Improving Corporate Governance through Mandatory Social and Environmental Reporting

Brief to the Canadian Securities Administrators
on Continuous Disclosure
(proposed National Instrument 51-102 and Companion Policy 51-102CP)

From The Social Investment Organization
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Submitted to:
Alberta Securities Commission
British Columbia Securities Commission
Manitoba Securities Commission
Securities Administration Branch, New Brunswick
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Department of Justice, Government of Northwest Territories
Nova Scotia Securities Commission
Registrar of Securities, Legal Registries Division, Department of Justice, Government of Nunavut
Ontario Securities Commission
Office of the Attorney General, Prince Edward Island
Commission des valeurs mobilieres du Quebec
Saskatchewan Securities Commission
Registrar of Securities, Government of Yukon

1. Introduction

The Social Investment Organization is pleased to present its views on the Canadian Securities Administrators' new Continous Disclosure Policy. We wish to commend the CSA in its effort to harmonize and strengthen continuous disclosure in Canada. While we will focus on what we view to be some shortcomings in the proposed policy, we wish to welcome the proposed changes in the spirit of improving the continuous disclosure regime.

Our interest in this topic comes from our background as Canada's national trade association for the socially responsible investment (SRI) industry. The SIO has more than 400 members across Canada, including staff and managers of leading socially responsible investment funds, asset managers, financial institutions and investment advisors. Our members manage funds on behalf of more than 200,000 investors. Among our members and others, there is approximately $50 billion in assets in Canada managed according to social and environmental guidelines. For more information, on the SIO and its membership, we have included a corporate profile at the end of this brief.

While our members approach SRI from many differing perspectives, they all share a commitment to corporate transparency, social responsibility and environmental sustainability. It is with these values in mind that we present this brief.

Specifically, this brief calls for mandatory social and environmental disclosure to be included in the Continuous Disclosure Policy. To implement this general policy objective, we have included specific recommendations to the proposed new rules concerning Annual Information Forms (AIFs) and Management's Discussion & Analysis (MD & A).

These recommendations are consistent with other recent policy briefs we have sent to the New York Stock Exchange Corporate Accountability and Listing Standards Committee; the MD&A project of the Canadian Institute of Chartered Accountants and the Public Finance Committee of the Quebec National Assembly. These briefs are available on our website at www.socialinvestment.ca.

2. Social and Environmental Disclosure as an Element of Good Governance

In the last few months, much attention has been focused on the shaken confidence of the world's capital markets resulting from the corporate abuses of Enron, WorldCom and other companies. As socially responsible investors, we believe this crisis of confidence involves more than just accounting and auditing abuses. We believe that these examples of corporate malfeasance are indicative of a larger underlying problem in which corporate management emphasizes short-term profit and short-term capital appreciation at the expense of stakeholders, including investors. These stakeholders can include communities, employees, suppliers, customers and the natural environment in which companies operate.

We believe that social and environmental risk is a significant, yet largely unrecognized, factor in determining share value. Environmental problems, human rights controversies, product liability issues, employee concerns and other reputational issues all impact on share prices over the short-term and into the future. Likewise, companies that implement sustainability policies, codes of conduct, employee benefits programs and other corporate citizenship practices are more likely to identify market and production opportunities in the future. In short, corporate reporting on social and environmental issues holds the potential to reduce risk and enhance long-term shareholder return. Social and environmental disclosure is increasingly viewed as an element of good corporate governance.

This view is not restricted to socially responsible investors. In a national survey of investors conducted by the American Institute of Certified Public Accountants in 2000, 79 per cent of those polled believed that "corporate responsibility" information (such as privacy policies, overseas labour and environmental standards) is necessary. Analysts, institutional investors and retail investors want this information, which is now considered off-balance sheet data. Investors want these types of disclosures to establish a true and accurate picture of the corporation. While less quantifiable, these social and environmental variables capture dimensions of corporate performance and culture not included in conventional financial analysis or even some of the most advanced concepts of corporate governance now under consideration.

In Canada, there is growing demand for this kind of reporting. Two of Canada's largest pension funds -- OPSEU Pension Trust and the Ontario Municipal Employees Retirement System -- have adopted proxy voting guidelines based on social responsibility, environmental and ethical issues. Many asset management companies have created products or services employing social responsibility investment guidelines. Interest in the social responsibility record of publicly-listed corporations is high and growing.

"A company that shows respect for its employees, the environment, the community in which it does business, and human rights is being socially responsible and tends to earn better returns," said OMERS Board Chair, Rick Miller, in announcing its socially responsible investment policy. "The OMERS Board feels that a corporation should account for all aspects that affect shareholder value."

The need for mandatory social and environmental disclosure requirements is clear. Yet, in spite of growing investor interest, Canadian social and environmental disclosure rules are less stringent and specific than they are in the US. As well, disclosure regulations in both jurisdictions fall far short of investor needs.

In the US, the SEC has specifically mandated environmental reporting under Regulation S-K, items 101 and 103. Item 101 requires disclosure of the material effects that complying with federal, state and local environmental provisions may have upon the company's capital expenditures, earnings and competitive position. Item 103 requires a company to disclose material environmentally-related administrative or judicial proceedings.

In Canada, there are no specific requirements to report potential environmental liabilities, although current Annual Information Form and prospectus rules require companies to report the impact of environmental protection expenses on capital expenditures, earnings and competitive position.

This means that in this one area of social and environmental risk -- environmental liability -- US law is stronger than Canadian law.

Nevertheless, researchers looking at the effect of disclsoure requirements have observed that current reporting rules fail to meet investor needs. In "A Comparison of Mandated and Voluntary Environmental Disclosure: The Case of Canada and the United States (http://panopticon.csustan.edu/cpa96/pdf/buhr.pdf)," authors Nola Buhr and Marty Freedman found that in both jurisdictions, the extent of disclosure is "woefully inadequate" and that there are some resource-based companies that choose to disclose nothing about their effect on the environment.

This finding is not surprising. The Ontario Securities Commission's recent review of continuous disclosure (OSC Staff Notice 51-708) frequently found companies that fail to adequately discuss key MD & A requirements, including "qualitative and quantitative risk factors that could have an effect on future operations and financial position." Such risk factors include a host of social and environmental issues that have an impact on short- and long-term share price.

We believe the CSA should specifically mandate social and environmental disclosure in the AIF and MD & A. Such a regulation would have two key effects.

1) Increased transparency will provide investors and capital markets with adequate information about social and environmental risks. This will encourage investors to work with management to rectify these problems, or to divest from companies with a high-risk profile. Social and environmental risk will begin to be priced into share values. Investors will have a higher level of risk protection and management will be encouraged to solve social and environmental problems.

2) By requiring management to publicly divulge social and environmental risks, and audit committees to publicly acknowledge these risks, social and environmental reporting encourages the establishment of continuous risk-management systems to address sources of risk previously ignored by management at many corporations. The very process of identifying and reporting social and environmental risk will set in process systems to address those risks and to minimize them.

Social and Environmental Reporting in Other Jurisdictions

Our recommendation for mandatory social and environmental reporting is not without precedent.

Reforms put in place in the UK by the Turnbull Committee have resulted in mandatory social and environmental reporting for LSE-listed companies. The document *Internal Control: Guidance for Directors on the Combined Code* (published by the UK Institute for Chartered Accountants) states that companies need to consider and report on significant risks including those related to "health, safety and environmental, reputation and business probity issues."

Under current Turnbull Committee practices, Boards are tasked with ensuring that management has developed appropriate, sensible, internal controls for identifying and mitigating attendant risks.

As well, the 2002 King Report on Corporate Governance in South Africa now mandates directors of companies listed on the Johannesburg Stock Exchange to undertake regular Social and Ethical Accounting, Auditing and Reporting (SEAAR) exercises as well as safety, health and environment (SHE) disclosures.

The SIO believes that these forward-looking jurisdictions recognize the benefit of requiring companies to report on their social and environmental risks and opportunities. By incorporating similar rules into the new Continuous Disclosure Policy, the CSA can help Canadian investors acquire a truer and more complete picture of publicly-listed companies in this country.

3. The Content of AIF and MD&A

The SIO commends the CSA for the new proposed Continuous Disclosure Policy. We agree that the new rules would harmonize continuous disclosure rules across Canada, enhance the consistency of disclosure in the securities markets, and facilitate capital raising initiatives.

However, SIO is concerned that the new CSA rules fail to pay heed to critical issues of social and environmental reporting. Specifically, we are concerned that the lack of social and environmental reporting content in the AIF and MD&A instructions will send a signal to corporations that it is acceptable to avoid reporting on social and environmental issues. Such a situation will perpetuate a regime in which a small minority of companies voluntarily report on their social and environmental record while the vast majority of publicly-listed companies continue to ignore such issues. Such an oversight would place Canadian securities law behind emerging jurisdictions -- such as the United Kingdom -- that have corporate social and environmental reporting standards.

SIO makes the following recommendations to strengthen your Continuous Disclosure Policy.

AIF

Under your proposed Form 51-102F1 AIF, you state: "Your AIF describes your company, its operations and prospects, risks and other external factors that impact your company specifically." The AIF is intended to be management's disclosure document that includes all information of a "material" nature.

By including discussion of the company's "operations and prospects, risks and other external factors," your instruction on AIFs would not be confined to discussion of financial issues. In fact, non-financial issues such as social and environmental risks would be included in this definition of the AIF.

Social and environmental risk would also be considered "material" risk under the definition included in your proposed rule. Under the definition, any information is considered material if a reasonable investor's decision whether to buy or not to buy, sell or hold securities would "likely be influenced or changed if the information in question was ommitted or misstated."

However, given these general principles, it would be difficult for companies to know what social and environmental information to include given the broad instructions and interpretation included in the proposed rule. Furthermore, the only specific direction to companies on this matter is contained in Form 51-102F1, item 4.1 (h), which instructs companies to include "the financial and operational effects of environmental protection requirements on the capital expenditures, earnings and competitive position of your company in the current financial year and expected effect in future years."

The effect of this instruction is to unnecessarily narrow the discussion of non-financial factors to "environmental protection requirements." This would not even come close to the full social and environmental disclosure required by investors. By focusing on environmental protection requirements, the instruction fails to capture the wider issues involved in sustainable development, as well as social issues such as employee relations issues, community involvement and human rights concerns.

As well, under item 4.2 RISK FACTORS, the lack of instruction on this item means that companies will be at a loss to determine which risk factors to include. Financial, operational and non-financial risk factors should be specified.

Recommendations:

Under Form 51-102F1 Annual Information Form, item 4.1 GENERAL, we recommend that item (h) be changed to: "(h) Social and Environmental Issues - A description of your social and environmental policies, and the measures your company is taking to implement those policies."

Under Form 51-102F1 Annual Information Form, item 4.2 RISK FACTORS, we recommend the following be added: "Describe your financial, operational and non-financial risk factors, including social and environmental risks."

MD&A

The accounting profession is placing increasing emphasis on the importance of MD&A reports. The MD&A provides a complete picture of the company from management's point of view, and provides a forum for management to discuss the company's strengths and weaknesses in a comprehensive manner.

SIO commends CSA for strengthening MD&A reporting under the new Continuous Disclosure Policy. Specifically, we commend CSA for requiring Boards of Directors to review the annual and interim MD&A reports. By requiring Boards to review these reports, you will be establishing Board accountability for the financial and non-financial information contained in these reports. This is an important principle of disclosure policy.

However, we are concerned that the proposed MD&A form does not mandate comprehensive social and environmental reporting.

The CICA MD&A Project, led by the Canadian Performance Reporting Initiative Board, generally supports the notion that social and environmental disclosure is an important component of MD&A reporting.

The CICA's draft guidance document (Management's Discussion and Analysis: Guidance on Preparation and Disclosure) states: "If so-called non-financial aspects of a business (perhaps those related to personnel, operational, environmental, technical, research and development, social, cultural or other matters) are expected to have a material impact on the economic condition and development of the business, such information should be disclosed."

While we commend the CICA draft guidance document, we believe that more elaboration is required to assist companies in understanding their obligations under MD&A.

Recommendation:

Under Form 51-102F1 Management Discussion and Analysis (MD&A), Part 2 CONTENT OF MD&A, a new section entitled "Social and Environmental Factors" should be added to the MD&A instruction. In this section, companies should be advised: "If non-financial aspects of a business (perhaps those related to personnel, operational, environmental, technical, research and development, social, cultural or other matters) are expected to have a material impact on the economic condition and development of the business, such information should be disclosed. Discussion should include issues of exemplary performance on key stakeholder matters. These stakeholders can include employees (programs to create employee loyalty, innovation and productivity), customers (production of high-quality products and services leading to customer satisfaction), communities (programs to create long term trust , enhancing the corporation's "social license to operate") and the environment (operational or product issues enhancing long-term sustainability). The relationship to long-term share value should be explained."

An important principle of the Turnbull Committee reforms in the United Kingdom is that Boards of Directors should assess a company's risk factors and put in place risk management strategies to address these risk factors. The SIO agrees with this general principle. We believe that it is important for Boards to identify significant financial and non-financial risks and to take responsibility for implementing overall strategies to mitigate these risks.

This principle underlies the recommended best practice by the CICA in its draft guidance document for MD&A. The recommended practice in the document states:

> "Risk should be disclosed as specifically as possible and tied to its effects on aspects of the disclosure framework including strategy, critical success factors, capability and results. Such disclosure should include:
>
> - The significant risks and uncertainties facing the company and it core businesses and segments, as appropriate;
> - The strategies and processes employed for managing these risks; and
> - The potential specific impact of these risks on results."

By contrast, the proposed MD&A form in the CSA Disclosure Policy fails to explicitly require discussion of risk factors. While risk factors could be discussed in form item 1.1 Overall Performance, 1.3 Results of Operations, 1.4 Liquidity, 1.5 Capital Resources and 1.6 Related-Party Transactions, there are no prescribed sections on risk factors included in the MD&A form.

SIO commends the best practice recommendations of the CICA draft guidance document, and urges CSA to adopt this framework in its MD&A guidelines. As well, we offer the following specific recommendation.

Recommendation:

Under Form 51-102F1 Management Discussion and Analysis (MD&A), Part 2 CONTENT OF MD&A, a new section entitled "Risk Factors" should be added. In this section, companies should be advised: "You should discuss financial and non-financial events, actions or circumstances that will adversely affect your organization's ability to achieve its business objectives. Social and environmental risks should be included. These would include stakeholder issues such as employees (union disputes, OSHA-type data on fatalities and lost time incidence, discrimination and harassment complaints), customers (product quality or safety issues), community involvement (human rights complaints or operational problems in developing countries) and environment (emissions problems or other sustainability risks)."

4. Other Issues

The CSA has asked reviewers of its draft Continuous Disclosure Policy to comment on selected specific issues. SIO has not arrived at a position on all the issues, but we offer these additional comments.

1) Elimination of requirement to deliver financial statements. We agree that it is not necessary to provide all secuityholders with copies of AIFs and MD&As. Not only does this material add to unnecessary corporate expense, it create needless waste. However, it is important that companies provide investors with electronic capability to obtain such reports. In addition to requiring companies to notify securityholders how to obtain paper documents, companies should be required to provide information on how to access these documents through the internet at SEDAR or corporate websites.

2) SEC Developments. SIO agrees that the rule should be changed to reflect recent SEC developments.

3) Combination of financial statement and MD&A filings. We believe that MD&A filings should be done at the same time as financial reports to encourage companies to treat MD&A issues (including social and environmental factors and risks) as an integrated part of the company's value creation strategy.

5. Conclusions

The members of the Social Investment Organization believe that the current crisis of confidence in world capital markets is more than a problem of financial accounting. It is a problem of short-term thinking that externalizes corporate risks to stakeholders. Recent corporate abuses have cost investors billions of dollars. But other stakeholders have also been injured by other kinds of non-financial corporate harm. These have resulted in numerous examples of hurt to our social welfare and environmental sustainability. These issues have also created untold erosion of long-term share value.

By requiring listed companies to report their social and environmental risks and opportunities, the Canadian Securities Administrators can help to create a more responsible and sustainable world and to enhance share value over time.

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Corporate Profile

Established in 1989, the Social Investment Organization is a national non-profit organization dedicated to the advancement of socially responsible investment in Canada. It is funded primarily from membership dues and is accountable to its membership. The SIO has more than 400 members across Canada, representing the following:

- Socially- and environmentally-screened mutual funds and their staff
- Financial institutions providing socially responsible investment products or operating according to corporate social responsibility principles
- Investment advisors providing advice and assistance on socially responsible investment
- Investment managers managing socially responsible investment assets
- Institutions investing according to socially responsible investment guidelines
- Retail investors investing according to socially responsible investment guidelines
- Non-governmental organizations and other groups with an interest in responsible investment

Our members manage funds on behalf of more than 200,000 Canadian investors.

The mandate of the SIO is to raise the public profile of socially responsible investment, to reach out to other groups interested in socially responsible investment, to provide information to our members and the public and to take a leadership role in coordinating the development of the socially responsible investment agenda in Canada.

Socially responsible investment is defined as the process of selecting or managing investments according to social or environmental criteria. We estimate there is approximately $50 billion in socially responsible investment assets in Canada.

Socially responsible investment includes three components:

1. Positive and negative screening. This is the application of social and environmental guidelines or “screens" to the investment process. Negative screens usually include issues such as tobacco and military production, companies operating with sweatshop or child labour, or the manufacture of alcohol or pornography. Examples of positive screens are companies making a

contribution to social, economic or environmental sustainability or industries with exemplary employee practices.

2. Community Investment. This is the investment of money in community development or micro-enterprise initiatives that contribute to the growth and well-being of particular communities. The idea is to reverse the drain of capital and income that debilitate low-income communities.

3. Shareholder Advocacy. This is the process of using shareholder influence to help to bring about positive social and environmental change at corporations. This can include corporate engagement (communicating with management on particular issues), filing shareholder resolutions and using the threat of divestment to bring about positive change.

SIO members believe that socially responsible investment represents a catalyst for positive social change as well as a useful investment tool to enhance returns and reduce risk by incorporating social and environmental factors traditionally excluded from portfolio management.

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