commissioned by the UNEP FI, with the penultimate goal of proving that the fiduciary had the right, authority and (potentially) obligation to examine non-financial factors.[880] Freshfield's concluded that institutional investors are allowed "at least sometimes" to take some ESG considerations into account.[881] In other words, Freshfields concluded that integrating ESG into investment analysis is permissible and arguably required in all jurisdictions.[882] The PRI and other international organizations have further assisted the uptake of RI by providing frameworks for pension funds to integrate non-financial factors.[883]

Several jurisdictions have expressly mandated the permissibility of the integration of ESG factors into their investment philosophies.[884] Canada is a world leader in RI initiatives.[885] The *Ontario Pension Benefits Act*, *Regulation 909,* requires pension funds in Ontario to disclose in their investment policies ""information about whether environmental, social and governance factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated."[886] The FSCO Financial Services Commission of Ontario ("FSCO") provides further ESG

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[879] Freshfields, Bruckhaus and Deringer, *A Legal Framework for the Integration of environmental, social and governance issues into institutional investment*, produced for the Asset Management Working Group of the UNEP Finance Initiative (London: UNEP FI, 2005) at 154 avalable online at: http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf The Freshfields report is a legal framework for the integration of environmental, social, and governance issues into institutional investment
[880] *Ibid* at 6
[881] See Joakim Sandberg, *supra* n 867 at 144
[882] Richardson, *supra* n 11 at 541, Freshfields, *supra* n 879 at 13
[883] Claire Woods & Roger Urwin, "Putting Sustainable Investing into Practice: A Governance Framework for Pension Funds" (2010) 92:1 Journal of Business Ethics 1 - 19
[884] Riikka Sievanen, John Sumelius, et al., "From struggle in responsible investment to potential to improve global environmental governance through UN PRI" (2013) 13 International Environ Agreements 197–217 at 203, 212
[885] UNEP FI, *Fiduciary Duty in the 21st Century – Canada Roadmap* (UNEP FI: New York, 2017) at 5
[886] *Ontario Pension Benefits Act, Reg*. 909 s. 78(3)

governance.[887] Manitoba also expressly allows for non-financial considerations in its pension legislation.[888] The legislation states that "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)."[889]

The American Law Institute's ("ALI") production of the *Third Restatement of Trusts* codified the modern *Prudent Investor Rule*.[890] Essentially, this rule follows MPT, which requires a trustee to 'properly' diversify the portfolio in an integrated and optimized manner and not to simply minimize risk and maximize profit.[891] The federal Department of Labour noted that for the *Employee Retirement Income Security Act* "where ESG issues are material to the economic value of an investment, those issues form part of the fiduciary's analysis."[892] They continue "In such instances, the ESG issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices."[893] Certain states, such as New York, have enacted enhanced ESG provisions as will be described below.

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[887] FSCO, *Investment Guidance Notes: Environmental, Social and Governance (ESG) Factors*, IGN-004, (1 January 2016)

[888] Manitoba, *Pension Benefits Act*, C.C.S.M. c. P32 s. 28.1

[889] *Ibid*, s. 28(2.1)

[890] American Law Institute, *RESTATEMENT OF THE LAW THIRD, Trusts*, (2007) §§ 70 to 92 c. 17

[891] Corina Weigl, "Prudent Investor Rule and Modern Portfolio Theory" (2014) 33 Estate Trust & Pensions Journal 145-152 at 151

[892] US Department of Labor, Interpretive Bulletin (IB 2015-01) *on Economically Targeted Investments (ETIs) and Investment Strategies that Consider Environmental, Social and Governance (ESG) Factors* (2015)

[893] US Department of Labor, Fact Sheet on IB 2015-01 (22 October, 2015) online at: https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/etis-and-investment-strategies-that-consider-esg-factors.pdf

In the UK, *The Occupational Pension Schemes (Investment) Regulation* requires a pension fund's 'Statement of Investment Principles' to include "the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realization of investments; and their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments."[894] The *UK Stewardship Code,* overseen by the Financial Reporting Council ("FRC"),[895] sets out standards of when institutional investors *should* (emphasis added) actively intervene.[896] This intervention can include concerns on environmental and social risk matters.[897] The Stewardship Code is supported by *Conduct of Business Rule 2.2.31*, which requires funds managed for professional clients to disclose the nature of their relationship to the code, or the alternative strategies in place.[898] The FRC publishes statements of commitment to the code on its website and announced that in 2016 it would begin publicly ranking signatories based on the quality of their disclosures against the code. This 'enlightened shareholder value model' advanced a paradigm shift to include the non-shareholder stakeholders.[899] This model has been further codified into the *UK Companies Act*, highlighting the links between pension, corporate and securities law.[900] This stewardship model can drive enhanced operational and financial performance, foster market stability and fuel economic growth.

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894 UK, *The Occupational Pension Schemes (Investment) Regulations 2005, 2005 No. 3378 at s 2(3)(b)vi*
895 Financial Reporting Council, *The UK Stewardship Code* (September 2012) at Principle 4
896 Ben Heinemann Jr., "A 'Stewardship Code' for Institutional Investors" (2010) Harvard Business Review, online at: https://hbr.org/2010/01/a-stewardship-code-for-institu accessed March 31, 2018
897 Stewardship Code, *supra* n 894, Principle 4
898 FRC, FCA Handbook, *COBS Conduct of Business Sourcebook*, Conduct of Business Rule 2.2.3, Release 26, (March 2018)
899 Virginia Harper Ho, *supra* n 109 at 111
900 *U.K. Companies Act, 2006*, c. 46 § 172 (Eng.)

There is a strong argument that portfolio managers should take ESG factors into account when conducting a portfolio analysis. First ESG factors should improve returns over the long term, and second, clients are demanding their fiduciaries take certain RI issues into account when making investment decisions.[901] Pension funds strive to obtain maximized "risk-adjusted returns."[902] The risk of investing in a company with low ESG ratings could outweigh the returns it creates, both in the short and the long term.

7.2 Institutional Investor Activism

In addition to the valuation techniques noted in Chapter 3, the three main ways that institutional investors become activist investors are the use of voting power, activist investing through dialogue building, and the divesting away from companies and industries with poor ESG records.[903]

Voting rights attached to the ownership of common shares can provide the power to change the market for the betterment of non-financial metrics.[904] Failing to vote shares, or voting without considering the consequences of the effects, or voting arbitrarily, breaches a fund manager's duty of care. In the US, the SEC clarified voting obligations in 2003, adopting disclosure rules for proxy voting.[905] While there is growing acceptance of the need to consider other stakeholders than just the shareholders, the 2008

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[901] Riikka Sievanen, Hannu Rita & Bert Scholtens, "The Drivers of Responsible Investment: The Case of European Pension Funds" (2013) 117 Journal of Business Ethics 137–151 at 139-141

[902] C Manescu, "Stock returns in relation to environmental, social and governance performance: mispricing or compensation for risk?" (2011) 19 Sustainable Development 95–118
This is in contrast to certain hedge funds, that attempt to achieve absolute returns regardless of risk or

[903] UN PRI, *supra* n 274, Principles 2 and 5

[904] SHARE, *Model Proxy Voting Guidelines* (Vancouver: SHARE, 2017);
SHARE's proxy voting service allows institutional investors to exercise their voting rights responsibly, online at https://share.ca/services/proxy-voting/ accessed April 12, 2018

[905] SEC, "Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management investment companies" (January 31, 2003) 17 CFR Parts 239, 249, 270, and 274; The SEC further clarified that investment advisors must also disclose. See SEC, *Proxy Voting by Investment Advisors* (January 31, 2003) 17 CFR Part 275. See also Benjamin Richardson, *supra n*. 11 at 314-317

financial crises and the passage of the *Dodd Frank Act* helped make proxy voting on other non-financial matters mandatory.[906]

Activist investing is a cornerstone paradigm shifting movement. Principle 5 of the UN PRI states that companies should build dialogues with investee companies. Shareholders, especially large institutional ones, are no longer comfortable with leaving to directors and management to run a company without activist supervision. "Through moral suasion, coalition formation, and publicity seeking, shareholder activists are sometimes able to be effective in their attempts to change corporate behaviors.[907] Institutional investors are now deeply involved with company leadership in reciprocal communication, building a two way relationship with management, to improve the financial and social performance of the company. This communication rarely gets the newsworthy attention it deserves, yet it is perhaps more effective at bringing about change.[908]

Yale University is an example for proxy voting.[909] In Investing in a Sustainable World,[910] published in 2008, the author went into length about Yale University's dogged refusal to adopt ESG principles. Only a few short years later, in 2014, Yale adopted their Committee on Investor Responsibility.[911] Yale now mandates the use of proxy voting to

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906 *Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010*, Pub. L. No. 111-203, 124 Stat. 1376 (2010) §§ 951 (―say on pay‖), 953 (executive compensation disclosures), 957 (limitations on broker voting)

907 Jeanne M. Logsdon & Harry J. Van Buren III, "Beyond the Proxy Vote: Dialogues Between Shareholder Activists and Corporations" (2009) 87 Journal of Business Ethics 353–365 at 353

908 *Ibid* at 354 & 362

909 Yale University, *Annual Report, Yale University Committee on Investor Responsibility*, (Academic Year 2016-2017) available online at: http://acir.yale.edu/annual_report.html accessed July 31, 2018

910 Matthew J. Kiernan, *Investing in a Sustainable World: Why GREEN Is the New Color of Money on Wall Street* (AMACOM, 2008)

911 Yale University, *Sustainability and Proxy Voting*, online at: http://sustainability.yale.edu/planning-progress/president accessed February 28 2018

influence change.[912] Yet, Yale also makes a specific reference to not divesting from fossil fuel companies or other companies with poor ESG records.[913] Unfortunately, Yale severely lags on other ESG reporting guidelines, such as CDP and PRI, as it has declined be a member of either.[914]

Divestments may be the ultimate demonstration of activist investing. Divestments are akin to the negative screen. Negative screens eliminate companies or industries prior to the investment decision. Divestments have already made the investment, but have determined that a company, industry or vehicle no longer meets ESG criteria and mandates the sale of the investment.[915] Governments, universities and Sovereign Wealth Funds ("SWFs") have been leaders in the divestment movement. New York State, in December 2017, announced that it would begin to divest its investments in fossil fuel companies.[916] This followed Columbia University announcing it was divesting

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[912] Yale News, "Yale expands leadership in sustainability" (27 August 2014) Press Release, online at: https://news.yale.edu/2014/08/27/yale-expands-leadership-sustainability
[913] *Ibid*
[914] Yale, *supra* n 909; see also UN PRI, PRI Signatories, online at: https://www.unpri.org/signatories , CDP, List of Investor Signatories and Members, online at: https://www.cdp.net/en/investor/signatories-and-members#7045b83784a78ee84c56f99c6ad0eb78 accessed July 31, 2018
[915] Rupinder Mangat et al., "Divestment discourse: War, justice, morality and money" (2018) 27:2 Environmental Politics 187-208
[916] Government of New York, "Governor Cuomo Unveils 9th Proposal of 2018 State of the State: Calling on the NYS Common Fund to Cease All New Investments in Entities with Significant Fossil Fuel-Related Activities and Develop a De-Carbonization Plan for Divesting from Fossil Fuel," Statement from NYC Comptroller Scott M. Stringer on De-carbonizing the NYC Pension Funds (19 December 2017) Online at: https://www.governor.ny.gov/news/governor-cuomo-unveils-9th-proposal-2018-state-state-calling-nys-common-fund-cease-all-new accessed April 12, 2018:
The statement reads: "Today, I'm announcing that my office will bring a proposal to the trustees of the NYC pension funds in the coming weeks to examine ways to de-carbonize the portfolios, including the feasibility of ceasing additional investments in fossil fuels, divesting current holdings in fossil fuel companies, and increasing investments in clean energy. I will work with our trustees to review any and all proposals that will safeguard the pension funds. As Comptroller, I will continue in my fiduciary duty to protect the fiscal health of the City and the retirement security of our City workers and beneficiaries."

away from coal companies[917] and the American Museum of Natural History noting that it was reducing its investments in fossil fuels.[918]

The New York Common Retirement Fund is the third largest public pension fund in the United States, with over $192.4 billion in assets under trust.[919] Created by statute in 1921 as a privately managed fund, it services the retirement assets of the New York State and Local Retirement Systems.[920] The fund began its campaign on divestitures in 2016 when it "made a stand against Exxon-Mobil."[921] According to DiNapoli, "Addressing climate risk is my fiduciary duty as trustee of the New York State Common Retirement Fund."[922]

Columbia University has established an RI committee, which made recommendations that its pension fund divest away from coal companies, (that is companies with revenues in excess of 35% of thermal coal production), join the CDP, and establish a separate 'fossil free' investment vehicle for alumni contributions.[923] There is a petition at Dalhousie University in Canada for its pension plan to divest holdings.[924] The board of governors, to date, has rejected its plea.[925] A comprehensive

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[917] Columbia University, *Columbia Announces Divestment from Thermal Coal Producers*, Press Release (13 March 2017) online at: http://news.columbia.edu/coal accessed April 12, 2018

[918] 350.org, "American Museum of Natural History slashes fossil fuel holdings as global divestment commitments hit $5 trillion in assets" Press Release, (12 December 2016) online at: https://350.org/press-release/american-museum-of-natural-history-slashes-fossil-fuel-holdings/

[919] NY State, *Common Fund*, online at: http://www.osc.state.ny.us/pension/

[920] Government of NY, *Retirement and Social Security Law, SS 1 Article 2*

[921] Environmental Finance, *Personality of the year 2017: Thomas DiNapoli,* Press Release, (30 June 2017) online at: https://www.environmental-finance.com/content/deals-of-the-year/personality-of-the-year-2017.html accessed March 30, 2018

[922] *Ibid*, see also Government of NY, Senate Bill S4696 *Fossil Fuel Divestment Act*., (21 February 2017)

[923] Columbia University, "Advisory Committee on Socially Responsible Investing Columbia University", Release (22 February 2017) online at :https://finance.columbia.edu/files/gateway/content/ACSRI/ACSCRI%20Report.%20Feb%202017.%20Final.%20022217.pdf

[924] Divest Dal, "Divestment Potential" *Reports to the Dalhousie Investments Committee and Board of Governors* (1 November 2014) online at: https://divestdal.files.wordpress.com/2014/10/divest-dalhousie-collaborative-reports-to-the-ic.pdf

report drafted to the university's Senate highlights the arguments both for and against divestment.[926] It also underscores the view that large pension plans, such as the Canada Pension Plan (discussed below) are taking, namely active investing is more productive than divesting. It also shows how fundamentally at odds negative screening/divestment techniques are against a dialogue building model. This shows that an employee of a firm cannot rely on their pension to be their sole source of RI.

The World Bank's goal is to reduce the share of global population living in extreme poverty, promote shared prosperity, and promote sustainable development.[927] According to the World Bank, over $90 Trillion in new infrastructure will be required to transition to a low carbon economy.[928] The World Bank has active divestment policies. As of December 2017, the World Bank announced that it will stop making investments in the oil and gas sector, starting in 2019.[929] This is not the first instance of divestment by the World Bank. In 1991, it stated that it would no longer support tobacco related projects.[930] Shortly thereafter, in 2020, the World Bank will disclose emissions from the investments it undertakes.[931] The World Bank has attempted to institute true responsible

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[925] Dalhousie University, *Fossil Fuel Divestment Statement*, Press Release, online at: https://www.dal.ca/dept/university_secretariat/board_of_governors/meetings/fossil-fuel-divestment-statement.html

[926] Meinhard Doelle, *et al., Ad Hoc Committee of Senate on Fossil Fuel Divestment – Final Report to the Senate* (19 January, 2016) Dalhousie University, online at: https://www.dal.ca/dept/university_secretariat/university_senate.html accessed August 9 2018

[927] The World Bank Group, *Who we are,* accessed February 21, 2018. Available at: http://www.worldbank.org/en/who-we-are

[928] *Ibid*

[929] World Bank, "World Bank Announcements at One Planet Summit" Press Release (12 December 2017), online at: http://www.worldbank.org/en/news/press-release/2017/12/12/world-bank-group-announcements-at-one-planet-summit accessed February 26, 2018

[930] Pranay Lal, "Multilateral development banks and socially responsible investments – the case of tobacco" (2012) 19:4 *Global Health Promotion* 51-55 at 52; this has not stopped tobacco financing at the international level as other arms of the IFC did not follow immediately. The IFC only included it on their no invest list in 2006.

[931] International Finance Corporation, *Green Cornerstone Bond Fund*, http://www.ifc.org/wps/wcm/connect/news_ext_content/ifc_external_corporate_site/news+and+events/news/impact-stories/green-bond-fund-offers-green-path-for-emerging-markets accessed February 26, 2018

investing practices, focusing on truly transformative climate and human rights practices, assisting the most disadvantaged individuals.[932]

International Frameworks adopt a pluralistic perspective, showing the need for honest, transparent, comprehensive, and accurate data so investors can assess a firm's performance and make accurate investment decisions.[933]

7.3 Sovereign Wealth Funds

The growth of SWFs, which are governmental or quasi-governmental asset managers managing large pools of assets of the taxpaying public,[934] can have a profound effect on RI.[935] SWF may be thought of as private actors in a state market, which would indicate that they need to be regulated like other private entities, or they may be thought of as 'state instrumentalities' projecting state power onto the territory of other states.[936] This highlights a possibility that a state is both a government and a body corporate depending on its action.[937] The aims of SWFs and other state owned enterprises are often conceptualized as nation building exercises, aiding national development.[938] As of September 2017, SWF's had amassed $7.4 Trillion in AUM,[939] with the majority of this

[932] World Bank, *Inclusive green growth: The pathway to sustainable development (*Washington, DC: World Bank, 2012)
[933] Talbot and Boiral, *supra* n 254 at 368
[934] Sovereign Wealth Fund Institute, 'What is an SWF?', online at: http://www.swfinstitute.org/what-is-a-swf accessed April 2, 2018
[935] Benjamin J. Richardson, "Sovereign Wealth Funds and Socially Responsible Investing: An Emerging Public Fiduciary" (2012) 1 Global Journal of Comparative Law 125-162 at 127
[936] Larry Cata Backer, "Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State-Owned Enterprises, and the Chinese Experience" (2010) 19 Transnational Law & Contemporary Problems. 3-144 at 5
[937] *Ibid* at 13
[938] *Ibid* at 14
[939] Holly Ellyatt, "the World's biggest Sovereign wealth funds in 2017" Press Release (20 September 2017) CNBC, online at: https://www.cnbc.com/2015/07/17/the-worlds-biggest-sovereign-wealth-funds.html#slide=1

wealth originating from oil and gas activities.[940] Many of these funds are now legislatively required to diversify away from oil and gas and even to divest their oil holdings.[941] Weapons manufacturers are also coming under pressure from SWFs.[942]

The *Santiago Principles* were developed to ensure that SWF's promote best practices and greater transparency.[943] Ethical and professional standards are explicitly mentioned, stating that the SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.[944] RI factors may be allowed under these principles, "if investment decisions are subject to other than economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed."[945]

Avoiding certain industries could have a major negative impact on diversification measures.[946] While research seems to indicate this would not have a material impact at a global level, there is no such research on resource economies, such as Canada, Australia or South Africa.[947] It is difficult to construct a broad large cap Canadian equity fund without a full 1/3 of potential underlying investments as shown in the previous chapter.

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[940] Sovereign Wealth Fund Institute, *Sovereign Wealth Fund Rankings,* 2017 (SWFI, 2017) online at: https://www.swfinstitute.org/sovereign-wealth-fund-rankings/

[941] Norway Council of Ethics, *Recommendation to Reverse the Exclusion of Thales SA*, (Norway, 2009) online: available at http://www.regjeringen.no/pages/2236625/Thales-2009eng.pdf. See also Styrer Rad Og Utvalg, Recommendations, http://www.regjeringen.no/en/sub/Styrer-radutvalg/ethics-councilRecommendationsRecommendations.html? (last visited Jan. 20, 2010) (listing excluded companies).

[942] The Local (Norway), "Norway wealth fund bans 9 groups, including BAE Systems" Press Release (17 January 2018) thelocal.no online at: https://www.thelocal.no/20180117/norway-wealth-fund-bans-9-groups-including-bae-systems accessed April 3, 2018

[943] International Working Group of Sovereign Wealth Funds, *Sovereign Wealth Funds, Generally Accepted Principles and Practices (Santiago Principles)* (October 2008) at 4, Principles, 2, 4

[944] *Ibid* Principle 13

[945] *Ibid*, Principle 19; under the associated commentary, this is made explicit by: Some SWFs may exclude certain investments for various reasons, including legally binding international sanctions and social, ethical, or religious reasons (e.g., Kuwait, New Zealand, and Norway). More broadly, some SWFs may address social, environmental, or other factors in their investment policy. If so, these reasons and factors should be publicly disclosed

[946] Trinks & Scholtens., *supra* n 34 at 741

[947] *Ibid* at 747

Divestment paradigms also do not take into account the FIs financing oil and gas. A broader divestment strategy may be a more useful methodological goal.

7.4 Private Equity and RI

The dearth of investment restrictions on private equity structures gives large institutional investors an inherent advantage to structuring their affairs. They are able to purchase privately held firms inaccessible to the public retail investor.[948] Entrepreneurs' that do not attempt to make ESG factors part of their business practices have more limited access to markets, have higher costs of capital, and destroy shareholder value.[949]

One of the primary unique PE structures used by institutional investors is the special purpose vehicle ("SPV").[950] An SPV is a specialized legal vehicle (whether LLP, corporation or trust) with a different ownership and organization structure to limit liability from its affiliated companies.[951] SPVs are used as tax vehicles, liability avoidance mechanisms, or project finance structures.[952] Used in asset securitizations or joint ventures, SPVs isolate an asset from other liabilities, reducing effects of bankruptcy.[953] They were involved in the financial crisis (some say a key component to

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[948] Patricia Crifo, Vanina D. Forget & Sabrina Teyssier, "The price of environmental, social and governance practice disclosure: An experiment with professional private equity investors" (2015) 30 Journal of Corporate Finance 168-194 At 169

[949] *Ibid* at 182; this study shows as much as 15% decrease in value. It is doubtful publically traded firms will have this significant a price discrepancy.

[950] The SPV is used by more than SWFs but SOE and many institutional investors, banks, finance companies.

[951] Samantha J. Rothman, "Lessons from General Growth Properties: the Future of the Special Purpose Entity" (2012) XVII Fordham Journal of Corporate & Fin Law 228- at 230

[952] Ainun Na'im, "Special Purpose Vehicle Institutions: Their Business Natures and Accounting Implications" (2006) 8:1Gadjah Mada International Journal of Business 1–19

[953] Leonard Rotman, "Debunking the "End of History" Thesis for Corporate Law" (2010) 33 2:2 B.C. Int'l & Comp. L. Rev. http://lawdigitalcommons.bc.edu/iclr/vol33/iss2/2 219- 272 at 233

the creating the crisis itself) but do exist for legitimate purposes.[954] There are valid reasons for using an SPV, but all of them are wholly unavailable to the public. As the former CEO of TD Bank once said, "If I can't explain it to my grandmother, we shouldn't be doing it."[955] The collapse of Enron and other SPV's, including hedge funds, makes the use of SPVs a 'deus ex Machina' as a way to restore law and order.[956]

Two types of SPVs are relevant for this paper. SPVs are used in extremely large project finance initiatives such as infrastructure.[957] The second, the use of an SPV to create a carbon fund, was previously described in Chapter 6. These are useful, utilitarian and legal purposes of SPVs that are unfortunately cut off from direct retail investor finance. Infrastructure is a representative PE/SPV vehicle.[958] Infrastructure is a key contributor to climate change and is believed to be a key to mitigating its effects.[959] Roads, bridges, airports, seaports, hospitals, subways, rail, electricity generation and transmission lines, to name a few, have significant influence on the level of carbon emissions, and create (and/or solve) a host of other environmental and social issues.[960] Taxpayers see infrastructure as a political issue, while many institutional investors see it

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[954] PwC, *The next chapter Creating an understanding of Special Purpose Vehicles*, (December 2011) online at: https://www.pwc.com/gx/en/banking-capital-markets/publications/assets/pdf/next-chapter-creating-understanding-of-spvs.pdf accessed April 12, 2018
[955] Author's personal interview with TD Bank CEO, 2008/2009
[956] Phillip Paschalides, "Playing God: A Newtonian Analogy for Structured Finance" (2012) 18:1 Journal of Structured Finance 22-25 at 24
[957] Accord Fintech, "Gammon Infrastructure Projects' promotes special purpose vehicle; the special purpose vehicle has signed the concession agreement with NHAI for the implementation of the project." (26 March 2012) LexisNexis Academic. Date Accessed: 2018/04/12.
[958] A further example will be case studied in Chapter 6
[959] Steven J. Davis, Ken Caldeira, & H. Damon Matthews ,"Future CO2 Emissions and Climate Change from Existing Energy Infrastructure" (2010) 329:5997 Science 1330-1333 at 1331
[960] Buildings and infrastructure accounts for approximately 20% of the CO2e emitted by developed states. Electricity is approximately 10%. While a retail investor can invest in certain electricity firms, such as Emera Inc. (TSX "EMA") and certain pipeline firms (such as TransCanada Corp ("TRP") the ability to invest directly in infrastructure projects is quite limited.

as a financial and economic linchpin of the economy as a whole.[961] Infrastructure can be a lucrative investment.

The Ontario Municipal Employees Retirement System ("OMERS") invests approximately 17% of their portfolio in infrastructure.[962] OMERS is the defined benefit pension plan for municipal employees of the province of Ontario.[963] It has recently purchased, through their infrastructure arm, a leading wind power asset owner from another private equity investor.[964] This type of investment would not be available to the retail market. Given their portfolio of investments, they would have an enormous influence potential on carbon and other environmental emissions, on a transnational level.

Infrastructure investments can be financed either with equity or debt. Green bonds are an ideal financing mechanism for this type of investment. The creation of green bond fund that would be available to the retail public would partially solve the access issue of getting infrastructure projects. Alternatively, an equity fund that provides for access to green infrastructure could be created.[965] Creating new structures are not needed; rather existing structures, with unique types of underlying assets, is a quicker, simpler solution.

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[961] As a political issue, the recent and ongoing pipeline issue with Kinder Morgan is a prime example. See Chris Hall, "Trudeau gives his definition of 'national interest': Chris Hall" Press Release (16 April 2018) online at: http://www.cbc.ca/news/politics/pipeline-kinder-morgan-analysis-chris-hall-1.4620823 accessed April 16, 2018 As a financial/investment issue, see the Council of Canadians, "Council of Canadians calls on CPPIB to break silence on Kinder Morgan investment" Media Advisory (30 May 2017) online at: https://canadians.org/media/council-canadians-calls-cppib-break-silence-kinder-morgan-investment accessed April 16 2018

[962] OMERS, *OMERS Investment Business,* online at: https://www.omers.com/Investing

[963] *Ontario Municipal Employees Retirement System Act*, SO 2006, c. 2

[964] OMERS, "OMERS Infrastructure Announces Agreement to Acquire Leeward Renewable Energy" Press Release, (22 March 2018) online at: https://www.omers.com/News/Investment_News/OMERS-Infrastructure-Leeward_renewable_energy accessed April 5, 2018
Other investments include ports, water utilities, nature gas, electricity transmission & distribution, airports, LNG terminals, pipelines, toll roads, and nuclear generators. See OMERS Private Markets, *Portfolio*, online at: https://omersprivatemarkets.com/what-we-do/infrastructure/portfolio

[965] Chapter 5 notes certain restrictions in fund construction.

The Canadian Pension Plan ("CPP") is the largest publically funded pension scheme in Canada.[966] The Canada Pension Plan Investment Board ("CPPIB") was created by an act of legislation[967] that created an independent board to invest the assets of the CPP not currently needed to pay pension, disability and survivor benefits.[968] CPPIB is governed and managed independently from the CPP, and operates with a singular objective: to maximize returns without undue risk of loss.[969] The CPPIB was born out of a need to ensure that the CPP would be "sustainable for generations to come, and this goal underlies everything that we do."[970] CPPIB is broadly diversified, with more than 3,100 investments in companies.[971]

The CPPIB is not considered to be a SWF.[972] Modern theorists have referred to these types of entities as "universal investors" and have the structural qualities that allow them to complement sustainable development.[973] The CPPIB is required to maximize investment returns of the CPP and make investments that a person of ordinary prudence would make.[974] The *CPPIB Regulations*[975] states: "in selecting investments, the Board shall evaluate them having regard to the overall rate of return and risk of loss of the entire portfolio."[976]

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[966] Government of Canada, *Annual Report of the Canada Pension Plan, 2015-2016* (Ottawa: CPP, 2017) at 2
[967] *Canada Pension Plan Investment Board Act,* SC 1997 c. 40 ("CPPIB Act")
[968] *Ibid* s. 5
[969] *Ibid*, ss. 34 & 35
[970] CPPIB, *Sustainable Investing Policy 2016* (Toronto/Ottawa: CPPIB, 2017)
[971] Gail Henderson, "Making Corporations Environmentally Sustainable: The Limits of Responsible Investing" (2012) 13:12 German Law Review 1412-1437
[972] As indicated, there is really no need to categorize CPPIB as an SOE or SWF or limit to such a 'formalist definition as the stated mandate is to align Canadians retirement for its taxpaying citizens. See Backer, s*upra* n 657 at 28-29 & 34 & 64. Funding sources, rather than investment purposes or state control seems to be a larger indication of definition. The real difference is the motivation and power of the entity.
[973] Benjamin J. Richardson & Maziar Peihani, *supra* n 108 at 406
[974] CPPIB Act, *supra* n 967
[975] *CPPIB Regulations* SOR/99-190 ("CPPIB Regulations")
[976] *Ibid*, s. 7

The CPPIB invests based on 75 year time horizon; much longer than the average investor or fund manager.[977] There is no provision in either the *CPPIB Act* or the *CPPIB Regulations* that specifically precludes the use of RI principles, nor is there a provision to mandate RI. This is an oversight that should be corrected. Mandating RI would solve many issues as Mass Affluent individuals rely heavily on CPP for retirement income. Despite the legislation's silence on RI, the CPPIB has internally mandated the inclusion of ESG. [978] ESG factors "effectively are more likely to create sustainable value over the long-term than those that do not. As we work to fulfill our mandate, we consider and integrate ESG risks and opportunities into our investment decisions."[979]

Does the CPPIB fit the role of a universal investor and an ideal RI participant? It is an active member of the PRI.[980] The CPPIB was a founding member of the S&P Long-Term Value Creation (LTVC) Global Index.[981] This index is designed to create long term value based upon sustainability criteria.[982] Allocating approximately 2 Billion CAD, CPPIB has taken an activist approach. However, with over $323 billion (CAD) in AUM a $ 2 billion investment is not a material risk. Infrastructure plays a key role.[983]

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[977] Most retirement plans for individuals are 25-30 years long. As such, there are certain investments that are unsuitable from a simple time-frame basis. This is where a risk model like the Fama/French model would be useful

[978] CPPIB, *2015 Report on Sustainable Investing* (Toronto: CPPIB, 2016) online at: http://www.cppib.com/content/dam/cppib/How%20we%20invest/Responsible%20Investing/Responsible%20investing%20reports/CPPIB%20Sustainable%20Investing%202015.pdf#page=23 accessed April 15, 2018

[979] CPPIB, *Sustainable Investing,* online at: http://www.cppib.com/en/how-we-invest/sustainable-investing/

[980] UN PRI, List of Signatories, online at: https://www.unpri.org/searchresults?qkeyword=&parametrics=WVSECTION%7cSignatories accessed April 15, 2018

[981] CPPIB, "Six of the World's Largest Institutional Investors Support Innovative New Index as a Powerful Tool to Focus Markets on the Long Term" (21 January 2016) Press Release, online at: http://www.cppib.com/en/public-media/headlines/2016/sp-ltvc-2016/ accessed April 15, 2018

[982] S&P, *S&P LTVC Global Index*, online at: https://eu.spindices.com/indices/strategy/sp-ltvc-global-index accessed April 15, 2018 The other members include the Singapore SWF fund, the GIC, the ATP Group, the New Zealand Superannuation Fund, Ontario Teachers, and PGGM

[983] Barbara Schecter, "CPPIB reaps almost 12% investment return as opportunities beckon in the U.S." (18 May 2017)

Screening techniques, including negative screens, are not used by CPPIB.[984] Proxy voting is a key priority; "voting proxies is not only our fiduciary responsibility as a shareholder; it is also a crucial way to convey our views to Boards of Directors and management."[985] Divestment is not.[986] The CPPIB states that it can 'do good' by staying as an engaged investor, rather than becoming a ''divestor''.[987] The CPPIB stated that "at this time, fossil fuels remain an important sector of the global economy. Coal is responsible for 30% of the world's energy consumption, while renewable energies provide 14% of the global energy mix. We are exploring opportunities in the renewable energy sector in a thoughtful, prudent manner."[988] They continue stating: "We believe that divestment can lead to substantially lower returns... and not result in changed corporate behaviors."[989] They follow the mantra of the dialogues model; believing that moral suasion is the key.[990] While much has been written positively about CPPIB and RI, it does not seem to be the silver bullet for the Mass Affluent. CPPIB's refusal to divest from oil may be as much a political statement as an economic argument.[991] It

[984] CPPIB, *Sustainable Investing Approaches*, online at: http://www.cppib.com/en/how-we-invest/sustainable-investing/ accessed April 16, 2018
[985] CPPIB, *Proxy Voting*, online at: http://www.cppib.com/en/how-we-invest/sustainable-investing/proxy-voting/ accessed April 16, 2018
[986] CBC News, "Failure to divest carbon assets has cost pension plans $22B, report finds" (16 November 2015) online at: http://www.cbc.ca/news/business/corporate-knights-fossil-fuel-divestment-1.3321265 accessed April 16, 2018 Corporate Knights founder Toby Heaps said, "Contrary to the conventional wisdom, divesting out of fossil fuels in favour of clean energy has been a huge money-maker."
[987] Shawn McCarthy, "Ontario Teachers, CPPIB opt to maintain fossil-fuel assets" Press Release (24 December 2015) the Globe and Mail, online at: https://www.theglobeandmail.com/report-on-business/industry-news/energy-and-resources/ontario-teachers-cpp-investment-board-opt-to-maintain-fossil-fuel-assets/article27934831/
[988] CPPIB, CPPIB's Approach to Climate Change, Article (21 March 2017) online at: https://www.cppib.com/en/public-media/headlines/2017/cppibs-approach-climate-change/ accessed April 16, 2018
[989] Mark Wiseman, Twitter feed, (6 June 2016) online via Twitter:@cppib accessed April 16, 2018
[990] Dialogues, *supra* n 907
[991] *Ibid*

shows the dilemma between using divestment/negative screens against an activist approach.

7.6 Summary Conclusions

Retail investors need their own RI products. Some pensions still believe that including ESG breaches their fiduciary duties. Legislation was needed in several jurisdictions. However, like securities disclosures, pension legislation is not universally adopted. Pension funds use activist investing to push RI forward. They actively vote their shares and build dialogues with companies to change business practices, for the betterment of society. Some institutions are divesting from coal and oil & gas companies, others are not. Proxy voting on the other hand is difficult for retail investors and those who do vote do not have any meaningful impact. Bonds, as debt instruments, do not give any power to vote a proxy. Certain structures, such as private equity and infrastructure, are mostly unavailable to the retail investor. New products need to be developed to allow retail investors to access these vehicles.

Retail investors, through direct lobbying of their government pension plans, and their union and/or work pension plans may only be able to access RI in an indirect manner. So, RQ6, pension plans may be the only practical way Mass Affluent investors can access RI. Everyone should have equal access to RI. An employee of Columbia should not have access to RI, while employees of Yale do not. They cannot rely on large pension funds. They must have access to retail funds.

> "Overcoming these issues requires a mixture of regulation, education, overcoming misconceptions about ESG integration and toolkits for investment practice."[992]

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[992] 21st Century Roadmap, *supra* n 885 at 5

CHAPTER 8 – CONCLUSION

Many corporations, and (some) governments are becoming more convinced that environmental issues pose a real and substantial threat to humankind. Human rights, indigenous rights, labour, and diversity are all becoming important factors to add to ESG analyses. Yet, there is no comprehensive framework, nor organized set of data to allow an investor to incorporate all information required to conduct a proper RI analysis.

This thesis provides evidence of a need for enhanced, organized data. The international normative standards, such as the PRI, attempt to financialize and integrate certain ESG and RI factors into the financial calculations. Qualitative metrics, such as emojis, are nice to haves, and for retail advisors, they may actually provide better information (as they provide easy to understand information). Portfolio managers need to fully integrate ESG risks into financial calculations. A unifying theory is difficult as each current theory applies to different organizations. The EPs apply to project finance. The PRI applies to asset management. The GRI applies CSR data. Each sector needs differing requirements as not all ESG factors apply to each company. A very recent report from the UN GC reaches the same conclusions regarding the SDGs. Companies need to determine which SDGs apply to them and report with accurate data.[993] An IT solution can be created to automate this analysis and assist with comparability of companies.[994]

Enhanced material disclosures from individual companies are required. This will require a deep change to the notion of materiality. A mandated inclusion of CDP scores

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[993] GRI & UN GC, *Business Reporting on the SDGs: Integrating the SDGs into Corporate Reporting: A practice guide* (New York: UN GC, August 2018). This report came out after the thesis had been submitted for review, so had not been fully incorporated into the thesis.
[994] John Ruggie & Emily Middleton, "Money, Millennials and Human Rights: Sustaining 'Sustainable Investing'" M-RCBG Faculty Working Paper Series No. 2018-01, June 2018 at 3, 9
Whether this solution is based on block chain, Artificial intelligence, or some other method is beyond the scope of the thesis to provide an answer.

into documents such as the MD&A would help. Aligning GRI and CSR reports into continuous disclosure obligations will assist, as the items in the CSR reports should be mandated to be material. Until ESG is conclusively and decisively deemed to be material, disclosures will be ineffective at creating positive and meaningful change. Standardized data is required. The answer to RQ1 is no, domestic securities laws do not provide for sufficient material disclosures and transnational frameworks do not fill in all gaps.

Practical RI investments do not fulfil the promise that the international normative agreements have striven towards. The evidence does not appear to support a claim that any quantitative goals have been truly indoctrinated into the financial analysis. There is some evidence of the 'emoji' hypothesis that states that while ESG goals are not financialized, they are used as a qualitative symbol to alert the investor or portfolio manager of the "ESG-ness" of an investment. This "ESG-ness" is suspect, as the disclosures of environmental, human rights and governance factors are not sufficient. RQ2 is no, current models do not incorporate all ESG factors, and new valuation techniques are required.

There is nothing structurally in the nature of a mutual fund that precludes proper RI principles. Several funds, including the fossil fuel free and women in leadership, show promise. ETFs show more evidence of "RI-ness," mainly through niche funds that focus on specific factors such as water, solar, cleantech, etc. There are tangible, specific ETF funds that invest in low carbon, alternative energy, and other environmental attributes that are unmistakably RI. Green Bonds also show evidence of true RI. This shows clear evidence of the fluid and dynamic nature of RI. These new funds hold promise but much more work needs to be done.

The unfortunate reality is that there is an inherent lack of accessibility to all of these vehicles for the Mass Affluent. A grand theory of RI is not needed to promote RI. There are RI products. At the retail level, access, not theory is what is needed. The answer to RQ3 then is yes, MFDA and Series 6 licensed representatives need to be allowed to sell a wider array of products, including ETFs and green bonds. New regulations around the licensing of MFDA advisors are required. New structures of fixed income investments that are available to the Mass Affluent are required.

Mutual fund RI, practically, is no different from non-RI funds. The answer to RQ4 is thus, no. A pure financial analysis will still be required, incorporating factors of size, portfolio manager skill, market capitalization, and others. This should be undertaken after new valuation models have been created that comprehensively incorporate ESG factors. Integrating the SDGs into investment and finance vehicles also holds great promise for RI.

Private equity structures offer promise as they allow for unique underlying asset bases, such as carbon credits and infrastructure. CEDIFs offer tax advantaged investment vehicles for smaller, more locally based projects. The answer to RQ5 is the enhanced use of CEDIF and alternative structures to create unique products. They must be structured to allow access to the Mass Affluent. Most infrastructure bond offerings are done via a private placement, and as such are not offered via prospectus and thus not available to the Mass Affluent retail investors. A larger emphasis on creating green and social infrastructure funds would alleviate this disparity.

Due to securities regulations, private equity structures are only available to institutional investors, and other Accredited Investors. Most complex structures would not be recommended to the Mass Affluent, as they would be too risky to hold as an individual Security. Some private equity structures, such as the Greening Canada Fund use the LP model for strategic reasons, and the underlying Investments are not complex. They could be held by Mass Affluent. The creation of an ETF or mutual fund that invests in LPs would alleviate this problem.

To access ETFs and CEDIFs only two options currently exist. The first is to go to an IIROC licensed investment advisor, such as RBC Dominion Securities[995] or certain advisors at independent IIROC firms.[996] Most of these advisors have large minimum investment assets, such as $1milllion or more. This is not an option for the Mass Affluent. The second option is to use an online brokerage account. Most clients do not have the time, energy or ability to undertake "do it yourself" investing. Most Mass Affluent investors need the services of an advisor. Banks and other FIs cater to the Mass Affluent, but most bank employees are MFDA licensed and cannot sell products that are outside their own company's mutual fund offerings. Even most other "independent" financial planning firms[997] are MFDA licensed. FIs must also eliminate propriety offerings, or at the very least, allow their advisors access to the universe of investments within their licensing. MFDA advisors should be able to access all types of mutual funds, granting access to specialized products.

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995 RBC Dominion Securities, online at: http://www.rbcds.com/
996 Such as Assante, see https://www.assante.com/legal
997 Such as Investors Group, Quadrus, etc., see MFDA, *Directory of Members*, online at: http://mfda.ca/members/directory-of-members/

Like Tesla, the access to RI is like the evolution of EV cars. To use a colloquial phrase, it is a "chicken and egg" scenario. One cannot purchase a car and then have no place to refuel the hydrogen or do a quick recharge. Companies (or governments) will not invest in the infrastructure (hydrogen stations or quick charging locations) until a substantial number of the vehicles are sold. RI has the same issue. Current RI products are not materially different than non-RI, yet cost more to purchase. This is not attractive to Mass Affluent retail investors. A better method of "mainstreaming" RI is required.

Implementing a best interest standard, along with enhanced education requirements is necessary. Standards for retail advisors must improve. Requiring education on ESG would elevate advisor knowledge. More informed advisors with knowledge of potential RI options would encourage investment. Aligning pay and commission structures would also help. Fund facts documents (and their US and Australian equivalents) need to be improved. The marketing aspects of these documents must be credible and better explain how and why the underlying companies, bonds or assets have been included in the fund.

Timing could not be better, as there are many other issues that securities regulators are dealing with for mutual funds and mutual fund advisors. Unfortunately, there does not seem to be any appetite to allow ETFs to be sold by MFDA licensed reps and little willingness for banks and firms to expand their 3rd party product offerings. They may have to settle and have their pension funds engage in RI investing.

Pension funds are slowly adopting RI principles. Interestingly, many US funds are taking the lead. New York state, Columbia and several other large US funds are looking at (or already have) divested in oil and gas firms. Canadian pension funds, such as

Dalhousie and the CPP, seem less willing to do so, especially relating to divesting from fossil fuels. With only approximately 270 stocks available to trade, and with the Canadian stock market composing of 33% from mining and oil and gas stocks, it is very difficult to run a domestic fund that could divest completely from oil and gas. Active investors would argue that divestment is not the proper way to go about change. Active investors prefer to build dialogues and change companies for the betterment of society. Practically speaking, the answer to RQ6 is that pension funds may be the only way Mass Affluent investors can access RI. The Paris Agreement was believed to mark a new milestone in international legal climate change development. Unfortunately, President Donald Trump plans to abandon the Paris Agreements.[998] This could impact environmental movements in the USA and could lessen RIs impact going forward, as fund managers in the country may perceive fewer risks. This provides more evidence that a multi-stakeholder soft law approach is necessary to enhance RI investing.

Maybe that is the point. RI cannot be all things to all people. Specialized, niche funds that are attractive to certain client segments may be the best solution. Rather than attempting to make an "ESG" fund of the same companies that comprise an index or broad based 'vanilla' equity fund, a portfolio manager should create a specialized vehicle, like a low carbon or women in leadership fund. The lack of a consistent, coherent definition of RI is justified.

This paper has established that there is a real issue with RI funds. There are important considerations that derive from this analysis. The first is that companies that actively state that they follow RI principles, such as the UN PRI, and have "sustainable

[998] Shilu Tong, Kristie Ebi, & Jorn Olsen, "Exiting the Paris climate accord: Trump administration misses the rising tide" (2017) 1:8 *The Lancet Planetary Health* E304-E305

investing policies" should "put their money where their mouth is." They need to develop and construct funds that follow the core principles of RI, not merely to the letter of these principles, but to its spirit. There is still much work to be done. Despite US legal and government policy,[999] investors are heading down a path towards a more sustainable future. This is only possible if the financial conditions merit the change. Let the client decide… and give them access to all the information needed to make a responsible decision.

[999] Robert Stavins, "Is President Trump's climate change policy an oxymoron?" (2017) 34:3 The Environmental Forum 17

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