



OPEN DISCLOSURE

Sustainability and the listing regime

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Claros Consulting is an independent consulting practice specialising in sustainable and responsible investment. Claros provides a range of advice for fund managers, pension funds, policymakers and non-governmental organisations (NGOs). A key area of expertise is understanding the financial potential of sustainable development generally, or of specific social and environmental issues. Services include developing research methodology, sourcing information and indicators, developing engagement approaches, considering investment strategies and understanding the portfolio implications of sustainable investment.

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EXECUTIVE SUMMARY

The disclosure of information is at the core of the listing process and is essential for the fair and efficient functioning of the markets. As such, disclosure is governed by extensive regulation, embodied in the Listing Rules to ensure listing documents contain “all such information as investors and their professional advisers would reasonably require”.

In recent years there have been substantial changes in the investment industry, leading to greater interest in social and environmental issues. These changes include:

- A regulation requiring pension funds to disclose their policies on how they consider environmental and social issues;
- Growing consumer interest in socially responsible investment funds;
- Share prices that increasingly value brand, reputation and intangible assets;
- The increasing importance of corporate governance and risk management, and notably the Disclosure Guidelines on Social Responsibility issued by the Association of British Insurers.
- Several financial sector initiatives on the role of social and environmental issues;
- Continuing concern over the short-termism of the markets;
- Interest in the idea of the “universal investor”, which justifies responsible investing;
- And rising pressure from a variety of other stakeholders, including government agencies.

A common theme emerges of the need for enhanced disclosure. And recent events such as the listing of Xstrata plc underline the need for adequate disclosure. However, the Listing Rules have not yet changed to reflect any of these developments. Without such disclosure, investors cannot be sure they are taking all financial factors into account, nor that they are meeting their fiduciary responsibilities, or the needs of their clients. Fortunately, there are opportunities for change with a review of the UK listing regime underway and the development of an EU Prospectus Directive.

While the current listing regime in theory permits environmental and social disclosure it does little to encourage or require it in practice. In contrast, the King Report on *‘Corporate Governance in South Africa’* calls for “every company to report at least annually” on its social and other policies, and specifies five key areas for disclosure. In the US, the Securities and Exchange Commission explicitly refers to environmental factors in its Listing Rules. The OECD Guidelines for multinational enterprises support enhanced disclosure of issues regarding employees and other stakeholders. The Global Reporting Initiative is aiming to set standards for environmental and social disclosure. Several countries have enacted laws or regulations requiring environmental/social disclosure, including

Australia, Belgium, Canada, Denmark, France, Norway, Sweden and The Netherlands. France, in particular, has specified detailed disclosure.

A number of options are available in terms of how the Listing Rules could be modified to include social and environmental disclosure. The key challenge is to ensure meaningful reporting does occur, while avoiding being over prescriptive and rules based, with long menus of data items to disclose. As a result, the preferred option is the integration of the ABI guidelines into the Listing Rules combined with specific requirements for the disclosure of key items. This would give legal force to what are at present voluntary guidelines.

Any enhanced disclosure regime also needs an effective mechanism for ensuring compliance. There are a number of problems with the current system, such as conflicts of interests of sponsors. A number of tools could be used to avoid these, including: developing more detailed rules and guidelines; inviting comments or getting third party input, changing the role of the sponsor, or adopting a more aggressive approach to enforcement (or a combination of these).

It is now time to revise the Listing Rules to incorporate social and environmental disclosure. High and broad standards of disclosure are likely to strengthen the standing of the UK as a financial centre. They would renew Britain's reputation for leadership in integrating sustainability and investment and play a significant part in realising the Prime Minister's hope "that the UK will be showing the world community the future for financial services"

To conclude, our key recommendations are:

- Firstly, that the UK Listings Authority (UKLA) conduct a review of the Listing Rules to examine the case for the inclusion of social and environmental information.
- Secondly, that the UKLA review its enforcement mechanisms to ensure they do indeed support adequate disclosure.
- Thirdly, that the UKLA work with other regulators and the European Commission to ensure that enhanced disclosure rules are not undermined by action elsewhere.

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Introduction

The ability to raise capital at the stock exchange through public offerings of shares and bonds is at the heart of modern capitalism. For this process to work fairly and efficiently, the key is information. Investors need to have adequate and accurate information about the company to ensure they can fairly assess its prospects and value its shares. Companies will be aiming to maximise the amount of money they can raise (or the terms on which they raise it), and so will want to put the company in the best possible light. There will always be a temptation to be selective about the information they provide, if possible. As a secondary issue, companies will also be concerned about the cost of providing information, which may lead them to seek listing on markets where the information requirements are lower or more suited to their needs.

The listing process is critical to the function of the financial markets. As a result, lawmakers and regulators are heavily involved in setting rules about what should be disclosed in a Listing Particulars or Prospectus – the document companies have to produce when they raise money on the stock market. This marks a change over the last 20 years from what used to be a self-regulatory system with largely unwritten rules.

In the UK, the fundamentals of *financial* disclosure when listing are reasonably well established. In contrast, however, the requirements regarding the listing of non-financial, and in particular, environmental and social information, are minimal. Yet this is despite the fact that there is growing evidence that environmental and social factors, and other long-term indicators (which can be collectively referred to as sustainability indicators) are increasingly of interest to investors, and that such factors can have a material impact on a company's financial performance. This has led to some criticism of the UK listing regime.

This report investigates the changing requirements of investors and their interest in seeing information on social and environmental factors included as part of the listing requirements; whether such information is relevant to performance; and what other countries have been doing. If there appears to be case for change, the report will consider how the Listing Rules could be modified to include information on social and environmental factors, and how such changes could be enforced. First we review this process in more detail and also look at changes which may be imposed by the European Union.

The listing regime: An overview

The general principles about listing and disclosure are laid down by European directives and UK Law, most recently the Financial Services and Markets Act 2000. Specific guidance is then developed by a regulator — in the UK, the UK Listing Authority (UKLA) is the responsible body. It is part of the Financial Services Authority (FSA), which is primarily accountable to HM Treasury.

The FSA publishes the formal *Listing Rules* in a large binder.¹ They run to several hundred pages. The Rules themselves are split into 27 chapters, together with a set of schedules, the Combined Code (on Corporate Governance), and a guidance manual. Chapter 6 is particularly important in that it deals with the contents of the listing particulars. It is also worth noting that chapters 17-27 deal with specific types of issuers – such as mineral companies (including oil & gas) [Chapter 19]; scientific research based companies (including biotechnology) [chapter 20]; and innovative high growth companies [chapter 27].

The Listing Rules cover both the initial listing and subsequent listings (both of further issues of the original securities and new securities by the same issuer (e.g. corporate

bonds), both of which require the production of 'Listing Particulars' or 'Prospectuses'. In addition, the Listing Rules cover annual reporting requirements (and half yearly), and the need for immediate announcements of any events which could substantially affect the share price in a circular to the Regulatory Information Service. However, annual reporting requirements are primarily specified by accounting standards (which can be the UK GAAP, US GAAP or International Accounting Standards), and by company law. The Listing Rules provide some additional requirements for the annual report and accounts, including:

- The need to provide such information as to give a true and fair view (i.e. if not required by the accounting standards);
- The need to provide commentary on any deviation from forecasts;
- Statements regarding the directors' interest in shares, major shareholdings and company purchases of shares;
- A statement on the Combined Code on Corporate Government;
- A report on directors' remuneration.

Our principle focus here is for initial listing requirements, but we also consider annual reporting requirements. Note that annual reporting is currently being reviewed in the UK context by the White Paper on Company Law. This will introduce an operating and financing review, which may include some disclosure of social and environmental information (see later). However, such changes will not affect the initial listing requirements.

The UKLA has to approve an application for listing. Issuers have to provide the UKLA with the draft listing particulars, and the UKLA reviews this to ensure it complies with the Listing Rules. The primary responsibility for compliance with the Listing Rules lies with the directors of the 'issuer', who must ensure that they provide all relevant information.

Also important is the role of sponsors. Issuers have to appoint sponsors – typically investment banks – to guide them through the listing process. Sponsors have to be independent of the issuer. They are responsible for ensuring the issuer and its directors are aware of the Listing Rules, and overseeing the listing process.

If the UKLA considers there to have been a breach of the Listing Rules it has a number of potential sanctions available to it. It can give a private warning, issue a public censure or impose a financial penalty. Most commonly these are given in response to regard of on-going listing requirements – such as a failure to make available new material information in a timely and proper manner.

The FSA is currently conducting a review of the Listing Rules, with a view to consolidating and simplifying them. However, the primary focus of the review does not include the adequacy of the existing disclosure rules and specifically the inclusion of environmental and social information. Note too that the UK Listing Rules are likely to be affected by the forthcoming European Prospectus directive – see below.

Consequences of failures in information provision

It is worth noting that the consequences of getting information provision wrong are asymmetric. If the information provided by a company is inadequate, then investors could form an inappropriate view of the company and potentially could lose substantial sums investing in the company – a major disaster. In contrast, if the information provided is excessive, then unnecessary information will have been provided, but the main consequence of this is that the issuing company will have incurred unnecessary costs – a relatively minor problem. This creates a presumption in favour of disclosure, reflected in the basic principles underlying disclosure contained in the law.

However, against this, the Government and financial services industry are concerned about maintaining the UK's position as a leading financial centre and, as part of this, there is a desire to make access to the capital market relatively easy and straightforward. This means there is a reluctance to impose unnecessary burdens on prospective issuers, and indeed some desire to lower the effort involved in obtaining a listing. The UKLA is required to have regard to:

“the principle that a burden or restriction which is imposed on a person should be proportionate to the benefits considered in general terms which are expected to arise from the imposition of that burden or restriction...”

and:

“the international character of the capital markets and the desirability of maintaining the competitive position of the United Kingdom”.²

From an environmental and social perspective, there is also an asymmetry. If a company discloses only limited environmental and social information (and particularly understates or ignores the potential environmental and social damage which may be caused by its activities) it may raise money more easily. It will then have money to develop its projects and business. When these have an adverse affect on the environment or on society, typically it will be too late (or expensive) to correct the impact, even if some corrective action, such as fines or legal liabilities, results. (For example, work-related deaths can never be corrected, although they may give rise to significant compensation and other costs). For the listing authority to issue censures or fines after the money has been raised is too late to protect investors, society or the environment.

European Union Directives

The legal framework governing Listing Rules is being complicated by the prospect of a new EU Prospectus Directive, which will form part of a raft of European legislation aimed at creating a single market for financial services. The European Commission has been developing a proposal for a “Directive of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC”³ to replace and strengthen existing EU legislation on prospectuses. The Directive is currently at an advanced stage of preparation.

The new Directive is intended to facilitate a single European market in financial services, and particularly to make it cheaper and easier for companies to raise capital, while at the same time enhancing investor reputation.

The Directive is intended to make it possible for issuers to have a single prospectus valid EU-wide. Once approved by a home market regulator, a company will be able to use its prospectus to offer securities for sale across the EU. In addition, once a prospectus with details of an issuer has been produced in its home market, the issuer need only publish shorter prospectuses with just the details of the securities when raising further capital (e.g. when issuing bonds).

The proposed basic rule about what should be contained in a prospectus is contained in Article 5, para 1:

“The prospectus shall contain all the information which according to the particular nature of the issuer and of the securities offered to the public or admitted to trading, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and any guarantor of the rights attaching to such

securities. This information shall be presented in an easily analysable and comprehensible form.”

This is basically the same as the FSMA 2000 Act, and earlier directives.

The proposed directive also seeks to specify in greater detail the information that should be included. This is referred to in Article 7: ‘Minimum information’. The first paragraph of this article places an obligation on the European Commission to develop detailed rules on the content of a prospectus within 180 days of the adoption of the directive. The rules are to be based on the standards set out the by the International Organisation of Securities Commissions (IOSCO).

At no stage does the Prospectus Directive specifically refer to environmental or social information, and indeed its focus at present is on narrowly defined financial information.

The Directive has been the source of some controversy, particularly from the UK where it is seen as representing a weakening of existing rules on disclosure. Concern centres around two key areas. Firstly, the Directive is seen as in conflict with the Combined Code on Corporate Governance. Secondly, there is concern that the directive may limit the discretion of domestic regulators to demand enhanced disclosure, both on non-financial issues such as climate change and human rights, and more generally.

In response to the issue of the Combined Code, the EU has stated that corporate governance issues are not affected as the Directive only formally concerns initial disclosure requirements.⁴ However, there is likely to be a degree of tension if initial rules for prospectuses set one standard and then ongoing disclosure requirements set another standard. In addition, the proposed Directive does impose an annual requirement to update and maintain prospectus information. However, of greater significance for annual disclosure is the Transparency Directive, which is at a fairly advanced stage of preparation. This Directive is likely to impose minimum requirements that will allow UK regulators to require disclosure of compliance with the Combined Code, but has a number of other controversies surrounding it. Most notable is the requirement to require quarterly reporting by large companies, which will increase focus on short-term results – many would argue if additional burdens are to be placed on companies they should concentrate on looking at long-term indicators of value. For example, the Association of British Insurers has stated in regard to quarterly reporting: “With excessive focus on financial figures applicable to short time periods it becomes more and more probable that analytical resources will be devoted towards attempting to predict the next set of financial results and less and less to understanding the underlying drivers of long-term value creation in the company in question.”

Concerns about the way the Prospectus Directive may limit the ability of regulators to require information appears better founded. Although Article 7 is indeed headed “Minimum information”, and uses the words “the specific information that must be included in the prospectus” which might appear to give national regulators the possibility to specify additional information, the Directive has been prepared under the ‘maximum harmonisation principle’ and the Commission has indicated that there is no possibility for Member States to ask for additional information and to adopt more stringent rules (e.g. as schedules). However, Article 21 on rights of competent authorities (national regulators) does give them the right to ask for supplementary information with regard to specific issuers if considered necessary for investor protection purposes.

There are further concerns about the processes for updating and amending the rules. The Directive does not appear to explain how the rules can be updated once initial

rules have been laid down. It also appears to have restricted its ability to develop new rules by stating in the Directive that the rules should be in accordance with the requirements set out by the International Securities Commissions (IOSCO) and also by specifying, in an annex, a basic framework for the Rules. The particular worry is that it will be difficult to modify and update the rules in the future to take account of changing investor concerns.

As a compensating opportunity, the regulation does provide some opportunity to press the EU to include the specification of social and environmental information as it starts to specify in more detail the information required in prospectuses, which must be done within 180 days of the approval of the directive. Here the role of the Committee on European Securities Regulators – the grouping of the EU's financial regulators, based in Paris – will play a key role.

Nonetheless, there must still be substantial concern that the prospectus will place significant obstacles in the way of integrating sustainability into the Listing Rules.

1: Environmental information: Do investors need to know?

Recent years have seen a rapid growth in interest from institutional investors in social and environmental issues. This has been driven by a number of factors, including regulation; interest in socially responsible investment (SRI, now increasingly called sustainable and responsible investment); evidence of the performance impacts; the rising prominence of corporate governance and risk management; ongoing concern about whether short-term factors are too dominant in the market; and new concepts of investment management – ‘the universal investor’. It has been reinforced by a number of initiatives involving investors and financial institutions.

While a wide range of individual issues are covered by the term “environmental and social”, climate change is an area that many have identified as a key issue, and has spawned a number of significant finance-related initiatives. We use climate change as a case study.

Regulation

One of the most fundamental reasons why investors are paying greater attention to social and environmental issues is because they are increasingly required to do so. In 1999 the Government introduced a regulation (under the 1995 Pensions Act) – commonly called the “SRI Disclosure Regulation”. This requires the trustees of pension funds, in their Statement of Investment Principles, to state their policy on:

“the extent (if at all) to which social, environmental and ethical issues are taken into account in the selection, realisation and retention of investments”.⁵

This regulation, which came into force in July 2000, requires pension funds and their fund managers to consider social and environmental issues in greater depth than previously. In particular, ever mindful of their duties to maximise returns to investors, they have focused on where such issues may have an impact on performance.

It is worth noting that this regulation has been copied to some extent by a number of other governments, including France, Germany and Australia.

Market interest

There has been steadily growing interest in ‘ethical’ or socially responsible investment funds, by both retail and institutional investors. This is creating a significant sector of the investment market specifically mandated to take account of social and environmental issues in investment management and stock selection.

The ‘visible’ retail market is put at some £3.8bn⁶ (unit trusts, OEIC, personal pension plans etc). To this must be added a significant amount of funds under private discretionary management. The institutional market is difficult to assess, but a growing number of religious, charity and local authority pension funds have allocated some or all of their funds to some form of formal SRI fund management (as opposed to factoring social and environmental issues into corporate governance or conventional investment management) and probably total in excess of £40bn. Including those fund managers factoring social and environmental issues into corporate governance or conventional investment management takes the figures to in excess of £300bn.⁷

Thus, there is a significant proportion of the market with an explicit interest in social and environmental issues, but whose needs are completely ignored by the current Listing Rules.

Furthermore, this represents only a fraction of the potential. Surveys indicate a considerable level of interest among end investors. For example, in an NOP survey for the research organisation EIRIS, 77% of respondents (adults with an occupational pension scheme) agreed with the statement that their pension scheme should operate an ethical policy whenever it could do so without reducing financial return issues.⁸ Other studies have indicated a very high level of potential interest among retail investors in socially responsible investment products. A number of factors are likely to lie behind this unrealised potential – a lack of awareness about product availability among advisors, confusion over the performance implications, and a limited commitment by fund managers. Whatever the reason, there appears to be a significant mismatch between what investors want and the way funds are managed, something which should be of concern to the Financial Services Authority. One way would be to address the provision of environmental and social information at source, which would not only give fund managers the information they need to be able to address these issues, but would also send a signal to the investment community more generally that these issues are significant and worthy of attention.

An area where consumer pressure is already affecting behaviour is within the life insurance companies. Like many businesses with a consumer focus, they are becoming increasingly aware of the importance of corporate social responsibility to their reputation and business. For a life insurance company how they invest their money is a critical factor in any CSR activities. As a result a number of life insurance companies are keen to be seen as responsible investors, and have developed activities in the area of CSR.

The public is clearly generally in favour of greater environmental and social reporting by companies. According to a recent survey by the Government, 71% of the public would support a policy that asked “all businesses to report on their impact on the environment”.⁹

Changing performance drivers

Another reason for increased interest in social and environmental issues are changes in the markets and in value drivers. Markets are increasingly recognising the importance of non-financial factors, with factors such as brand value, reputation and intellectual/human capital becoming important in assessing and valuing companies. The premium of market capitalisation to net asset value has increased substantially over the last couple of decades (although declined from its peaks with recent market falls). Many of these factors relate directly or indirectly to social and environmental issues. Increasingly fund managers appear willing to accept the basic proposition that social and environmental performance can have an impact on value, even if the exact nature of the relationship can at times be illusive. For example, in research with investors on health and safety indicators, all the respondents were broadly supportive of the proposition that good health and safety management was an indicator of good overall management.

Increased interest in environmental and social factors was confirmed in a study by the business-led group Business in the Environment (BiE). Their report, *Investing in the Future*,¹⁰ published in May 2001, draws on the results of a MORI survey commissioned by BiE and supported by Association of Chartered Certified Accountants, CGNU and the Environment Agency. The research covered interviews with over 200 analysts,

investors, investor relations managers, city and business journalists. *Investing in the Future* found a growing interest among sell-side analysts in environmental and social issues compared with 1994. When asked directly about the importance of environmental factors, 33% of analysts said it was “quite or very important” in their evaluation of companies in 2001, compared to only 20% in 1994. The figures for social issues have increased by an even wider margin, from 12% to 34%. For investors, the figures were higher, with 38% believing social issues, and 40% environmental issues, were “quite or very important”. Most agreed that an emphasis on environmental and social performance indicates a company which is forward-looking and actively managing its reputation. In particular, integrating environmental, social and financial strategies is highly rated in assessing companies, with 53% of analysts and 54% of investors rating such a vision as “quite or very important”.

Governance and risk management

Recent collapses of major companies have only highlighted the importance of good corporate governance, a fact long recognised by the UK investment community. The Combined Code is now integrated into the Listing Rules. Institutional investors have recently started to recognise social and environment issues can naturally be brought into the governance framework, with larger investment managers such as Hermes Pension Management Limited¹¹, Morley Fund Management¹² and Henderson Global Investors¹³ updating their corporate governance policies to include explicit mention of social and environmental issues.

The foundation for much of this activity is the *Turnbull Report* on internal controls.¹⁴ This calls on companies to identify significant risks, to develop a system of internal controls to manage those risks and to report to shareholders on the adoption of such a system. However, it does not specify what risks should be considered or specify detailed disclosure – and so many companies have produced very similar and rather meaningless reports on internal controls. As a result, some investors are seeking more detailed disclosure, especially on environmental and social factors which can present significant risks, but which until now have been the subject of limited disclosure. In effect, the question is whether the environmental and social governance implicit in the Combined Code should be made more formal through amending the Listing Rules, as the current approach rarely leads to meaningful disclosure.

The most notable initiative in this area has been by the Association of British Insurers, the industry body for the life insurance industry. It issued a set of *Disclosure Guidelines on Social Responsibility* in 2001. The full guidelines are in Appendix A1; the following is an extract:

With regard to policies, procedures and verification, the annual report should:

2.1 Include information on SEE [social, environmental and ethical]-related risks and opportunities that may significantly affect the company’s short and long-term value, and how they might impact on the business.

2.2 Describe the company’s policies and procedures for managing risks to short and long-term value arising from SEE matters. If the annual report and accounts states that the company has no such policies and procedures, the Board should provide reasons for their absence.

These disclosure guidelines are targeted at annual reports rather than the Listing Particulars of companies. This is the area that institutional investors can directly influence through corporate governance, in particular, the annual vote on the accepting

of report and accounts. They have been widely adopted not only by life insurance companies, but also by fund managers and institutional investors.

In one of the strongest confirmations of the importance of environmental and social issues, a number of institutional investors have indicated that they will start to vote against the annual report and accounts if there is inadequate reporting on environmental and social issues. Morley Fund Management introduced a policy on these lines in 2002, and it has since abstained or voted against accepting the annual report and accounts of some 20 UK companies because of their failure to produce environmental reports.¹⁵

Financial sector initiatives

Building on the various drivers discussed above, a number of private sector initiatives have emerged to provide a focus for considering the role of social and environmental issues in the financial sector.

The United Nations Environment Programme (UNEP) Financial Initiative dates back to 1992 when the UNEP Statement by Banks on the Environment and Sustainable Development was launched in New York. Insurers followed in 1995, and now over 275 financial institutions work with the Initiative, including a considerable number of UK organisations.¹⁶ The 'Statements', signed by the members, recognise that identifying and quantifying environmental risk should be part of the normal process of risk assessment and management, and encourage the development of products and services which will actively promote environmental protection.

Another more recent initiative is the London Principles, launched at the Rio+10 summit in South Africa as part of the British Government's contribution.¹⁷ The project was backed by the City of London Corporation and the Department For Environmental and Rural Affairs (DEFRA), and supported by the Prime Minister. It aimed to examine the role of the UK financial services sector in promoting sustainable development, to compile a compendium of best practice, and to put in place mechanisms to ensure continual progress, including the development of a set of seven London Principles. These have gained a number of major financial institutions as signatories.

UK Members of the UNEP Financial Institutions Initiative.

Abbey National Plc.
Barclays Group Plc.
AVIVA Plc.
Cooperative Bank.
Co-operative Insurance Society Ltd.
Friends Provident Life Office
HSBC Holdings Plc.
Legal and General Group Plc.
Lloyds TSB Bank
NatWest Group
NPI (part of the AMP Group)
Prudential Plc.
Royal Bank of Scotland Plc.
Standard Chartered Plc.
Sumitomo Marine & Fire Insurance Co. (Europe)
Woolwich Plc.
Aon Group (Associate)
Barlow Clyde & Gilbert (Associate)

In addition, many overseas organisations with significant presence in London are members, such as Deutsche Bank and Credit Suisse

A number of the Principles depend on the availability of the environmental and social information. Prices cannot reflect environmental and social risks (Principle 3) unless they are known, nor can investors exercise responsible equity ownership without knowing about a company’s activities. The Prime Minister, Tony Blair, has stated: “I fully support the ambitions of the London Principles project and believe that the UK will be showing the world community the future for financial services.”¹⁸ Yet it is difficult to see how these ambitions can be fulfilled if investors do not have access to the basic raw material they need – information. Furthermore, as we discuss later, in the area of Listing Rules and information disclosure, the UK is far from leading the way.

<p>THE LONDON PRINCIPLES Signatories agree, where relevant to the product and geographical scope of their business, to:</p> <p>Economic Prosperity Principle 1 Provide access to finance and risk management products for investment, innovation and the most efficient use of existing assets Principle 2 Promote transparency and high standards of corporate governance in themselves and in the activities being financed</p> <p>Environmental protection Principle 3 Reflect the cost of environmental and social risks in the pricing of financial and risk management products Principle 4 Exercise equity ownership to promote efficient and sustainable asset use and risk management Principle 5 Provide access to finance for the development of environmentally beneficial technologies</p> <p>Social development Principle 6 Exercise equity ownership to promote high standards of corporate social responsibility by the activities being financed Principle 7 Provide access to market finance and risk management products to businesses in disadvantaged communities and developing economies</p>	<p>Signatories to the London Principles ABF Capital Management ADAM Allianz Dresdner Association of British Insurers Apax Partners Co-operative Bank Co-operative Insurance Society Friends Ivory & Sime Friends Provident Jupiter Asset Management Morley Fund Management Henderson Global Investors Quadris Environmental Investments SG Asset Management Storebrand UK Social Investment Forum Universities Superannuation Scheme</p>
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Several other activities and initiatives are encouraging or supporting financial institutions to consider environmental and social issues. The UK Social Investment Forum (UKSIF) now has more than 30 fund management members, of which the vast majority are mainstream institutions.¹⁹ The FORGE initiative on financial sector environmental management and reporting has high-level backing from several institutions²⁰. Networks such as the Local Authority Pension Fund Forum²¹ and the informal Responsible Investor Forum (of major institutional investors) are looking at issues of corporate social responsibility and governance, often with a focus on encouraging disclosure.

Short-term focus?

It could be argued that one of the key problems with the current Listing Rules is that they place an unbalanced emphasis on the short-term. The Listing Rules cover, in some detail, aspects such as disclosure of the activities of the group, recent financial statements and trading position, current directors and management etc. In contrast, the only area where some detailed attempt is made to look forward is in paragraph 6.G.1(b) and this is very brief, general in nature, and seems to emphasis looking forward only up to one year.

There has been a continuing concern in the UK about the short-term focus of British financial markets and investors, which are seen as having potentially adverse impacts on the long-term growth of the UK economy and its competitiveness. Furthermore, many investors do have a long-term focus, which can span decades. Indeed, such investors (notably pension funds and insurance companies) account for a very substantial part of the ownership of the UK stockmarket. However, in the absence of information that enables them to take a longer-term view, it is almost inevitable that many find it easier to focus on short-term results.

Some long-term investors are starting to express concern that an excessive short-term focus, to some extent brought about by brokers and short-term trading activity, may not be the best way to generate long-term value. For example, Hermes Pensions Management have recently stated: “What can cause problems is if the attention given to short-term performance distracts company managers from the goal of creating long-term shareholder value.” While the causes of short-termism are complex, and also include cultural and market factors, the current Listing Rules represent a key area where a short-term focus is essentially written into official regulation.

This short-term focus in disclosure is particularly ironic given that companies are brought to market with a valuation of many times current earnings. Currently the market is trading on an overall Price Earnings ratio of around 18 which implies it will take 18 years of current earnings merely to repay the price, without generating any return – and many new issues involve an even higher ratio. Even allowing for some growth in earnings it will still be a decade or more before companies cover their valuation with earnings. This implies that some degree of long-term perspective is clearly justified.

It appears perfectly possible for companies to provide a longer-term discussion of their business, including potential growth rates (and over what period), the assumptions underlying growth rates, and the risks to those assumptions, including possible social and environmental constraints. Such a discussion would be useful, particularly at first listing.

Most recently, the dot-com bubble provides a clear example of the risks that can arise when short-term behaviour is extrapolated into the future. Some form of longer-term discussion might well have curbed the worst excesses of that speculation.

One argument in defence of the current system could be that that asset values can provide a longer-term perspective on the share price, as they indicate underlying value regardless of current performance. However, firstly, as mentioned earlier, many companies trade at a significant premium to net asset value – and the average premium has increased substantially over the last 20 years (although it has declined recently). Secondly, asset values can be highly misleading. Even relatively tangible assets such as capital equipment can have a book value significantly different from the actual value to the business, and less tangible values can be even more vulnerable. Thirdly, asset values can be directly affected by social and environmental issues, either directly, e.g. through environmental liability or through becoming obsolescent on environmental grounds, or more indirectly, e.g. the impact on reputation and goodwill. Thus, even when an asset value based approach to company valuation is taken, there is still a need to consider social and environmental factors.

Universal investors

Another way in which investors are beginning to see the relevance of the social and environmental investors is through the concept of the “universal investor” (or global

investor). This recognises that most modern institutional investors essentially invest across the economy – in most listed companies and all sectors – and increasing across the globe. As a result, the most important factor in ensuring successful long-term investment is likely to be long-term sustainable growth in the economy as a whole, rather than individual stock selection. Investors have a substantial degree of common interest with the economy as a whole, and should consider taking action to ensure help ensuring a framework that enables long-term sustainable success.²²

This puts the social and environmental impacts of companies in a very different light. From the traditional viewpoint, it may be of limited concern whether a company externalises its social and environmental impacts as long as its financial results are not impacted. But a universal investor will recognise that a company that does so will impose costs on the rest of the economy, adversely affecting long-term economic growth and so damaging returns in the rest of the portfolio. (For example, if the cost of remedying the damage caused falls on the public purse, one consequence may be higher taxes, which will result in lower growth.) As a result, universal investors are likely to be interested in understanding the external impacts of their investee companies, and in encouraging both company and public policies that reduce these impacts and make the economy more efficient.

The concept of the universal investor is new and has not yet gained widespread acceptance. However, a number of leading institutions have expressed some interest in the idea and are exploring how it might be implemented in practice.

Stakeholder interest

A growing number of other stakeholders are calling for greater disclosure in the Listing Rules, both government agencies and non-governmental organisations.

The Environment Agency has actively called for greater disclosure of environmental factors by companies. In their submission to the Company Law Review²³ (see appendix A6) the Agency stated that it considers that companies that actively reduce environmental risks and impacts are more sustainable, profitable, valuable, and competitive. The Agency recommended that companies with over 250 employees should be required to report on how they have assessed and managed environmental risks and describe their environmental performance in their statutory annual report and audited accounts. This is to enable shareholders, stakeholders, investors, employees, customers, and the general public to be assured that environmental risks have been properly managed and reduced.

The Agency also recommended:

- Companies and directors should disclose environmental convictions.
- Companies should set targets and report on historic trends for key indicators of environmental performance that includes verified emissions to air, land and water.
- Companies should use their financial systems to disclose revenues and value derived from the environment.
- Environmental performance statements should be audited and verified.

The Agency is seeking to apply these principles to its own corporate governance, to those companies it regulates, and to companies in which its Pension Fund Managers invest. Its Pension Fund Managers will vote against the approval of annual reports and accounts at the AGM's of UK companies that do not comply. In addition, in a speech to the City, Howard Pearce, now head of Environmental Finance at the Environment

Agency, has called for greater disclosure of environmental liabilities specifically in the Listing Rules.

The Health and Safety Executive are developing activities to work with investors to promote attention in the boardroom to issues of health and safety, and commissioned a report earlier this year to look at health and safety indicators for investors called *Health and Safety Indicators for Institutional Investors*.²⁴ According to the Commission Chair, Bill Callaghan, "Investors, by having access to accurate information on health and safety performance, will be in far better position to judge a company's effectiveness in meeting its business and social goals, as well as compliance with the law. The economic case for improving the management of occupational health and safety remains as strong as ever. More and more businesses are now convinced of the strength of this case. [...] We call on business and investors to support us in our efforts to promote greater corporate responsibility."²⁵

NGO interest has also been considerable. The Just Pensions project established by Traidcraft and War on Want has sought to work with the pensions industry to enhance the integration of social and environmental issues into the management of pensions funds.²⁶ Working with a high level advisory committee of investment professionals and NGOs, Just Pensions described reporting of Corporate Social Responsibility as "Important in enabling a continuous improvement process to be monitored, and ensuring accountability to stakeholders".²⁷

Another campaign calling for enhanced disclosure is the Publish What You Pay appeal.²⁸ This coalition of more than 40 international NGOs, including Global Witness, Save the Children, CAFOD, Amnesty International, Christian Aid and Friends of the Earth from the UK, is calling for compulsory reporting by resource companies of their payments of tax and royalties to individual governments. The purpose is to help combat corruption in developing countries, and enable citizens to hold governments accountable. The appeal has gained the active support of the financier George Soros. The principle of enhanced disclosure in this area was also endorsed by the Prime Minister at the Johannesburg Summit, although he supported a voluntary framework. Five major companies, including minerals giant Rio Tinto and oil companies Shell and BP, are reported to be backing the 'transparency initiative'.²⁹

Case study: Climate change

Climate change is generally acknowledged to be one of the biggest social and environmental issues facing business and society in the 21st century. Governments have recognised the importance of climate change, notably when the majority of governments signed the Framework Convention on Climate Change (UNFCCC) at the Rio Earth Summit in 1992. International negotiations on climate change have continued since then under the UNFCCC, leading to the development of the Kyoto Protocol in 1997. National governments have developed climate change action plans. Business also recognises the importance of climate change. For example, at the 2000 World Economic Forum, business leaders voted climate change as the most significant issue facing business in the 21st century.

Investors have also increasingly recognised the importance of climate change. A number of investor-related initiatives have been developed.

The United Nations Environment Programme Financial Initiative has three working groups, one of which is on climate change. This working group has been involved in the UNFCCC process, attending the various Conferences of the Parties. It has been involved in developing a Greenhouse Gas Indicator, for measuring an organisation's greenhouse gas emissions. It has just completed a major new study on climate change and its implications for the financial services industry: *Climate Change and the Financial Services Sector*.³⁰ This found that climate change was a "major risk to the global economy", and the financial sector has a key role to play in addressing the challenge, particularly in delivering market solutions. However, it identified a number of cognitive, political, analytical and market operational barriers that have prevented the financial sector from earlier engagement with climate change. Among these is the fact that "poor data availability on corporate climate change strategies makes the analysis of potential company risks very difficult". The report recommended that asset managers and pension funds "extend engagement with companies to include climate change-related issues and encourage them to improve disclosure of potential carbon assets and liabilities". The report went on to make recommendations for policy-makers, including that governments in industrialised countries should "show securities and exchange regulators the need for greater transparency and disclosure regarding the implications of future climate-related impacts and GHG regulations on the risk profiles of listed companies and of debt or equity issues".

One of Britain's biggest pension funds, the Universities Superannuation Scheme, commissioned a study of the risk management implications of climate change, *Climate Change — a Risk Management Challenge for Institutional Investors*.³¹ The study found that climate change was a major emerging risk-management challenge for institutional investors. The report recommended 10 action points for investors. One called on investors to engage with companies on the need to report on their climate change exposures and the management's response. As a result of that study, it was decided to form an informal investors group to continue exploring the impacts of climate change and how investors should respond. That group now has 12 members, with over £300bn of assets under management.

A large international group of institutional investors, with assets under management of around US\$4 trillion, supported the Carbon Disclosure Project (CDP)³². Launched in May 2002 the project has substantial UK support. According to the project co-ordinator, "there are potential business risks and opportunities related to actions stemming from the perception of climate change that have implications for the value of shareholdings in corporations worldwide". The CDP wrote to the 500 largest quoted companies in the world by market capitalisation asking for the disclosure of investment-relevant information concerning their greenhouse gas emissions (see appendix A5 for this). The data will be used to compile a sectoral analysis and investment report.

A number of major investment institutions have also conducted their own research on climate change and affected sectors. They include Friends Ivory & Sime, Henderson Global Investors, Co-operative Insurance Society and Morley Fund Management. Morley in its

UK* supporters of the Carbon Disclosure Project

Abbey National
Allianz / Dresdner,
Baillie Gifford & Co
Central Finance Board of the Methodist Church,
Clerical Medical Investment Management
Cooperative Insurance Society
Credit Suisse Group,
Henderson Global Investors,
Jupiter Asset Management
Local Authority Pension Funds Forum,
Legal & General,
Merrill Lynch Investment Management
Morley Fund Management,
Newton Investment Management
Societe Generale Asset Management UK
Storebrand Investments
Swiss Re Asset Management,
Threadneedle Investments,
UBS Global Asset Management (UK),
Universities Superannuation Scheme

**Includes institutions where support is coordinated from the UK or with significant UK presence.*

forthcoming study states that deficiencies in the disclosure of information on climate change exposures and greenhouse gas emissions make analysis of climate change risks impossible and conclude that there is a need for greater disclosure.

It is worth noting that investor interest in climate change is not limited to the UK. Investment institutions on the continent, notably the large reinsurers – Munich Re and Swiss Re, have increasingly become interested in climate change and its implications. In the US, investor interest has also been growing, despite the non-participation in the Kyoto Protocol. One example is a major report commissioned for the Coalition for Environmentally Responsible Economies (CERES) Sustainable Governance Project: Value at Risk: Climate Change and Future of Governance.³³ The report recognised that climate change presented a substantial risk to investment across a range of sectors and that, among other points, for fiduciaries to fulfil their duties they must “Request – and, if necessary, demand – greater disclosure of climate risks by companies wishing to be considered as investment candidates”.

Overall it is clear that increasingly investors are recognising that climate change is a significant risk issue and adequate disclosure is necessary if they are to be able to maximise their performance and meet their other obligations to investors. Thus, information on climate change exposure appears to be very much the sort of information that investors would ‘reasonably require’, to use the legal test for disclosure.

Summary: Disclosure is the key

What this study makes clear is that there are multiple pressures, which require investors to look more broadly at a range of issues. Rising interest in social and environmental issues comes not from a single source but from many. One recurrent theme, however, emerges clearly. Enhanced disclosure of social and environmental issues is at the core of investors’ concern. Without such disclosure, investors cannot be sure they are taking all financial factors into account, nor that they are meeting their fiduciary responsibilities or the needs of their clients. Access to such information is not impossible, as many progressive companies show. But, information on social and environmental factors remains frustratingly inconsistent in its availability, consistency and comparability. In this situation there appears to be a strong case for regulatory intervention. And in particular the FSA, as the listing authority, should take the lead in ensuring that such information is made available.

2: Financial impacts of environmental / social performance

The case for environmental and social disclosure is made much stronger if such issues have an impact on business, financial performance and the share price. The nature of such a link has been the subject of much debate and analysis.

At a theoretical level environmental and social issues can impact on the financial success of a business in a number of ways – see the table below. It is essentially the aim of environmental and social disclosure to provide investors with some insight into how important these factors are and to identify what their impact may be on the financial performance, particularly in the long-term.

Establishing evidence for a link between environmental / social impact and investment performance is challenging, not least because the availability of environmental and social information has been erratic. Other challenges include the fact that in many of the examples of SRI investing, funds are involved where key portfolio decisions are made for explicitly ethical rather than what could be termed ‘argued financial’ reasons. Similarly, there is a need to allow for other investment factors such as style biases – for example, many social and environment investors have essentially a growth bias.

At a portfolio level a number of studies have looked at the impact of screened portfolios or the performance of indices. Two recent general studies which provide an overview of the substantial body of work in this area are the Co-operative Insurance Society study, *Sustainability Pays* produced by Forum for the Future³⁴, and *The Environmental Fiduciary* produced by the Rose Foundation.³⁵

One of the most robust observations comes from the US. The performance of the screened index, the Domini 400, which is a widely based index of large cap stocks, screened for social and environmental issues, and which is broadly intended to act as an alternative to the S&P 500. It has the advantage of a long live history, having been established in 1991. It outperformed the S&P 500 significantly during the first 10 years of its existence, but has underperformed in the last two years, although it is still well ahead since its inception. Much of the outperformance appears to be due to an emphasis on growth and technology stocks. It is not clear whether there is an underlying effect beyond this, but nonetheless, investing in Domini 400 would have been a successful long-term investment option.

Studies of the various ‘ethical’ funds have generally found no significant effect on returns, although this does depend on the timeframe examined. Some impact is found on volatility, with an increase in relative risk to an index, but surprisingly no increase or even decrease in absolute levels of volatility. However, in focusing on the needs of their motivated retail investors, to some extent these funds have not sought to control relative risk or they have sought to manage the screens with a view to financial performance. Unfortunately there are relatively few examples from institutional SRI, where investors have had to operate under fiduciary responsibilities and manage risks. One example however, is provided by the Central Finance Board of the Methodist Church which has produced excellent long-term returns while operating an ethical policy of some complexity. Risks analysis has shown this appears to be genuine ‘alpha’. According to Russell Sparkes, European Fund Manager, the managers believe this outperformance has arisen because their social and environmental analysis gives them additional insights into the company management.

LINKING ENVIRONMENTAL/SOCIAL AND FINANCIAL PERFORMANCE³⁶

Operation Factors	Environmental and social factors can directly influence the operating margins of a company. The production of waste or the inefficient use of energy is not only environmentally unsound but also bad financially.
Management Quality	Environmental and social issues present management with complex, multidimensional problems. Management that can address these challenges well are likely to be good managers. Conversely environmental problems can serve to divert management time.
License to Operate	In extremis a bad environmental or social record can threaten a company's or an industry's 'license to operate'. Initiatives by the chemical industry such as 'Responsible Care' sprang out of a fear that the sector could lose its license to operate in the eighties. The genetically modified food sector is currently facing a similar challenge.
Balance Sheet Implications	Environmental and social factors can impact on the value of assets. Environmental contamination can affect property values. Legal liability arising from the company's activities (processes, products, employment practices etc.) can seriously damage the company's asset base. Environmental and social factors can render assets obsolescent.
Reputation Risks	For many companies, business success is built around the ability to leverage brand value and reputation. Social and environmental factors can directly damage reputation brand value. Many companies, particularly retailers, are thus concerned about managing environmental and social risks, including along the supply chain. Companies such as Nike and Gap have experienced significant reputation damage from being targeted by campaigners.
Human Capital	Businesses increasingly recognise the importance of human capital for success. Management of such capital is itself important – e.g. through training - while a company's broader environmental and social behaviour can directly influence staff motivation and recruitment.
Event Risks	Disasters or other high profile events can immediately damage a company's business and share price – as investors respond to the potential for liabilities and damage to reputation.
Strategic Risks and Opportunities	Environmental and social factors can create long-term social and environmental challenges including changing demand for certain products, changing processes and raw materials etc.

Many of the academic studies have looked at the question of whether environmental performance leads to financial outperformance (or underperformance). Few have found evidence that underperformance results. Several have found some evidence of outperformance. Most have found no clear evidence or statistically insignificant results. However, some studies using some of the more sophisticated analysis of social and environmental factors are showing potentially more positive results. For example one study looked at the impact of Bank Sarasin environmental ratings. They found that the ratings could explain a substantial part of the outperformance of a portfolio of European Stocks. While this effect was weak across the whole market, it was very significant for sectors such as pharmaceuticals and chemicals.³⁷

One of the more compelling analyses has been conducted by Innovest Strategic Value Advisors. Their research on environmental performance of companies is explicitly focused on identifying links to financial outperformance. In a test of their environmental analysis, they set out to eliminate all factor biases in the model portfolio. They found that on average their model portfolio substantially outperformed the S&P 500 between 1997 and 2000 – producing a return of 3.4% in 2000, compared with a fall of 9.1% in the S&P.³⁸

Tangible realisations of how much the bottom line can be affected by addressing environmental issues can be seen with many companies. In 1975, 3M adopted its

voluntary Pollution Prevention Pays (3P) programme, based on the then novel idea that pollution prevention is both an environmental and a competitive/ financial strategy. From 1975 – 1999, 3P has prevented 807 000 tonnes of pollutants and saved US\$827 million.³⁹ Similarly, Chevron (now ChevronTexaco) began tracking its energy consumption levels in 1991. By focusing on energy efficiency, as well as other waste minimisation and environmental risk control measures, it saved US\$1.55 billion from 1991 to 2000.⁴⁰

Counterfactually, a number of companies have seen significant damage to their assets from environmental liabilities. Most notable have been asbestos related liabilities, which have affected many companies including blue chip names such as ABB. A recent and very relevant example is Alfa Laval, the Swedish engineering group, whose shares dropped 32% after news emerged of its potential exposure to asbestos claims in the US. Notably, it admitted on Monday 18th November 2002 that it was aware it was facing asbestos claims at the time of its May IPO, but said they were not mentioned in its prospectus because they were considered “immaterial” — the company believes the claims against it are without merit. However, shareholders who bought Alfa Laval shares in the IPO (and now face major losses) may take the view that some disclosure should have been made. According to press reports, some Alfa Laval shareholders are considering whether they have grounds for legal action.⁴¹

Determining the nature of the link between environmental and social performance and investment returns is difficult. This should come as no surprise. After all, the market is reasonably efficient and there is a huge volume of data that could have an investment impact, and should be considered in any analysis, therefore establishing the link between even common financial data and investment returns is difficult. There can be little doubt that environmental and social performance can have an impact on investment returns, even if the nature of the link can be elusive at a general level. Investors can sensibly and reasonably ask: “How are the social and environmental impacts of a company likely to affect its financial performance?” On that basis, the authorities can reasonably be expected to ensure that investors have access to the information they need to make that assessment.

Case study: Climate change and shareholder value

Climate change represents one of the most significant and wide-ranging challenges for business, both in its direct impacts and as a result of measures to ‘mitigate’ climate change. It could have a major impact on shareholder value, as well as governance implications.

The direct impacts of climate change are expected to include rising sea levels, generally warmer weather, extremes of precipitation, with major floods becoming more likely, and potentially more storms and hurricanes. The consequences will affect a number of sectors. The insurance sector is most likely to face the major impacts, as it bears the cost of major weather events. According to the recent UNEP Financial Initiative study, “the increasing frequency of severe climate events, combined with social trends, has the potential to stress insurers, re-insurers and banks to the point of impaired viability or even insolvency.”⁴² The report warned that worldwide economic losses due to natural disasters, on current trends, will reach almost US\$150bn annually in the next decade. Re-insurers in particular have become very concerned about the risks of climate change and have made significant efforts to understand the risks of climate change. Nonetheless, they have warned that climate change presents potentially a greater risk that they can manage or cover.

Other sectors may also be affected by climate change considerations. Property is probably the next most significant area. Asset values could be significantly altered if property becomes vulnerable to flooding or other risks, particularly if insurance becomes harder to obtain. Insurers are increasingly taking a tough view on these risks and so impacts on value are likely to follow. Property may also be significantly affected by climate change mitigation measures (see below). A changing climate is also expected to have significant impacts in many other sectors, ranging from textiles to tourism, although quantifying and measuring these impacts is challenging.

Climate change mitigation — the reduction of emissions of greenhouse gases, notably carbon dioxide — may be even more challenging for business and significant for shareholder value. All businesses use energy to some degree, and are directly responsible for a significant proportion of greenhouse gas emissions. And even where they are not directly responsible, they often have an indirect responsibility – most notably through emissions arising from the energy their products use (e.g. automobiles, domestic energy use). Business is also heavily involved in other contributions to greenhouse gas emissions, such as halocarbons, methane emissions (e.g. from coal mining, and oil and gas exploration) and the impact of land use changes and deforestation.

Significantly, policy measures are now starting to limit these emissions, and most importantly place a value on them. Internationally, the Kyoto Protocol sets legally binding targets for developed countries to reduce their emissions. At a UK level, policies such as the climate change levy and the UK emissions trading scheme serve to place a cost on greenhouse gas emissions, or a value on emissions reductions.⁴³ And at a European level there are advanced proposals for a European emissions trading system.⁴⁴

As these policies start to place a direct value on greenhouse gas emissions, so emissions move from matters that are indicative and useful but not immediately financially relevant, to matters that need to be directly recognised in the financial statements and accounts of the company. This is an area where practice is only just being developed but a study by a major accountancy firm for emission trading industry has looked at what it believes standard practice should be.⁴⁵ Based on existing accountancy principles, they suggest that:

- Emissions allowances should be recorded as current assets (even if at nil cost);
- Emissions should be recorded as liabilities in the balance sheet;
- Financial incentives should be recorded as contingent assets in the balance sheets;
- Carbon is an emerging risk that requires a clearly defined risk management policy, including providing shareholders with “clarity over whether the allowances are being held for hedging or speculative purposes as the risk profile of the company, and its financial results, are directly affected by these choices”.

Currently, emissions trading markets are developing rapidly and companies are acquiring significant liabilities and assets as a result of these commitments. It is important that disclosure standards keep up with these developments to ensure investors are properly informed.

A number of studies have looked at the impact of the climate change mitigation measures on shareholder value. Two studies have taken a macro-economic approach looking at sectoral impacts in the US of climate change mitigation.⁴⁶ Under reasonable scenarios, they have found potentially significant impacts upon shareholder value. In

one, coal mining could see a fall in value of 27.8%, oil and gas 5.0%, and electricity utilities 5.4%. In the second, using a higher carbon price, the falls in value were respectively 64%, 6% and 4%.⁴⁷ The studies also investigated the potential for policies to neutralise some of these impacts, but it is clear that substantial risks exist.

The impacts on the coal mining industry are most dramatic, but are not surprising in view of the fact that a tax on carbon dioxide emissions of US\$25 essentially increases the cost of burning coal by US\$75 dollars a tonne – two to three times the current market price. For the coal industry, climate change presents a fundamental business challenge, directly affecting the desirability and competitiveness of their products.

The Xstrata listing and climate risks

A direct example of the weakness of the current listing regime is the listing of Xstrata plc in March 2002. Xstrata is a mining company with a large exposure to coal which makes up around 70% of earnings. The principle market for coal is for use in generating electrical power. The burning of coal produces higher levels of greenhouse gases than does the use of alternatives such as natural gas. Hence, any agreements restricting greenhouse gas emissions such as the Kyoto Protocol are of significance to Xstrata. The Listing Particulars failed to recognise these risks, and downplayed the potential impact for investors. *The Xstrata Listing: An Analysis of Climate Risks*, a recent analysis of its Listing Particulars, identified serious shortcomings, with some 30 specific failures of the rules cited.⁴⁸ Recent events have confirmed the risks identified, with the share price falling (and falling relative to the market) and the share price specifically reacting to news stories of a potential Japanese coal tax, falling some 12% over two days.⁴⁹ Such a tax was predictable, given Japan's commitments under the Kyoto Protocol, and the listing particulars should have disclosed risks in this area.

Other analysis has focused on the oil and gas sector. A recent study by the World Resources Institute took a scenario-based approach. It assessed the aggregate impacts on shareholder value of oil companies of a fall between 1 and 5%, with the major oil companies typically seeing a fall of 2%. This focused on the direct impact of Kyoto and associated mechanisms.⁵⁰ Other analysis has looked more broadly at the impacts of oil major, ExxonMobil.⁵¹ With this company the picture is complicated by its aggressive involvement in climate change lobbying, which appears to have created additional risks to reputation and in terms of legal liability. Analysing it as a governance issue, the company did not seem to have justified its actions in terms of shareholder value, and was ignoring several possibilities for win-win policies. The report, written partly in support of shareholder resolutions the company was facing, convinced the mainstream governance organisation, Institutional Shareholder Services, to recommend support of one of the resolutions (on renewable energy).

The third sector that has seen significant analysis of the impact of climate change mitigation policy is the utilities sector. A key interest here is that the impact may vary significantly between companies. This is because the amount of greenhouse gas emissions involved in generating electricity varies widely from near zero, in the case of renewable energy, to significant, in the case of coal-fired power. As a result some utilities may not be able to pass on the costs of their greenhouse gas emissions, with major impacts on margins and profitability. One study in the US identified that the potential impact of a carbon tax could vary substantially – between 11.5% of current market value at American Electric Power to 0.9% at Exelon.⁵² Another major study has looked at the impact of the proposed European emissions trading regime on the European power sector, simulating the impact of emissions trading at an individual plant level on operation, investment and closure.⁵³ The study identified major shifts in operational patterns, with load factors at certain plants falling sharply, leading to falling

and even negative cash flow. Potential for significant plant closures was identified (totalling 38GW by 2010 in one scenario), with old or heavily leveraged coal and oil-fired power stations being most vulnerable. Although the study did not go on to look at the potential impact on shareholder value for the main companies, it is likely to be significant. Despite this, it does not appear that any European power utilities have disclosed the potential impact of emissions trading on their business.

Other sectors are also likely to be affected by climate change, but in many cases the impacts may be difficult to assess and evaluate. In many cases climate change may affect the demand for their products, as either consumer preference or regulation makes the energy efficiency of their products a significant purchasing factor, which may affect the competitive position of their products (e.g. automobiles). In other sectors, it may influence the relative attractiveness of a product once emissions costs are included (for instance, wood based products may gain relative to metals). In some sectors, such as construction, the impacts may be complex – new opportunities, increased costs, operational impacts etc may all play a part. In these circumstances it is important that investors are informed about potential risks and what the company is doing in regard to the challenge of climate change so they can fulfil their governance function – ensuring that the Board has adequately considered the issue and has adequate policies in place.

3: Existing environmental disclosure: UK and abroad

The current listing rules

The current UK Listing Rules make no express mention of environmental and social issues. However, there are a number of areas where disclosure of environmental and social factors could, depending on the particular circumstances, be indicated under existing rules.

(1) General duty of disclosure

The first area where environmental and social issues may be relevant is the basic requirement underlying Listing Particulars as provided by UK Law, under Section 80(1) of the Financial Services and Markets Act 2000, which states that the Listing Particulars:

“must contain all such information as investors and their professional advisers would reasonably require, and reasonably expect to find there, for the purpose of making an informed assessment of-

(a) the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the securities; and

(b) the rights attaching to the securities”.

(2) The recent developments and prospects of the group

The second area where the disclosure of social and environmental factors may be indicated comes from the Listing Rules and the specification of contents of the Listing Particulars. Under Chapter 6, paragraph 6.G.1 (b) of the Listing Rules, the following information must be included in the Listing Particulars (unless otherwise agreed by the UK Listing Authority):

“Information on the group’s prospects for at least the current financial year. Such information must relate to the financial and trading prospects of the group together with any material information which may be relevant thereto, including all special trade factors or risks (if any) which are not mentioned elsewhere and which are unlikely to be known or anticipated by the general public and which could materially affect the profits.”

(3) Other areas

There are a number of other areas where disclosure of social and environmental factors may be appropriate or necessary. Under the description of the Group’s Activities (Section 6.D. of the Listing Rules), information has to be provided on any significant new products and/or activities (para. 6.D.2); the policy on research and development of new products and processes (para. 6.D.7); and information on any legal or arbitration proceedings which may have a significant effect on the group’s financial position or an appropriate negative statement (para. 6.D.8). Interestingly, the Listing Rules specify disclosure of the average numbers employed (para. 6.D.10), which can be seen as more of a social rather than a financial indicator, and provides a precedent for the disclosure of non-financial information.

Under the special rules for specific types of companies there are also areas where disclosure of environmental and social factors may be appropriate. For example, under Chapter 19 of the Listing Rules (the specific rules for mineral companies), the Listing

Particulars must contain a 'Competent Person's Report'. Under paragraph 19.15 (r) "Special Factors" this report must contain the following information:

"A statement setting out any additional information required for a proper appraisal of [...] special circumstances such as difficulties in transporting or marketing the extracts which may affect the commercial viability of the project, or an appropriate negative statement."

(4) Ongoing information

Chapter 12 of the Listing Rules concerning "financial information" also contains rules on the provision of information in the annual report. There is little mention of social and environmental issues. The main area of significance is that covering corporate governance and directors' remuneration. This provides a link to the Combined Code, provided as a supplement to the Listing Rules. It is worth noting that the Listing Rules do not specify compliance with the Combined Code. Instead companies are required to disclose how they applied the general principles laid out in the Combined Code, together with a statement on whether or not they have complied with the specific provisions in the Combined Code and reasons for any non-compliance.

Although the existing regulations do not explicitly mention social and environmental issues, there is also scope for them to be mentioned if the directors or sponsor consider them relevant for investors. However, in practice few do, even where the impacts are potentially significant. Often disclosure is only made when liabilities are materialised or business affected. Yet both the letter and the spirit of the regulations imply that some disclosure must be made when there are appreciable risks of an impact on assets, turnover or profitability, even if they are not yet materialised. "Contingent Liabilities" are usually interpreted in a very narrow sense. Alternatively some factors may be referred to, but no measurement or assessment given. Perhaps the classic example is the commonly seen statement "our greatest asset are our employees" [sic]. Curiously, given that it is the greatest asset, companies make little attempt to measure or quantify that asset and how it has changed – despite the potential to do so.

The reason for this practice is a combination of custom: "Nobody else is doing it so why should we?", and weak enforcement in this area. If regulators were prepared to press for such disclosure then companies would almost certainly start to respond – see section 5.

Changes in UK company law

Another source of regulation on disclosure is company law. This has been the subject of extensive review over the last three years, which has *inter alia*, looked at the issue of social and environmental disclosure by companies. Following the review, the Government published a White Paper on company law with a view to introducing a new Companies Act.⁵⁴ In the White Paper the Government is proposing that larger companies should be required to produce an extensive Operating and Financial Review (OFR) in their annual report. As part of the OFR proposed directors would be required to consider whether the disclosure of environmental or social information is necessary to enable shareholders to make an informed assessment of the company, including its future business strategies and prospects. The current proposed text is included below.

“73 Operating and Financial Review [OFR]”⁵⁵

[The directors must prepare an OFR and must secure that the information contained in it is such that the OFR will, in their opinion, achieve the following review objective]

- (3) The review objective is: providing such information as will permit the members of the company as at the approval date, to make an informed assessment of -
- (a) The company’s operations;
 - (b) Its financial position; and
 - (c) Its future business strategies and prospects

74 Compulsory Content of OFR

[The OFR must contain core elements including]

- (c) A fair projection of the prospects for the company’s business and of events which will, or are likely to, substantially affect that business.

75 Duty to Consider Other Matters in OFR

- (1) If the directors of a company are required to form an opinion for the purposes of section 73(2) they must consider whether the inclusion of information about any matter mentioned in subsection (2) is necessary in order to achieve the review objective.
- (2) The matters are -
- (c) the company’s policies in relation to employment by the company;
 - (d) the company’s policies on environmental issues relevant to the company’s business;
 - (e) the company’s policies on social issues relevant to the company’s business;
 - (f) the company’s performance, in the financial year to which the operating and financial review relates, in carrying out the policies mentioned in paragraphs (c) to (e);
 - (g) matters not falling within the preceding paragraph which affect or may affect the company’s reputation.”

Listing rules or company law?

The current proposed changes do make a step forward as directors are required to consider the issues as outlined. However, this is a long way short of requiring disclosure by companies as, if directors do not consider these issues material (ie relevant to business), they can still ignore them. Exactly how companies will respond is difficult to determine at present, and may depend on how actively the requirements are enforced by the proposed Standards Board. However, there must be a real concern that the new OFR will fail to result in a substantive change in the level of disclosure.

In particular, the great danger is that it is the companies with boards that are relatively dismissive about the risks and opportunities arising from social and environmental issues, and so the companies least likely to report, may be precisely the companies where there is cause for greatest concern (as it is the risks that are not acknowledged or managed that may be the most dangerous). As such, the proposed OFR would provide limited improved protection for investors. It also does not address many of the changing dynamics of investors outlined in the first chapter. For example, it does not advance the corporate governance debate beyond where it is at present – pressing companies to disclose adequately.

It is also worth noting that it is some way behind recent regulatory initiatives in countries such as South Africa, France, Norway and Denmark (mentioned later), with the result that the UK is far from demonstrating leadership in this area.

It might be argued that with changes in disclosure in the Company Law Review probable, changes to the Listing Rules are superfluous. However, there are a number of specific advantages to targeting the Listing Rules rather than the company law review, and so they should be regarded more fundamentally as complementary.

Indeed, there are several clear advantages of addressing the disclosure of social and environmental information in the Listing Rules over company law. These include:

Ensuring transactions are properly priced. The Listing Rules are particularly relevant at public offering and other major corporate events such as mergers and acquisitions. These events are not covered by the Company Law Review yet are particularly important both for investors and for addressing social and environmental issues. For investors, the terms and information given when finance is raised in the primary market will have a fundamental long-term impact on returns – disclosure once a company has listed is too late to prevent losses to the market as a whole. And if finance is raised without full disclosure, impacts can arise for the environment and society as whole, which are difficult to correct after the event.

Meeting investor needs and mobilising financiers. The Listing Rules are explicitly geared to the needs of investors. As discussed earlier, there is a growing body of investors interested in both environmental and social information. Disclosure based on the Listing Rules is likely to be more geared to investor needs, and specifically may be better able to evolve to ensure that the disclosure is relevant and meaningful to investors. Furthermore, while many investors are showing greater interest in social and environmental information, the ‘sell-side’ of investment banks and brokers has been slower to consider these issues, although there are encouraging signs of change. However, because of the role of investment banks, e.g. as sponsors in approving listing particulars, including environmental and social disclosure in the Listing Rules would be highly effective in mobilising investment banks (and their company analysts) to pay attention to social and environmental issues, assess their impact, and possibly even to take a longer-term perspective of value.

Enforcing adequate disclosure. There are more direct mechanisms for the enforcement of disclosure under the Listing Rules compared to the company law system, with the UKLA in place to review the adequacies of disclosure under Listing Rules and able to use both formal and informal mechanisms to ensure adequate disclosure. In particular, UKLA can gradually press for better disclosure.

Demonstrating international leadership. Company law is more of a national focus (although there is considerable activity at a European level), while the Listing Rules are the subject of extensive international dialogue, through IOSCO and other bodies. If the UK were to take leadership in this area it could help encourage enhanced standards of disclosure across the globe.

Practical advantages. It is likely to be some years before changes in company law take place, and then some time for guidance to be developed, good practice to be encouraged and eventually required. In contrast, developing the Listing Rules requires no change in law, can be implemented readily, effectively and a regime is in place for modifying and developing standards flexibly.

Other UK activities

Environmental reporting

The UK has taken pride from the fact that it has been in the lead in the initial development of environmental and social reporting. A significant number of leading companies report and the UK has had one of the highest reporting rates among major companies in the world. According to a recent KPMG survey, the UK has the second highest level of reporting in the world, after Japan, with some 49% of the top 100 companies producing some form of environmental or sustainability report, compared

with 36% of leading US companies and 32% of German and 21% of French. The UK has also built up substantial expertise in environmental reporting, with British accounting and consulting practices providing advice globally on reporting. The UK is also home to a number of institutions that have led the development of social and environmental reporting, such as the Centre for Social and Environmental Research (CSEAR), the Chartered Institute of Management Accountants (CIMA) and Association of Certified Chartered Accountants.

However, there is a real risk that much of the progress to date is running out of steam, with other countries instituting more progressive action, including mandatory action. The UK Government has urged companies to report, with the Minister of the Environment repeatedly writing to the top 350 companies in the UK asking them to report on social and environmental issues. This call has been endorsed by the Prime Minister, who in an October 2000 speech said: "I would also like to see more reporting on environmental and social performance. The pioneers of environmental reporting – companies like BA, BT, British Gas and BP – are seeing increasing benefits from both improved efficiencies and public image as a result. This is something that all companies should be doing and I am issuing a challenge, today, to all of the top 350 companies to be publishing annual environmental reports by the end of 2001."⁵⁶ Despite this pressure from the Prime Minister for greater disclosure of social and environmental issues, the number of new companies activity reporting has not increased significantly and a hard core of companies remain reluctant to report.

The experience of reporting does demonstrate that environmental and social reporting is perfectly possible and practical and all large companies can do it. It also demonstrates that some companies are reluctant to disclose unless required to do so. For investors the question must be: "Does this reluctance signify any environmental or social risks they should be concerned about?"

The CORE Campaign

Partly in response to the weak guidance provided by the proposed Company Law Review, an independent initiative to improve reporting has been gaining momentum. A Private Members Bill, The Corporate Responsibility (CORE) Bill has just been introduced into Parliament. This challenges the Government's voluntary approach to corporate responsibility and calls for greater corporate transparency and accountability. The campaign is backed by a coalition of more than 25 charities, environment, human rights and development NGOs, unions, and church groups. It has also won widespread cross-party backing from MPs, with 260 signing an Early Day Motion supporting the Bill's principles.⁵⁷

The Bill requires mandatory reporting for companies with a turnover of £5 million or more. In addition, the Bill requires companies to undertake stakeholder consultation before embarking on major projects; expands directors' duties to include consideration of the impacts of their business on the environment and society, and provides for the creation of a Standards Board to provide for robust enforcement.

The broad political support for the CORE Bill shows that there is widespread concern that the Company Law Review does not go far enough and many believe there is a good case for stronger legislation. Clearly, the pressure for further changes is likely to be reduced if there is real progress on improving disclosure within existing frameworks and initiatives, such as the Listing Rules.

THE CORPORATE RESPONSIBILITY BILL 2002

3 Duty to prepare and publish reports

- (1) It shall be the duty of every company to prepare and publish a report annually on—
- (a) any significant environmental, social, economic and financial impacts of any of its operations in the preceding year; and
 - (b) an assessment of the significant environmental social, economic and financial impacts of any proposed activities; and
 - (c) the employment policies and practices of the company which shall include the effects of its operations and any proposed operations on its employees; and
 - (d) the amount, or a reasonable summary thereof, of—
 - (i) taxes and other payments made to governments for any country of operation; and
 - (ii) grants, tax dispensations or other benefits received from any government or government agency in any country of operation; and
 - (iii) any donations or contributions to any political party either directly or indirectly,
 - (e) the way in which the directors of a company have discharged their duties [to consider environment and social impacts]

South Africa: The King Report on corporate governance

The final *King Report on Corporate Governance 2002* (known as *King II*) was released by the Institute of Directors in Sandton on 26 March 2002. This report represents a formal review of South African corporate governance arrangements, in a similar way to the Combined Code in the UK. It has been endorsed by the Johannesburg Stock Exchange, who incorporated the report into their Listing Rules, and so the Code of Corporate Practices and Conduct will apply to companies with securities listed on the JSE Securities Exchange South Africa whose financial years commence on or after 1 March 2002.

The Code recommends that all companies, in addition to those falling within the categories listed above, should give due consideration to the application of the Code insofar as the principles of the Code are applicable. A key component of the code, referred to as Integrated Sustainability Reporting, is that:

“every company should report at least annually on the nature and extent of its social, transformation, ethical, safety, health and environmental management policies and practices. The board must determine what is relevant for disclosure, having regard to the company’s particular circumstances.”

Appendix A2 contains the full section on the Code on Integrated Sustainability Reporting. The Code includes recognition of the need for an evolutionary approach with gradual rising levels of reporting. It also lays down key principles for use in reporting, with reference to the Global Reporting Initiative Sustainability Reporting Guidelines on economic, environmental and social performance. It also specifies certain matters requiring specific consideration including:

- Health and safety practices (including HIV/AIDS);
- Environmental governance, including use of the Best Practicable Environmental Option standard;
- Social investment and black economic empowerment;
- Human capital development and equal opportunity;
- The development and implementation of a company Code of Ethics, and disclosure of adherence to that code.

These five items appear very reasonable from a South African viewpoint. All the five items should be highly relevant to most companies operating in South Africa, and thus, requiring some disclosure is perfectly sensible.

The *King Report* represents a landmark in official recognition of the importance of the social and environmental reporting. It is the first time that social and environmental reporting has been backed by an official code on corporate governance for companies, with the support of business, financial institutions and government. It achieves a good balance between ensuring meaningful disclosure and avoiding being too burdensome or complex. It would not be overstating the case to say it gives South Africa and the Johannesburg Stock Exchange a leadership position when it comes to integrating sustainability into financial institutions.

The United States

The Securities and Exchange Commission (SEC) has taken some active steps to integrate environmental factors into its Listing requirements. In Regulation S-K, which is the main set of rules governing the disclosure of the US companies, it states:

“Appropriate disclosure also shall be made as to the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries. The registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material.”

It also mentions environmental issues when discussing disclosure of pending legal proceedings. Legal proceedings on environmental matters are not deemed to be “ordinary routine litigation incidental to the business” — which need not be disclosed — and thus disclosure is required unless certain circumstances apply. (Full details of the US SEC regulations on environmental disclosure are in Appendix A3)

Finally, companies are also required to disclose instances “where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial condition or results of operation.” Such trends must be disclosed in the ‘Management Discussion and Analysis’ section of a financial report, and would clearly appear to have scope to include environmental issues such as impending regulation on environmental issues such as climate change.

For foreign issues a different approach is taken. In form 20-F, which specifies listing requirements for foreign companies, firms are requested to: “Also describe any environmental issues that may affect the company's utilization of the assets.” It is this rather broad statement that caused BP to make the following disclosure in its annual report to the SEC for the fiscal year ended 31 December 1998:

“In December 1997, at the Third Conference of the Parties to the United Nations Framework Convention on Climate Change in Kyoto, Japan, the participants agreed on a system of differentiated internationally legally binding targets for the first commitment period of 2008-2012. The range in Annex I countries (OECD, former Soviet Union and Eastern Bloc countries) is from -8% to +10%. The USA agreed on a reduction of 7%, and the European Union on a reduction of 8%, on 1990 levels of emissions of greenhouse gases. Projections of the increase in

emissions without any reduction measures are estimated at 32% for the USA and 19% for the European Union. If these targets are to be met a major reduction in the use of fossil fuels would be required, and this would be likely to have a significant effect on BP Amoco's main businesses, but the Group does not expect that it will be affected differently from other companies with comparable assets engaged in similar businesses."

Significantly BP did not make any such disclosure in its annual reports in the UK. It is believed that there are several other examples of UK companies providing more extensive disclosure of environmental risks in their reports to the SEC than is provided in their UK annual reports, but this is an area for further research.

The SEC also mentions the environment in its industry guides, although only for the real estate sector. Despite the fact that smaller companies have a less onerous set of reporting requirements generally, they are still required to make disclosures of environmental matters. The relevant sections of the various SEC rules are given in the appendices.

The SEC has reinforced these disclosure requirements through a joint agreement with the staff of the Environmental Protection Agency (EPA) whereby the Commission receives from the EPA lists of companies identified as potentially responsible parties on hazardous waste sites; companies subject to clean-up requirements under Resource Conservation and Recovery Act; and companies named in criminal and civil proceedings under environmental laws. The SEC states that it uses this information in its reviewing of companies' disclosures to the SEC.

Despite the potential of these requirements and arrangements, there is some doubt about their effectiveness. Progress on the level of environmental disclosure appears modest and substantial differences exist in the level of disclosure. SEC has not publicly made any enforcement actions on environmental disclosure, and while it appears to have responded to some disclosure issues raised by environmental groups, the overall level of enforcement does not appear significant.

For example, in 1998, the Environmental Protection Agency's Office of Enforcement and Compliance Assurance completed a study⁵⁸ that found that 74% of companies failed to report in their 10-Ks cases in which environmentally related legal proceedings could result in monetary sanctions over US\$100,000. The failure to report these events appears to be a violation of SEC rule S-K, and leaves investors at a distinct disadvantage, because they cannot fully assess a corporation's assets and liabilities.

The disclosure of environmental factors has been particularly poor in response to the broader requirement covering trends. This would appear to cover issues such as climate change, which is potentially a major challenge for a number of industries. However, disclosure in this area has been very patchy and lags behind that of European companies. The disclosure of non-environmental factors such as human rights and labour standards, which could appear relevant under this section, has been very modest.

Much of the debate in the US is over the issue of materiality. Companies only have to report if a particular impact is 'material', which is typically taken to mean as greater than 5% of net assets. Despite SEC guidance that the qualitative information can be material, companies find it easy to use 'materiality' to limit disclosure of information on environmental and social factors. This is compounded by the fact that the US case law has made it clear that in the absence of a specific regulation to disclose defined information, it is difficult to press companies to disclose using general principles. The

UK takes a somewhat different approach in this area, although materiality remains a key concept.

Recently a group of investing foundations and socially responsible investors, led by the Rose Foundation for Communities and the Environment, petitioned the SEC to improve its environmental disclosure with a particular focus on environmental liabilities.⁵⁹ They called for a formal use of the standards for estimation and disclosure of environmental liabilities developed by the American Society for Testing and Materials International⁶⁰, which include aggregation of the liabilities to see whether they meet materiality thresholds. They develop a proposed rule in extensive detail (approximately 15 pages). It provides detailed guidance on how the amounts of environmental liability should be estimated. In their petition, the foundations stated:

“without full and accurate disclosure, significant under-reporting and inaccurate reporting will continue. As a consequence, investors will not be able to accurately assess the value of the equities in their portfolios[...]. Complete and accurate disclosure of financially material environmental risk furthers the Commission’s mission of protecting investors and the public and protecting and restoring public confidence in our markets and in publicly traded companies.”

Overall the US experience of environmental disclosure demonstrates several important aspects. Firstly, it is significant that the largest financial regulator in the world recognises the importance of the environmental factors and requires some disclosure. Secondly, the concept of a link to other regulators, such as the EPA is valuable and innovative. Finally, however, the US experience does highlight the difficulty of a rule-based approach to environmental disclosure and the fact that materiality will be frequently used as an excuse not to disclose, which reinforces the need for some stronger guidance.

Other international initiatives

There is a wide range of further activity to require, support or encourage disclosure of environmental and social issues by corporations, both at an international level, and in other national governments.

OECD Guidelines

Perhaps one of the most substantive examples, because it has the support of governments, comes from the OECD: the OECD Guidelines for Multinational Enterprises.⁶¹ According to the preface, these

“are recommendations addressed by governments to multinational enterprises. They provide voluntary principles and standards for responsible business conduct consistent with applicable laws. The Guidelines aim to ensure that the operations of these enterprises are in harmony with government policies, to strengthen the basis of mutual confidence between enterprises and the societies in which they operate, to help improve the foreign investment climate and to enhance the contribution to sustainable development made by multinational enterprises.”

The guidelines place a high emphasis on disclosure and the key items are listed below. These guidelines build on and reinforce the OECD’s own Principles of Corporate Governance, which it adopted in 1999.⁶² Under section IV: ‘Disclosure and Transparency’, these state that disclosure should include, but not be limited to, material information on the points listed under 4 above.

III Disclosure

2. Enterprises should apply high quality standards for disclosure, accounting, and audit. Enterprises are also encouraged to apply high quality standards for non-financial information including environmental and social reporting where they exist. The standards or policies under which both financial and non-financial information are compiled and published should be reported.
4. Enterprises should also disclose material information on:
....
 5. Material foreseeable risk factors;
 6. Material issues regarding employees and other stakeholders;
 7. Governance structures and policies.
5. Enterprises are encouraged to communicate additional information that could include:
 - a) Value statements or statements of business conduct intended for public disclosure including information on the social, ethical and environmental policies of the enterprise and other codes of conduct to which the company subscribes. In addition, the date of adoption, the countries and entities to which such statements apply and its performance in relation to these statements may be communicated;
 - b) On systems for managing risks and complying with laws, and on statements or codes of business conduct;
 - c) Information on relationships with employees and other stakeholders.

Global reporting initiative

The Global Reporting Initiative (GRI)⁶³ is an international initiative established in late 1997 with the mission of developing globally applicable guidelines for reporting on economic, environmental, and social performance. The GRI seeks to make sustainability reporting as routine and credible as financial reporting in terms of comparability, rigour, and verifiability. It has been endorsed by the United Nations. It was recently established as a permanent body, with a headquarters in Amsterdam. The GRI encourages multi-stakeholder participation in its consultation process, including corporations, NGOs, accountancy organisations, business associations, and other stakeholders from around the world.

It has just released its second set of Sustainability Reporting Guidelines.⁶⁴ The Guidelines are built around 11 core principles: transparency, inclusiveness, auditability, completeness, relevance; sustainability context, accuracy, neutrality, comparability, clarity, and timeliness. The Guidelines then go on to map out the report content in some detail:

GRI report content

1. **Vision and strategy** – description of the reporting organisation’s strategy with regard to sustainability, including a statement from the CEO.
2. **Profile** – overview of the reporting organisation’s structure and operations and of the scope of the report.
3. **Governance structure and management systems** – description of organisational structure, policies, and management systems, including stakeholder engagement efforts.

4. **GRI content Index** – a table supplied by the reporting organisation identifying where the information listed in Part C of the Guidelines is located within the organisation’s report.
5. **Performance indicators** – measures of the impact or effect of the reporting organisation. These include core indicators that must be reported (or reason given for their omission), and additional indicators that are optional. The indicators are divided into the following sections (with the number of core indicators in each section in brackets): integrated (n/a), economic (10), environmental (16), and social, which is further divided into: labour practices (11), human rights (7), society (3) and product responsibility (3).

Other national initiatives

A wide variety of individual governments have taken some form of action to promote environmental and or social reporting/disclosure. Particularly noteworthy is the French legislation, which specifies quite a high level of disclosure by listed companies (see appendix A4 for the full details). The table below provides a list of some of the major national activities.

<p>Australia</p>	<p>Introduced in 1999, the Corporations Law makes specific provision for environmental disclosure:</p> <p>“Section 299 Annual Directors’ Report – General Information (1) General information about operations and activities: The Directors’ Report for a financial year must [include]: (f) if the entity’s operations are subject to any particular and significant environmental regulation under a law of the Commonwealth or of a State or Territory – details of the entity’s performance in relation to environmental regulation.”</p> <p>This has been backed up by guidance published by the Australia Industry Group (Ai Group) on how to make such disclosure, which envisages typically a one to two page report. They also state “Ai Group as Australia’s largest industry body is appealing to industry to properly comply with this new requirement. This a chance to enhance Australian industry’s environmental image, particularly over the long-term by reporting our performances and communicating the good work on improving the environment that many companies have achieved.”⁶⁵</p> <p>Further official backing for environmental reporting comes from the guidance issued in March 2000 by Environment Australia (a government body): ‘A Framework for Public Environmental Reporting: An Australian Approach’, outlines a recommended approach to reporting for all types of bodies. It has been strongly endorsed by the Minister for the Environment and Heritage.⁶⁶</p>
<p>Belgium</p>	<p>Article 4.1.8 of VLAREM II (1995) stipulates that certain companies have to issue an annual environmental report. Companies subject to this obligation are listed in Appendix I of VLAREM I and mainly concern class I & II hazardous activities.</p>
<p>Canada</p>	<p>The Securities Commission requires public companies to report the current and future financial or operational effects of environmental public protection requirements in an Annual Information Form.</p>
<p>Denmark</p>	<p>The Law on Annual Accounts introduced in 2001 requires disclosure of the following in the directors’ and management report:</p> <ul style="list-style-type: none"> • Description of intellectual capital resources if these are of special

	<p>importance to future earnings</p> <ul style="list-style-type: none"> • Description of environmental issues – influence on the external environment and remedying measures <p>The Law on Green Accounts and a statutory order from the Ministry of the Environment and Energy has been applicable since 1996 and obligates certain listed activities/companies to draw up green accounts. It is estimated to cover around 3000 companies of which around half have reported to date.</p>
France	<p>Law no2001-420 related to new economic regulations (art 116) (May 2001) requires listed companies to disclose: “how the company takes into account the social and environmental consequences of its activities”. The details of the reporting requirements are determined by a decree of the Council of State, (enclosed in appendix A4) but quite specific information on employment and environmental factors is required.</p>
Norway	<p>The Accounting Act (Regnskapsloven) (1999) requires that all companies include more detailed environmental information in directors’ reports in annual financial reports from 1999 onwards. Under 3.3 Directors’ Report, companies must disclose:</p> <p>3: <u>Information about the working environment:</u> An account must be given of the working environment and an overview must be given of implemented measures that are of importance to the working environment. In addition, separate information is required about injuries, accidents and absence due to illness.</p> <p>4. <u>Information about conditions that may affect the external environment.</u> An account must be given of matters relating to the enterprise, including its resources used in production and products, which contribute to an impact on the external environment and of the measures which have been implemented or are being planned to prevent or reduce negative impacts on the environment.</p> <p>In the accompanying guidance it is suggested that companies provide quite extensive detail, and an extensive range of environmental and social indicators are specified.</p> <p>Norway is also in the process of introducing a law to give right of access to environmental information held by public authorities and private companies.</p>
Sweden	<p>Amendment to the Annual Accounts Act (Arsredovisningslagen) applicable since 1999. Companies that are required to have environmental permits or must notify the environmental authorities, have an obligation to include a brief disclosure of environmental information (mainly relating to permit conditions and restrictions) in the board of directors’ report section of the annual report. Potentially around 20,000 companies are affected.⁶⁷</p>
The Netherlands	<p>The Environmental Protection Act (1997) includes a section on environmental reporting. This section indicates which companies are required to report. To date over 250 companies have each published two reports a year, one public and one governmental.</p>

Overall, these various initiatives indicate a broad consensus towards developing greater disclosure by corporations of environmental and social issues, with clear support for this general principle from the OECD down. Thus, moves to incorporate environmental and social reporting into the Listing Rules should not be seen as unusual but as part of an international trend to improve corporate accountability and transparency.

4: Addressing disclosure

This report has demonstrated that investors are increasingly interested in enhanced environmental and social disclosure, that such disclosure is relevant to the understanding of businesses' long-term financial prospects and that a number of models and frameworks exist for requiring environmental and social disclosure.

Based on this, there is a clear case for moving forward to realise clarified and enhanced disclosure. Voluntary measures have had only limited effect, and have their own drawbacks, including a proliferation of standards and methodologies, lack of enforcement mechanisms, and limits for environmental disclosure. In contrast, formal specific reporting requirements as part of the Listing Rules would level the playing field ensuring all companies were assessed on similar information levels. Additionally, it should serve to simplify process and clarify expectations as there would be a clear set of rules, and reporting requirements as part of the Listing Rules could even reduce costs through standardisation, and through reduced PR and verification costs.

The principle drawback of requiring disclosure is the potential for increased costs that might arise for listed companies, and it is important that these do not outweigh the benefits. Many progressive and responsible companies are already reporting on social and environmental issues in some form, and for them the costs are likely to be modest. For other companies, some cost may arise but increased disclosure will be more valuable for investors and others. Even for these companies the potential costs of disclosure appear reasonable if regulation is done sensibly. An Environ/DEFRA report found the cost of production of environmental reports averaged under £100,000. As this was based on stand-alone environmental reporting rather than disclosure in the listing particulars and annual reports, it probably represents an upper limit for the sort of rules suggested below. Furthermore, the study found those companies who had a more mature reporting regime actually realised financial benefits, and that some companies could produce environmental reports for as little as £10,000.⁶⁸ What appears to push up the cost is when reporting degenerates into an extensive PR exercise, rather than focusing on the basic facts. Nonetheless a key consideration in looking at options for enhancing disclosure is that the costs should not be excessive and should be proportionate to the arising advantages.

Below we look at a number of the options for enhanced disclosure within the framework of the Listing Rules. The list is not necessarily exhaustive, but presents a broad range of possibilities for consideration.

Listing Rules Option 1: ABI Guidelines.

Perhaps the easiest step forward would be to integrate the ABI Guidelines into the Listing Rules. There are substantial advantages in using the ABI Guidelines. The Guidelines are written in a similar language to the Combined Code, have the support of a large number of major investors and are designed with businesses' needs in mind – there is a real focus on what is of concern to the business.

Practically, the ABI Guidelines could be integrated into section 12.43A of the Listing Rules, which deals with annual listing requirements and specifically corporate governance and directors' remuneration. The section on directors' remuneration in particular provides a better model for how the ABI Guidelines would be integrated (as it directly specifies disclosure requirements). In order to ensure that disclosure at initial listing is compatible, they should be included into section 6.G.1 on the prospects for the group and other information.

The drawback of this option is that the ABI Guidelines leave it to the company to decide what to disclose in detail. Given the slow progress that is being made in improving environmental and social disclosure through voluntary mechanisms, and the erratic and inconsistent nature of the disclosure to date, there is a real risk that any resulting disclosure would be bland and difficult to compare, thus limiting its usefulness. (Just as much of the disclosure that arises from the Turnbull Guidelines is fairly bland – the real point about Turnbull is it encourages improved internal processes by the board.) It might be possible to address this through identification of best practice and a process of comparison and development, but this could take a considerable time.

Overall, this option represents a realistic and straightforward step forward, which many financial institutions are likely to find reasonable. The principal question is whether adequate disclosure would result.

Listing Rules Option 2: ABI Guidelines Plus

To address the deficiencies in disclosure that might arise from unspecific guidance, a version of the basic ABI Guidelines could be supplemented with a specification of key issues and data that should normally be reported. For example, the results could specify the publication of greenhouse gas emission data for companies in sectors with significant emissions (e.g. those eligible to participate in the UK's emissions trading schemes).

The *King Report* in South Africa takes this sort of approach – laying out a number of specific areas where reporting is seen as appropriate in most circumstances. It leaves little doubt in that companies should report on certain key aspects - health and safety; environmental governance; social investment and black economic empowerment; and human capital development.

Within the general concept of providing additional guidance, there is a question of how much detail to provide. On the one hand it is possible to be quite specific, identifying specific indicators (e.g. tonnes of CO₂ emissions). Or one can take a fairly broad-brush approach — as is the case with the *King Report*. The advantage of being relatively specific is that there is a greater chance of comparable and consistent data being produced which will enable useful comparison and analysis to be made. Perhaps the best way forward is a hybrid one — requiring disclosure of certain key matters, and recommending key indicators to use in making the disclosure.

Again the relevant sections of the Listing Rules are 12.43 for annual disclosure and section 6.G.1 for initial disclosure. In addition, there should also be a system for reviewing and updating the specified guidance, both at a general level and in terms of specific indicators, involving both investors and business.

This option has much to recommend it. It will identify key areas where progress in disclosure can be made rapidly. Most businesses are likely to have something to say on these areas, and much of the time it will be of use to investors, making the risk of placing unnecessary burdens on companies small. More progressive companies will be able (and willing) to disclose more.

As a starting point the box below contains a first suggestion of what should be specified for disclosure. It should be seen as following on from section one and two of the ABI Guidelines.

Required disclosure: Discussion draft		
<p>The following matters should normally be disclosed. Where the board considers disclosure inappropriate reasons must be given. The board should consider the use of the recommended indicators in making the disclosures, but if it considers other data more appropriate or the data is not available, it may use other indicators, but the board should also have regard to need for comparability in disclosure in making this assessment.</p>		
Issue	Required disclosure	Recommended indicators
Employment	Description of policy, risk analysis, and if appropriate, management practices, targets and progress against targets in the areas of <ul style="list-style-type: none"> - Health & safety, - Equal opportunities, - Development of human capital, including training. 	<ul style="list-style-type: none"> • Fatalities • Loss time injury rate • Absenteeism rates • Analysis of employee diversity • Training expenditure.
Environment	Description of policy, risks analysis and if appropriate, management practice, targets and progress against targets. To include, <ul style="list-style-type: none"> - Specific discussion of climate change. - Consideration of potential impacts of products and/or supply chain. - If appropriate, use of or exposure to endocrine disrupting chemicals - Raw material and water use and constraints 	<ul style="list-style-type: none"> • CO₂ emissions. • Environmental prosecutions and enforcements • Endocrine disrupting chemicals used • Water consumption
International development	Description of policies, risk analysis and if appropriate, management practice with regard to operations in developing countries concerning human rights, supply chain issues (including fair trade), freedom of association and collective bargaining, labour rights, disciplinary / security practices and indigenous rights.	<ul style="list-style-type: none"> • Payment to foreign governments (taxes, royalties etc) • Percentage of supply chain compliant with International Labour Organisation (ILO) standards
Community	Description of policies and management practice on communities in areas affected by activities, as well as description of procedures/ programmes to address community relationships.	

Listing Rules Option 3: Extensive Risk Disclosure

One area of significant weakness in the current Listing Rules generally is in the area of express reference to risks, including but not limited to social and environmental risks. There are no explicit requirements in the Listing Rules to disclose or systematically analyse the risks that a company faces, although typically new issuers do make some risk disclosure in their prospectus. Risks are particularly likely to be relevant with new issues, where companies are relatively unknown to investors, although risks can change or develop through a company's life. Despite risks and internal control being the focus of the *Turnbull Report*, all that is expressly required is for companies to disclose whether or not they have a system of internal controls, rather than disclosing the risks themselves.

In theory, under the general requirement to list all information investors need to assess a company, the Listing Particulars should highlight and discuss the risks that a company faces. However, in practice, their discussions of risks tend to be unsatisfactory. There are number of ways issuers can vary the way they disclose risks:

- Simply failing to discuss risks, if the market is not particularly aware of them or they can argue they are not proven. A common version of this is to disclose only risks of current legislation and to ignore the risks from pending legislation or underlying social or environmental issues, which may give rise to legislation.
- Only discuss risks in limited way – for example treating a risk as a regulatory issue, and not discussing its potential impact in areas such as reputation, for civil liability or product acceptability.
- Confusing different types of risks, for instance, discussing fundamental business risks together with relatively technical operating risks. This may make it difficult to assess which risks are most important.
- Creating a false impression by discussing at length risks that are well managed while only briefly mentioning other risks.
- Failing to quantify risks or their impact, even where this may be possible. This is why estimated risks are often subjective.

The recent Xstrata listing illustrated all these various deficiencies.⁶⁹

There would appear to be good grounds to substantially expand the discussion of risks in listing procedures, specifically through a clarification and extension of section 6.G. This could make explicit that companies must identify and disclose all risks which may have a material affect on their business, what action they are taking to manage these risks and what extent of risks may be borne by investors. Risks should not just be those based on known or proven risks but also refer to possible risks arising from scientific research, public opinion, and prospective legislation. In addition the annual reporting requirements should be reviewed to include a discussion of any significant changes in the risk environment in the previous year.

This option is to some extent similar to the ABI Guidelines, but is potentially more general in scope. It also focuses more on initial listing rather than annual reports. It has the advantage that it is strongly financially focused and provides a natural extension of the *Turnbull Report*. As most companies should have an internal controls manual, such reporting should involve very modest costs. However, it has some downsides – by leaving the determination of risk to the company it still leaves the question of what happens if the management fails to recognise or analyse a risk properly. It is also focused on the downside of risks, rather than the opportunities that social and environmental issues may present for new business, or as an indicator of management quality.

Listing Rules Option 4: Detailed Disclosure (GRI)

The next option is to require companies to produce full and proper environmental and social reports. Most sensible would be to base such reports on the GRI Guidelines, which have the greatest level of acceptance, both from different stakeholder groups and different countries. It might be possible to include some variation from the GRI Guidelines, but as the guidelines already have a fair degree of flexibility, this is probably not necessary.

Producing a social and environmental report fits in well with the annual reporting cycle so could be added as part of the annual reporting requirements. For companies coming to the market for the first time, there would have to be a requirement that they either

produce a social and environmental report before the listing or include such information in the listing document.

Such a report would clearly address the broad issue of environmental and social disclosure. It would anticipate and forestall any other needs for environmental disclosure, and would enable analysts and others to move on from a debate about disclosure per se, to a consideration of what really are significant indicators for understanding business performance.

The principle disadvantage of requiring the production of a social and environmental report is that it is a complex task and potentially involves significant expenditure (although some small organisations have demonstrated it is possible to produce useful sustainability reports relatively easily, as confirmed by the Environ/DEFRA research mentioned at the start of this chapter). To get around this obstacle, it would probably be appropriate to set some limits for reporting – for instance companies with a capitalisation in excess of £1bn, or employing more than 250 staff. Potential lower levels could be set for companies operating in critical sectors, including resources and basic materials. Another disadvantage is that such reports are poorly targeted at financially significant impacts, reducing their relevance to investors.

Listing Rules Option 5: Sustainability Statement

An alternative approach is to take the issue of short-termism head-on and require companies to produce a statement outlining their longer-term vision for the business – a Sustainability Statement. Such a statement could include:

- A statement outlining the longer-term vision for the business.
- Disclosure of estimated potential growth rates and as well as growth rates in underlying areas (e.g. total consumption), and other assumptions used. Such estimates would not be forecasts as such, but indicators of potential business development over the medium to long-term. Companies making forecasts of revenue growth significantly in excess of nominal GDP growth, or based on significant growth in physical factors (e.g. land use) should be required to justify these assumptions.
- An analysis of risks to these assumptions, and identification of factors that could result in limiting the potential growth rates, including the impact of environmental and social issues.

To some extent such a statement could be seen as building on the idea of a “going concern” but extending it into the future. The idea is not to provide an exact forecast but to identify what potential might exist for the business in the medium to long-term, and what might be the key issues.

The use of sustainability statements could have substantial advantages. They address concerns over market short-termism, helping to avoid speculative bubbles; and integrate social and environmental concerns into investment analysis. The disadvantages are essentially that it is an unproven concept, which might prove impractical, difficult to implement robustly or of limited use to investors.

However, there is no reason not to explore the feasibility of producing some form of sustainability statement, and the value it might have to investors. As such we believe it would be worth working with certain businesses and investors to see if useful sustainability statements can be produced, to identify what would be involved in producing them and whether a reasonable standard of guidance can be produced.

While other bodies could lead this work, the leadership of FSA would give it particular authority and impetus.

Recommendation

A number of approaches to integrating the social and environmental factors into the Listing Rules clearly appear possible. The key challenge is to ensure meaningful reporting does occur, while avoiding being over prescriptive and rules based, with long menus of data items to disclose, which would not only be less effective but also expensive to companies. Of the various examples from around the world, the approach that seems to achieve the best balance in our view is the *King Report* from South Africa.

Building on this, we believe the most preferable of our options is the second – the ABI Guidelines Plus. This is the integration of the ABI Guidelines into the Listing Rules *combined with* specific recommendations for disclosure of key items (or a statement explaining why they are not disclosed). We emphasise the importance of including strict recommendations so the exercise does not reduce to bland statements. This has the key benefits of a broad principle-based approach, combined with:

- Specific disclosure of key issues to permit comparisons (and to ensure some useful disclosure);
- The ability to identify key issues up front;
- The option of flexibility and being progressive;
- While making a reasonable imposition on companies.

Note too that as a result of the proposed changes both the ABI Guidelines and any specific additional recommendation would no longer be voluntary or suggested, but be brought into a legal framework. The use of the term 'guidance' partly reflects the existing use of the term by the ABI, and also that proposed rules should operate to a significant degree on a principles based approach, rather than a narrowly prescriptive approach.

It should also be recognised that many of the suggestions above are not exclusive. The ABI Guidelines could be incorporated together with enhanced risk disclosure, while research started into sustainability statements. Furthermore, there are undoubtedly other options and ways of meeting the needs of investors for more social and environmental information. However, we believe we have identified one sensible way forward for the Listing Rules.

5: Enforcement mechanisms

While the Listing Rules can be clarified and modified to improve disclosure of environmental and social issues, such rule changes may be of limited value without adequate enforcement. Because of the importance of ensuring adequate disclosure, an enforcement regime exists alongside the Listing Rules. The regime consists of clearly assigned responsibilities combined with potential sanctions for non-compliance. This section looks at that enforcement regime; at how well it is working at present, and at how it could be improved; particularly with regard to social and environmental disclosure. It is worth noting that if disclosure of environmental and social issues were to be adequately monitored and enforced under the existing rules, the need for further explicit rules to enhance environmental and social disclosure in practice would be reduced.

Existing system

Under the current system, the directors of a company have primary responsibility for preparing the listing particulars, and have to sign a letter to the effect that all relevant information has indeed been disclosed. The role of directors is fundamental and the vast majority of directors exercise their functions diligently and responsibly. However, occasionally directors have not performed to the standards expected. It is then that the limitations of directors' responsibility become apparent. These limitations are, firstly, that directors are clearly unable to give an independent view, and, secondly, that there can be a limited scope to seek redress if investors have suffered losses as a result of directors' failures in disclosure, as the directors' assets may be limited (compared to the losses of investors) and suing the company is unlikely to be make sense (as the investors own it). Nonetheless directors' responsibility is important and there is little argument to radically change it.

The sponsor who brings the company to the market has the next level of responsibility. Their responsibilities are laid down in the Listing Rules and include:

- “2.9 (a) [A Sponsor must] satisfy itself, to the best of its knowledge and belief, having made due and careful enquiry of the issuer and its advisors, that the issuer has satisfied all applicable conditions for listing and other relevant requirements of the Listing Rules.
- 2.12 The Sponsor must complete the declaration by a sponsor [...] confirming that, to the best of its knowledge and belief, it [...] has satisfied itself having made due and careful enquiry of the issuers and its adviser: [...]
- (d) That all matters known to it which, in its opinion, should be taken into account by the UK Listing Authority in considering the application for listing of the relevant securities have been disclosed in the listing particulars or otherwise in writing to the UK Listing Authority.
- 2.13 The sponsor must be satisfied, before any application for listing is made [...] that the directors have had explained to them by the sponsor or some other appropriate professional adviser the nature of their responsibilities and obligations as directors of a listed company under the Listing Rules.”

Implicit in this, although not explicit, is that, in the sponsor's view (or rather to the best of its knowledge and belief) the listing particulars must contain all such information as investors and their professional advisers reasonably require for the purpose of making an informed assessment of the assets and liabilities, financial position, profits and

losses, and prospects of the issuer of the securities, as this is the fundamental condition for listing.

Sponsors also have a de facto, if not formal, responsibility to investors for ensuring that the listing particulars are complete – their reputation would suffer if they were to be involved in the listing of companies whose prospectuses were felt to be deficient, even if not formally censured by the market. An additional level of control may be provided by investors if they are shown the draft prospectus, as they may comment on the lack of information (or more directly, may indicate a lack of interest unless certain factors are explained in more detail), although it is not clear whether this is a significant control on listing particulars. It is unlikely that a significant number of investors would feel sufficiently strongly to act in this way on social and environmental issues.

The next level of control is provided by the UK Listing Authority itself, which has to approve all applications for listing (on the Stock Exchange) and the listing particulars. However, it is not clear exactly in what detail the UKLA checks on the information provided, particularly in areas such as the prospects or risks a company or a sector faces. Potentially there is great scope in this relationship as the UKLA can act to pre-emptively request more information if it feels it is justified. However, there are issues regarding the accountability of the UKLA, and in particular over its willingness to act on inadequate disclosure.

Not only is the UKLA responsible for checking and potentially improving disclosure of companies proposing to list, it is also responsible for monitoring disclosure and ensuring the issuers and sponsors have complied with the rules. If there is a failure in the listing, the FSA has four levels of sanctions it can take against the issuer, the directors of the issuer, or the sponsor. These include a private warning, a public censure, the imposition of a financial penalty, or barring the sponsor or individuals involved in the issue from such activities in the future. In theory, the UKLA as part of the FSA has very substantial powers it can use – it is able to issue enforcement actions without referral to the legal system. In practice, it remains to be seen how willing the UKLA will be to use them, particularly in the areas of social and environmental information.

Problems in the current system

Although the current listing regime generally works well, a number of weaknesses can be identified in the current arrangements:

- The UKLA can be reluctant to censure new listings – as this would be in part an admission of its own failure when approving the listing.
- The sponsor is seriously conflicted – they usually have a vested interest in the success of a new listing and will generate substantial fees from it, so have an interest in presenting the company in the best possible light.
- Furthermore, there is a particular conflict between the supposedly independent analysts and the corporate finance arm of the sponsor (and other managers) of the issue — as has been witnessed in the case of the certain dot com companies.
- There are no independent checks on the completeness of the information – the sponsor is conflicted, and the UKLA has limited scope to access third party information.
- The onus of proof is obscure — proving that key information has been omitted or that the listing particulars are misleading is likely to be obscure where the problems are in areas such as the prospects for the group or the risks involved.

- There is a reluctance to take legal action – institutional investors are likely to be reluctant to sue directors or sponsors if losses arise from inadequate disclosure – given the difficulty in proving a case, the diversion of their time, and the problem of getting adequate compensation (if the company is failing), as well as the fact that this would be an admission of failure by the investor.
- Many longer-term factors may be more general and so the issuer can argue that they were not included on the basis that investors should know about them already, or can find out about them from other sources – i.e. issuers could claim that such factors are excludable because an investor should not “reasonably expect to find [them] there”.⁷⁰ (Note this phrase is not in the proposed EU Directive.)
- In societal terms, the damage may have already been done if the capital raised has been used for a project or activity that harms society or the environment. And this damage can then cause the company to fail financially, harming investors as well.

Generally, the existing system may be reasonably effective at preventing outright fraud and misrepresentation, where the consequences are likely to be spotted rapidly and result in a collapse of the share price. However, it is perhaps less effective at preventing companies from raising money at excessive prices, with investors suffering long-term loss. In such cases, the understated risks and overstated prospects are likely to become apparent over time, and the share price will fall as a consequence. However, because the impacts are not immediate, few may make the links back to the original issue.

The listing of Xstrata provides examples of a number of the points above. This coal mining company is exposed fundamentally to the risks from climate change, yet its listing particulars disclosed very little about the risks of climate change. In the first six months since issue, its share price has declined substantially, and it has underperformed the market. This decline included a sharp fall one day in September 2002, directly in response to an announcement that the Japanese Government was considering a tax on coal imports to help meet its greenhouse gas targets. In July, a report, mentioned earlier, analysed the Listing Particulars of Xstrata and identified 30 specific deficiencies. As a result the report recommended that UKLA consider censuring the Company and its sponsor JP Morgan. To date the UKLA has not taken any public action, despite the sharp fall in the share price and the fact that it appears that a number of institutions did raise the issue of climate change with the company in presentations around the time of the launch and did receive an interesting response. This demonstrates both investors’ interest and the deficiencies in the company’s disclosure.

Another issue is with consistency *within* investment banks and stockbrokers. There is real concern that when it comes to new issues, financial institutions may say whatever they need in order for the issue to succeed, even if this means contradicting what they have said elsewhere. Cases in the US have highlighted this, but it still occurs in the UK.

Xstrata again provides an example of this, this time involving Deutsche Bank, one of the ‘Bookrunners’ for the issue. Deutsche Bank is well aware of the problem of climate change and its potential implications through its involvement in the climate change working group of the UNEP Financial Initiative; and indeed has indicated that it is keen to see international action to mitigate the risks of climate change. However, in its research note, which accompanied the issue, Deutsche played down the risks of climate change to a coal business. It did recognise that the “growth outlook for coal have been negatively impacted by the 1997 Kyoto Protocol” and that “Assessments of

future coal demand have had to be sensitive to the impact of GHG emissions policies”. But Deutsche then went on to downplay these implications stating that they were all discounted and claimed the outlook is now much improved for coal, especially since the US withdrawal from Kyoto. This conveniently ignored a number of facts – the market has in all probability not fully discounted Kyoto and its impact; Kyoto was becoming more certain; and the dynamics of emissions trading could enhance the negative impact on coal demand. More fundamentally, they ignored the key underlying problem of climate change and its potential longer-term implications, despite the fact that this is precisely the area of concern to Deutsche when discussing the subject in other arenas.

As a result the FSA should consider mechanisms for addressing the internal consistency of financial institutions and of listed companies. Organisations that claim that social and environmental issues are important should not then be allowed to ignore them or make opposing claims if it helps a new issue or other transaction to succeed. Practically they should be required to state their own internal position if relevant for a particular transaction.

Remedies and resolutions

There are a number of potential remedies that could make the system more robust, and specifically protect the needs of long-term investors:

- **Social and environmental disclosure rules and guidance.** The UKLA could develop rules and guidelines to cover in more detail the risks and prospects of the issuer, including social and environmental factors, as outlined in the previous section.
- **Duty to consult other agencies.** The UKLA could develop a partnership, similar to the US model, with government agencies responsible for certain issues, such as the Environment Agency or the Health and Safety Executive. This could be implemented as a formal duty to consult.
- **Third party assessment.** Alternatively, the UKLA could develop a partnership with an independent organisation (or organisations) to improve scrutiny. While some private sector organisations (e.g. SRI research organisations) might be able to provide a broad overview that would be very useful, this might create concerns about access to sensitive information.
- **More active enforcement.** The UKLA could adopt a more consciously proactive position to censuring listing, and make it clear that its technical approval did not mean it was not going to ignore cases where additional information was drawn to its attention after the issue launch.
- **Opportunity to comment.** The UKLA could invite comment on the draft listing particulars. This might cause some problems with confidentiality and market timing. However, many professional investors already see draft particulars or details. Thus one option might be a facility for confidential feedback by investors (possibly to include individuals wishing to act independently of their organisations).
- **Sponsors as independent advisors.** The role of the sponsor could be changed so they are not involved in underwriting or placing the issue, but instead are genuinely independent advisors. This would represent a major change and needs further consideration – but there are clear justifications for this in a post Enron world.

Clearly these remedies could be combined. The first two, Social and Environmental Disclosure Guidance, and Duty to Consult Other Agencies, are practical, implemented in other regimes, and are recommended for urgent considerations by the UKLA. There is also a clear case for the fourth More Active Enforcement, as can be seen by the Xstrata case. The others — Third Party Assessment, Opportunity to Comment, and Sponsors as Independent Advisors — are more major and would probably require some further analysis.

Overall, however, it appears there are a number of potential remedies that could help make the listing regime much more effective, and would enhance the effect of any improved disclosure rules.

6: Conclusions

The financial markets are changing. Environmental, social and ethical issues are becoming increasingly more important to investors, for a variety of reasons. Yet in the UK the Listing Rules have not evolved to take account of these trends. While they do a good job at consolidating the financial experience of the investors in previous decades, they do not expressly address many current environmental and social risks and do not look forward to the needs of investors in the future. It is time to update the Listing Rules to include explicit and detailed disclosure requirements on social and environmental issues.

Far from such action being a threat to the UK as a financial centre, the opposite is likely to be the case. In the wake of the scandals concerning companies such as Enron, investors will be looking for high standards of disclosure. In traditional financial terms the UK has had these for some years. Now is the time to expand this to other factors that can affect the business, and especially the fundamental issue of business sustainability.

Indeed inaction carries greater risks. For many years, the UK had a reputation as ‘the dirty man of Europe’. Inaction on disclosure of social and environmental issues could well lead to London being branded ‘the dirty investor of Europe’. Practically, this might mean being a centre for businesses which are unsustainable and do not offer the best long-term prospects. Should these business fail, the reputation of London will suffer. In contrast, it would be far better to encourage businesses that contribute to sustainability and offer true long-term growth potential – well managed responsible businesses in all sectors, and business in sectors such as healthcare and clean energy. A regime that requires clear and specific social and environmental disclosure is likely to hold few fears for the sort of businesses that Britain wants to encourage.

When the Pension Disclosure Regulation was announced, the UK gained a reputation as being at the forefront of integrating sustainability and investment. Recently, this leadership has looked increasingly at risk as other countries have leapfrogged the UK with stronger regulations and innovations, most notably South Africa and the *King Report*, which shows how sustainability can be integrated into corporate governance in the 21st century. There is now a real chance to regain this leadership and make the UK the leading centre of sustainable international finance.

Our recommendations to achieve this are:

Firstly, that the UKLA conduct a review of the Listing Rules to examine the case for the inclusion of social and environmental information. Our preference is for rules based on the ABI Guideline plus specific recommendations, in a similar model to the *King Report*.

Secondly, that the UKLA review its enforcement mechanisms to ensure they do indeed support adequate disclosure. The best steps to take initially are to develop links with the external agencies and to ensure that any internal reluctance to censure or otherwise take action is addressed.

Thirdly, to work with other regulators and the European Commission, to ensure that clarified and enhanced rules are not undermined by weak disclosure elsewhere or by harmonisation of standards, notably in the forthcoming EU prospectus and transparency directive, and their related schedules.

APPENDICES

A1 The ABI Disclosure Guidelines

The guidelines take the form of disclosures, which institutions would expect to see included in the annual report of listed companies. Specifically they refer to disclosures relating to Board responsibilities and to policies, procedures and verification.

With regard to the board, the company should state in its annual report whether:

- 1.1 The Board takes regular account of the significance of social, environmental and ethical (SEE) matters to the business of the company.
- 1.2 The Board has identified and assessed the significant risks to the company's short and long-term value arising from SEE matters, as well as the opportunities to enhance value that may arise from an appropriate response.
- 1.3 The Board has received adequate information to make this assessment and that account is taken of SEE matters in the training of directors.
- 1.4 The Board has ensured that the company has in place effective systems for managing significant risks, which, where relevant, incorporate performance management systems and appropriate remuneration incentives.

With regard to policies, procedures and verification, the annual report should:

- 2.1 Include information on SEE-related risks and opportunities that may significantly affect the company's short and long-term value, and how they might impact on the business.
- 2.2 Describe the company's policies and procedures for managing risks to short and long-term value arising from SEE matters. If the annual report and accounts states that the company has no such policies and procedures, the Board should provide reasons for their absence.
- 2.3 Include information about the extent to which the company has complied with its policies and procedures for managing risks arising from SEE matters.
- 2.4 Describe the procedures for verification of SEE disclosures. The verification procedure should be such as to achieve a reasonable level of credibility.

A2 The King Report on Corporate Governance in South Africa

5. Integrated sustainability reporting

5.1. Sustainability reporting

5.1.1. Every company should report at least annually on the nature and extent of its social, transformation, ethical, safety, health and environmental management policies and practices. The board must determine what is relevant for disclosure, having regard to the company's particular circumstances.

5.1.2. Stakeholder reporting requires an integrated approach. This would be best achieved gradually as the board and the company develop an understanding of the intricate relationships and issues associated with stakeholder reporting. Companies should categorise issues into the following levels of reporting:

- First level would be disclosures relating to acceptance and adoption of business principles and/or codes of practice that can be verified by reference to documents, board minutes or established policies and standards.
- Second level should address the implementation of practices in keeping with accepted principles involving a review of steps taken to encourage adherence to these principles evidenced by board directors, designated policies and communiqués, supported by appropriate non-financial accounting mechanisms.
- Third level should involve investigation and demonstration of changes and benefits that have resulted from the adoption and implementation of stated business principles and/or codes of practice.

5.1.3. When making such disclosures, boards will be required to consider the following:

- Clarity on the nature of the disclosing entity, the scope of issues subject to disclosure, performance expectations as an integral aspect of the "going concern" concept, the period under review and the extent to which items disclosed are directly attributable to the company's own action or inaction.
- Disclosure of non-financial information should be governed by the principles of reliability, relevance, clarity, comparability, timeliness and verifiability with reference to the Global Reporting Initiative Sustainability Reporting Guidelines on economic, environmental and social performance.
- Criteria and guidelines for materiality should be developed by each company for consistency, having regard to international models and guidelines, as well as national statutory definitions.

5.1.4. Matters requiring specific consideration should include:

- Description of practices reflecting a committed effort to reducing workplace accidents, fatalities, and occupational health and safety incidents against stated measurement targets and objectives and a suitable explanation where appropriate. This would cover the nature and extent of the strategy, plan and policies adopted to address and manage the potential impact of HIV/AIDS on the company's activities.
- Reporting on environmental corporate governance must reflect current South African law by the application of the Best Practicable Environmental

Option standard (defined as that option that has most benefit, or causes the least damage to the environment at a cost acceptable to society).

- Policies defining social investment prioritisation and spending and the extent of initiatives to support black economic empowerment, in particular with regard to procurement practices and investment strategies.
- Disclosure of human capital development in areas such as the number of staff, with a particular focus on progress against equity targets, achievement of corporate training and development initiatives, age, employee development and financial investment committed. This should also address issues that create the conditions and opportunities for previously disadvantaged individuals, in particular women, to have an equal opportunity to reach executive levels in the company and to realise their full potential. It should include progress made in this regard, and mechanisms to positively reinforce the richness of diversity and the added value and contribution from this diversity.

5.2. **Organisational integrity / Code of ethics**

5.2.1. Every company should engage its stakeholders in determining the company's standards of ethical behaviour. It should demonstrate its commitment to organisational integrity by codifying its standards in a code of ethics.

5.2.2. Each company should demonstrate its commitment to its code of ethics by:

- creating systems and procedures to introduce, monitor and enforce its ethical code;
- assigning high level individuals to oversee compliance to the ethical code;
- assessing the integrity of new appointees in the selection and promotion procedures;
- exercising due care in delegating discretionary authority;
- communicating with, and training, all employees regarding enterprise values, standards and compliance procedures;
- providing, monitoring and auditing safe systems for reporting of unethical or risky behaviour;
- enforcing appropriate discipline with consistency; and
- responding to offences and preventing re-occurrence.

5.2.3. Disclosure should be made of adherence to the company's code of ethics against the above criteria. The disclosure should include a statement as to the extent the directors believe the ethical standards and the above criteria are being met. If this is considered inadequate there should be further disclosure of how the desired end-state will be achieved.

5.2.4. Companies should strongly consider their dealings with individuals or entities not demonstrating its same level of commitment to organisational integrity.

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A3 US Securities and Exchange Commission (SEC) Regulations

Regulation S-K⁷¹

Reg. §229.101. Item 101. (c) (1)

(c) Narrative description of business.

- (1) Describe the business done and intended to be done by the registrant and its subsidiaries. ... The matters specified in paragraphs (c)(1)(xi) through (xiii) of this Item shall be discussed with respect to the registrant's business in general; where material, the segments to which these matters are significant shall be identified.
 - (xii) Appropriate disclosure also shall be made as to the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries. The registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material.

Reg. §229.103. Item 103. Legal Proceedings

Describe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought. Include similar information as to any such proceedings known to be contemplated by governmental authorities.

Instructions to Item 103.

5. Notwithstanding the foregoing, an administrative or judicial proceeding (including, for purposes of A and B of this Instruction, proceedings which present in large degree the same issues) arising under any Federal, State or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment shall not be deemed "ordinary routine litigation incidental to the business" and shall be described if:

- A. Such proceeding is material to the business or financial condition of the registrant;
- B. Such proceeding involves primarily a claim for damages, or involves potential monetary sanctions, capital expenditures, deferred charges or charges to income and the amount involved, exclusive of interest and costs, exceeds 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis; or
- C. A governmental authority is a party to such proceeding and such proceeding involves potential monetary sanctions, unless the registrant reasonably believes that such proceeding will result in no monetary sanctions, or in monetary sanctions, exclusive of interest and costs, of less than \$100,000; provided, however, that such proceedings which are similar in nature may be grouped and described generically.

Reg. §229.303. Item 303. Management's Discussion and Analysis of Financial Condition and Results of Operations

(a) *Full fiscal years.*

(3) Results of operations.

- (ii) Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations. If the registrant knows of events that will cause a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments), the change in the relationship shall be disclosed.

Instructions to Paragraph 303(a).

The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. This would include descriptions and amounts of (A) matters that would have an impact on future operations and have not had an impact in the past, and (B) matters that have had an impact on reported operations and are not expected to have an impact upon future operations.

Form 20-F⁷²

Item 4. Information on the Company

- D. Property, plants and equipment. The company shall provide information regarding any material tangible fixed assets, including leased properties, and any major encumbrances thereon, including a description of the size and uses of the property; productive capacity and extent of utilization of the company's facilities; how the assets are held; the products produced; and the location. Also describe any environmental issues that may affect the company's utilization of the assets. With regard to any material plans to construct, expand or improve facilities, describe the nature of and reason for the plan, an estimate of the amount of expenditures including the amount of expenditures already paid, a description of the method of financing the activity, the estimated dates of start and completion of the activity, and the increase of production capacity anticipated after completion.

Securities Act Industry Guides⁷³

Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships

7 RISK FACTORS

- C. Risk factors relating to the specific partnership might include, where applicable:
- v) Risks associated with contemplated rent stabilization programs, fuel or energy requirements or regulations, and construction in areas that are subject to environmental or other federal, state or local regulations, actual or pending;

11. DESCRIPTION OR REAL ESTATE INVESTMENTS

- A. Risks associated with specified properties, such as competitive factors, environmental regulation, rent control regulation, fuel or energy requirements and regulation should be noted.

Small Business Initiatives⁷⁴

Section 228.101 (Item 101) Description of Business.

- (11) Costs and effects of compliance with environmental laws (federal, state and local);

Section 228.103 (Item 103) Legal Proceedings

Instructions to Item 103.

3. Any proceeding that involves federal, state or local environmental laws must be described if it is material; involves a damages claim for more than 10% of the current assets of the issuer; or potentially involves more than \$100,000 in sanctions and a governmental authority is a party.

Offering Circular Model A

Business and Properties

3. With respect to the business of the Company and its properties:
 - (i) If the Company's business, products, or properties are subject to material regulation (including environmental regulation) by federal, state, or local governmental agencies, indicate the nature and extent of regulation and its effects or potential effects upon the Company.

Offering Circular Model B

Item 6. Description of Business

- (a) Narrative description of business.
 - (1) Describe the business done and intended to be done by the issuer and its subsidiaries and the general development of the business during the past five years or such shorter period as the issuer may have been in business. Such description should include, but not be limited to, a discussion of the following factors if such factors are material to an understanding of the issuer's business:
.....
 - (v) The material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, may have upon the capital expenditures, earnings and competitive position of the issuer and its subsidiaries. The issuer shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and for such further periods as the issuer may deem material.
 - (2) The issuer should also describe those distinctive or special characteristics of the issuer's operation or industry which may have a material impact upon the issuer's future financial performance. Examples of factors which might be discussed include dependence on one or a few major customers or suppliers (including suppliers of raw materials or financing), existing or probable governmental regulation, material terms of and/or expiration of material labor contracts or patents, trademarks, licenses, franchises, concessions or royalty agreements, unusual competitive conditions in the industry, cyclicity of the industry and anticipated raw material or energy shortages to the extent management may not be able to secure a continuing source of supply.

A4 French Disclosure Requirements⁷⁵

[To apply to all listed companies from 2002]

Decree N° 2002-221 of February 20th, 2002 relative to the implementation of the article L. 225-102-1 of the Code of commerce and modifying the decree N° 67-236 of March, 23rd 1967 on company law

Social

Art. 1. - In the above-mentioned decree of March, 23rd 1967, the following article 148-2 is being inserted, after the article 148-1:

" Art. 148-2. - By application of the fourth paragraph of the article L. 225-102-1 of the Code of Commerce, the following social information must appear in the report of the board or of the executive board:

1. a) Total workforce, recruitment's with a distinction between fixed term contracts and permanent contracts and with an analysis of the possible difficulties in recruiting, of the redundancies and their motives, of overtime, of sub-contracted labour.
 - b) If need be, information relating to staff reduction and employment safeguard plans, to the efforts made for staff redeployment, reemployment and subsequent accompanying measures;

2. Organisation of working hours, their duration for full time and part time wage earning employees, absenteeism and its motives;
3. Wages and their evolution, welfare costs, the application of the Title IV, Book IV of the code of Labour, professional equality between women and men;
4. Industrial relations and the assessment of collective bargaining agreements;
5. Health and safety conditions;
6. Training;
7. Employment and integration of disabled workers;
8. Company benefits and social schemes;
9. Importance of sub-contracting.

The report should detail how the company takes into account the territorial impact of its activities as far as employment and regional development are concerned.

It should describe, if need be, the relations the company develops with associations for social integration, educational institutions, associations for the protection of the environment, consumers' associations and neighbourhood populations.

It should indicate the importance of sub-contracting, how the company promotes to its subcontractors the provisions stipulated by the fundamental conventions of the International Labour Organisation and how the company makes sure its subsidiaries abide by them.

It should indicate furthermore the way the foreign subsidiaries of the company take into account the impact of their activities on the regional development and neighbourhood populations.

Environment

Art. 2. - In the same decree is inserted an article 148-3 after the article 148-2:

" Art. 148-3. - Must appear in the same terms, in the report of the board or of the executive board, the following information on the environmental consequences of the activity of the company, relatively to its specific nature and impacts:

1. Consumption of water resources, of raw materials and energy and description, if need be, of the measures taken to increase energy efficiency and the use of renewable energies, conditions of soil use, air - water - soil pollution emissions that could affect dramatically the environment, the list of which will be determined by an order of the ministers of the Environment and of the Industry, noise and olfactory pollution and waste;
2. Measures taken to limit the damage to biological balance, to the natural environment, to the protected animal and vegetal species;
3. Assessment or certification actions taken in terms of environmental protection;
4. Actions taken, if need be, to ensure the conformity of the company's activity with the legal provisions in that field;
5. Expenditures made to prevent the consequences of the company's activity on the environment;
6. Existence within the company of internal departments in charge of environmental management issues, training and information of employees on these issues, means dedicated to the reduction of environmental risks as well as the organisation put in place to deal with pollution accidents with consequences beyond the company's sites;
7. Amount of provisions and guaranties allocated for environmental risks unless this information is likely to cause a serious prejudice to the company in an ongoing lawsuit;

8. Amount of compensation for environmental damages paid during the fiscal year in execution of a court order and measures taken to repair these environmental damages;
9. All elements on the objectives the company assigns to its foreign subsidiaries on above paragraphs 1° to 6°."

A5 Carbon disclosure project questionnaire

Greenhouse gas emissions questionnaire

We request as full a reply as possible to the following questions (Note 1) by no later than 30 November 2002. Please send these electronically in English to the project co-ordinator at info@cdproject.net. Please adhere to the guidelines footnoted below (Note 2) so that we may fairly compare responses.

If at this stage you can only provide indicative information we would still welcome this. A "best guess" is more valuable than no response. If you are unable to answer any of these questions please state the reasons why.

General:

1. Do you see climate change as posing potential risks and / or opportunities to your company? Please provide information to explain your answer.

Your emissions:

2. What is the quantity of annual emissions of the main greenhouse gases produced by your operations (Note 3)?

Product use and disposal:

3. Have you begun to measure the quantity of emissions generated by the use and disposal of your product?
 - If yes, please provide information.
 - If no, when are you planning on doing so?

Supply chain:

4. Have you begun to measure the quantity of emissions generated by your supply chain?
 - If yes, please provide information.
 - If no, when are you planning on doing so?

Emissions reduction:

5. Do you have emission reduction programmes and targets in place? If so please state the baseline year and assumptions you are using in setting emissions reduction targets.
6. Are you engaged or do you intend to engage in greenhouse gas Emissions Trading? If you do so, please give brief reasoning for your decision.
7. Please explain how you could reduce your emissions by 5%, 10%, and 20% respectively, within five years? What would be the additional costs or savings of each reduction?

Note 1: For financial services companies we suggest that you consider these questions in the context of the assets you own.

Note 2: We recommend that you use the guidelines produced by the World Business Council for Sustainable Development and the World Resources Institute (www.ghgprotocol.org) as a basis for preparing your response.

Note 3: The main such gases are Carbon dioxide (CO₂), methane (CH₄), nitrous oxide (N₂O), Hydrofluorocarbons (HFCs), Perfluorocarbons (PFCs) and Sulphur Hexafluoride (SF₆).

A6 The Environment Agency: Submission to the Company Law Review

Corporate Environmental Governance Policy

- 2.17 The Agency considers that companies that actively reduce environmental risks and impacts are more sustainable, profitable, valuable, and competitive. This is good for the economy and the environment (the win-win situation). Those that ignore environmental risks and impacts are less sustainable in the long-term. Exploitation of resources for short-term gain is detrimental both to the economy and the environment (the lose-lose situation). The Agency aims to praise the good environmental performers and seeks to change the behaviour of poor performers.
- 2.18 The Agency considers that companies should have an environmental policy covering all aspects of their business activities and that the Directors of the company should promote this to their employees, contractors and customers as part of their staff training and management procedures.
- 2.19 We also suggest companies should put quality management systems in place because they help reduce and minimise environmental risks and add value to the company. We recommend they should adopt internationally recognised management systems such as ISO14001 and EMAS. SME's should consider signing up to the DTI/DETR Project Acorn.
- 2.20 We think all Company Directors should have a legal duty of care for the environment in the same way they have a duty of care towards their employees and customers. This should not be an optional or voluntary requirement. We think this necessary not only to protect natural resources for future generations but because it is good for the planet, good for employees, good for the public, and good for the long-term sustainability and reputation of the company. This policy is absolutely fundamental but not yet adequately addressed by the latest consultation document.
- 2.21 Directors of companies with over 250 employees should be required to report on how they have assessed and managed environmental risks and describe their environmental performance in their statutory Annual Report and audited Accounts. This is to enable shareholders, stakeholders, investors, employees, customers, and the general public to be assured that environmental risks have been properly managed and reduced.
- 2.22 The Annual Report and audited Accounts should also disclose whether the Company or any of its Directors has ever been previously prosecuted for any environmental or wildlife offence that resulted in enforcement action, prosecution, a fine, or other punishments including disqualification or imprisonment. This is to enable shareholders and stakeholders to assess if they are competent to run the company.
- (We note your support for this on page 325)
- 2.23 Companies should set targets and report on historic trends for key indicators of environmental performance that includes verified emissions to air, land and water. They should also include any serious pollution incidents, damage to wildlife,

enforcement action and prosecutions or fines against the company in their published Annual Report. Companies should also explain how they are positively seeking to continually reduce their emissions and incidents and their other environmental impacts to improve overall company performance. Companies should also take the opportunity to report on positive actions to improve environmental performance.

- 2.24 The Agency believes it makes economic and environmental sense that companies use their financial and other management information systems to track the cost and input of labour and raw materials, and output of goods/services and waste products, so as first to understand, and then to improve, their eco-efficiency. Any waste is loss of productivity and profit, as well as an environmental concern, and is bad both for the firm and the UK economy.
- 2.25 Companies should use their financial systems to disclose revenues and value derived from the environment. Producing, for example, a simple environmental profit and loss statement and green balance sheet in the audited financial statements in their Annual Accounts. These should cover income from and value of environmental assets, services and by-products, expenditure on natural resources, licences/permits to operate, capital investment in anti-pollution equipment, payment of green taxes and court fines, and any provisions made for contingent liabilities, for e.g. remediation of contaminated land.
- 2.26 This should not represent a large burden on companies and could be readily incorporated and phased into normal accounting and reporting systems and processes. Hopefully it will result in companies being able to track and reduce the cost of raw materials and waste products thus increasing profitability.
- 2.27 Both financial and non-financial environmental performance statements should be audited and verified to recognised accounting, reporting and auditing standards, and their audited Annual Report and Accounts lodged at Companies House and placed on an Internet web site. In this way they will be available to the Government, shareholders, stakeholders, and the general public to assess the company environmental performance alongside its economic and social performance.
- 2.29 Companies in the FTSE All Share Index should also voluntarily produce a more detailed Environmental Report for their stakeholders and shareholders, and operate site reports for local communities on businesses with high environmental impacts. They should be prepared to agree standards and be audited and verified.
- 2.30 The Agency is seeking to apply these principles to its own corporate governance, to those companies it regulates, and companies in which its Pension Fund Managers invest. Our Pension Fund Managers will vote against the approval of Annual Report and Accounts at the AGM's of UK companies that do not comply.

- ¹ http://www.fsa.gov.uk/ukla/1_listinginfo4.html
- ² Cited in the UKLA Sourcebook of rules and guidance *The Guidance Manual*; para 1.3.6 (2) and (4)
- ³ COM(2002) 460 final; Brussels, 9.8.2002.
- see http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0460en01.pdf
- ⁴ See European Commission Press Release IP/02/1209 9 August 2002
- ⁵ The Occupational Pension Schemes (Investment and Assignment, Forfeiture, Bankruptcy etc) Amendments Regulations 1999; Statutory Instrument no 1849, para. 2 (4)(b)
- ⁶ *The Ethical investor*, Autumn 2002, EIRIS
- ⁷ Based on, and updated from, the analysis (p349) in: Sparkes, Russell *Socially Responsible Investment – A Global Revolution*, John Wiley & Sons, 2002
- ⁸ “Three quarters of adults want an ethical pension” EIRIS Press Release, 25 June 1999. See <http://www.eiris.org/Files/PressReleases/PensionsSurvey992.pdf>
- ⁹ Survey of Public Attitudes to Quality of Life and to the Environment – 2001, DEFRA, 9 October 2002 <http://www.defra.gov.uk/environment/statistics/pubatt/index.htm>
- ¹⁰ see http://www.business-in-environment.org.uk/s_stakeholder.html
- ¹¹ see http://www.hermes.co.uk/corporate-governance/PDFs/Hermes_Principles.pdf
- ¹² see <http://www.morleyfm.com/cgov.pdf>
- ¹³ see http://www2.henderson.com/global_includes/pdf/sri/Henderson_Corporate_Governance.pdf
- ¹⁴ *Internal Control: Guidance for Directors on the Combined Code*, ICAEW, 1999. Available at http://www.icaew.co.uk/viewer/index.cfm?AUB=TB21_6342&tb5=1
- ¹⁵ “Morley Targets the Laggards”, *Ethical Performance Magazine*, October 2002
- ¹⁶ See www.unepfi.net for more information.
- ¹⁷ http://www.cityoflondon.gov.uk/living_environment/sustainability/sustainable_development.htm
- ¹⁸ *Financing the Future - Executive Summary*, Corporation of London, 2002. Available at http://www.forumforthefuture.org.uk/uploadstore/London_principles_executive_summary.pdf
- ¹⁹ see www.uksif.org
- ²⁰ See <http://www.abi.org.uk/forge>
- ²¹ See <http://www.lapforum.org/>
- ²² For further discussion of the concept of the Universal Investor see *The Rise of Fiduciary Capitalism*, James Hawley and Andrew Williams, 2000, University of Pennsylvania Press or *The New Global Investors*, Robert A.G. Monks, 2001, Capstone Publishing Limited.
- ²³ http://www.environment-agency.gov.uk/commondata/105385/company_law.pdf
- ²⁴ <http://www.hse.gov.uk/revitalising/csr.pdf> The author of that report is also the author of this report.
- ²⁵ <http://www.hse.gov.uk/press/press/2002/c02025.htm>
- ²⁶ See <http://www.justpensions.org/>
- ²⁷ Guide to Company Best Practice in *Socially Responsible Investment and International Development - A Guide for Trustees and Fund Managers*, Just Pensions Project. See <http://www.justpensions.org/jph-5.shtml>
- ²⁸ <http://www.publishwhatyoupay.org>
- ²⁹ <http://news.bbc.co.uk/1/hi/business/2228808.stm>
- ³⁰ CEO Briefing to *Climate Change and the Financial Services Industry*, commissioned by the United Nations Environmental Programme Finance Initiative Climate Change Working Group, written by Innovest Strategic Value Advisors, 2002.
- ³¹ Available on-line at www.ushq.co.uk. The author of this report was also lead author of that study.
- ³² See www.cdproject.net for more information.
- ³³ See www.ceres.org
- ³⁴ Available at <http://www.cis.co.uk/socacc2002/pdf/SusPays.pdf> or via www.forumforthefuture.org.uk/
- ³⁵ Goodman, Kron & Little *The Environmental Fiduciary - The Case for Incorporating Environmental Factors into Investment Management Policies*, Rose Foundation 2002. Available at <http://www.rosefdn.org>
- ³⁶ This table is based, *inter alia*, on the discussions in Mansley, Mark *Socially Responsible Investment, a guide for pension funds and institutional investors*, Monitor Press 2000, and on Goodman, Kron & Little, *The Environmental Fiduciary - The Case for Incorporating Environmental Factors into Investment Management Policies*, Rose Foundation 2002.
- ³⁷ Butz, C. & Plattner, A. *Socially Responsible Investment: A Statistical Analysis of Returns*, Bank Sarasin Basic Report 2000.
- ³⁸ Kiernan, Matthew J. “Eco-Value, Sustainability, and Shareholder Value: Driving Environmental Performance to the Bottom Line” *Environmental Quality Management*, Summer 2001. pp 1-12.
- ³⁹ 3M website 2002
- ⁴⁰ Goodman, Kron & Little *The Environmental Fiduciary - The Case for Incorporating Environmental Factors into Investment Management Policies*, Rose Foundation 2002. pp 4.
- ⁴¹ “Alfa Laval clarifies asbestos lawsuit claims”, *Financial Times*, 4 November 2002.
- ⁴² CEO Briefing to *Climate Change and the Financial Services Industry*, commissioned by the United Nations Environmental Programme Finance Initiative Climate Change Working Group, written by Innovest Strategic Value Advisors, 2002
- ⁴³ see <http://www.defra.gov.uk/environment/climatechange/trading/index.htm>

- ⁴⁴ see <http://europa.eu.int/comm/environment/climat/emission.htm>
- ⁴⁵ *Accounting for Carbon under the UK Emissions Trading Scheme*, Discussion Paper, Deloitte and Touche, May 2002
- ⁴⁶ *Neutralizing the Adverse Industry Impacts of CO2 Abatement Policies: What Does It Cost?* A. Lans Bovenberg and Lawrence Goulder, April 2000. *Allowance Allocation: Who Wins and Loses Under a Carbon Dioxide Control Program*, by Anne E. Smith and Martin E. Ross of Charles River Associates, prepared for the Center for Clean Air Policy, February 2002
- ⁴⁷ First figures based on a US\$25 carbon tax, revenue recycled through personal income taxes, second used US\$72 carbon tax, again recycled through income taxes.
- ⁴⁸ *The Xstrata Listing: An Analysis of Climate Risks*; A report by Claros Consulting For Friends of the Earth, July 2002. The author of that report is responsible for this report.
- ⁴⁹ "Japan considers coal tax in greenhouse push" *Reuters*, 4 September
- ⁵⁰ *Changing Oil – Emerging Environmental Risks and Shareholder value in the Oil & Gas Industry*, Duncan Austin and Amanda Sauer, World Resources Institute, 2002.
- ⁵¹ *Risking Shareholder Value? ExxonMobil and Climate Change - An Investigation of Unnecessary Risks and Missed Opportunities*, Mark Mansley, Claros Consulting, May 2002. (The author of this report)
- ⁵² *Electric Utilities Industry Sector Report*, Innovest Strategic Value Advisors, 2000.
- ⁵³ *European Carbon Market Outlook: Implications for Power Prices and Asset values, June 2002*, ICF Consulting.
- ⁵⁴ See <http://www.dti.gov.uk/companiesbill/whitepaper.htm>
- ⁵⁵ <http://www.dti.gov.uk/companiesbill/whitepaper.htm>
- ⁵⁶ "Richer and Greener" speech by the Prime Minister, the Rt Hon Tony Blair MP, to the CBI/Green Alliance conference on the Environment, 24 October 2000
- ⁵⁷ See <http://www.corporate-responsibility.org>
- ⁵⁸ "Guidance on Distributing the Notice of SEC Registrants' Duty to Disclose Environmental Legal Proceedings in EPA Enforcement Actions", Environmental Protection Agency, cited in *The Environmental Fiduciary - The Case for Incorporating Environmental Factors into Investment Management Policies*, Susannah Blake Goodman, Jonas Kron & Tim Little, The Rose Foundation for Communities & the Environment available at <http://www.rosefdn.org>.
- ⁵⁹ see http://www.rosefdn.org/images/SEC_Enviro_Disclosure_Pet.pdf
- ⁶⁰ The 2001 Standard Guide for Disclosure of Environmental Liabilities [E 2173-01] and the 2001 Standard Guide for Estimating Monetary Costs and Liability for Environmental Matters [E2137-01]. See www.astm.org
- ⁶¹ Annex 1, *The OECD Declaration and Decisions on International Investment and Multinational Enterprises: Basic Texts*, Committee on International Investment and Multinational Enterprises, OECD, 9 November 2000, DAF/IME(2000)20. Available at www.oecd.org
- ⁶² OECD Principles Of Corporate Governance, Ad Hoc Task Force on Corporate Governance, OECD 19 April 1999, SG/CG(99)5. Downloadable from www.oecd.org
- ⁶³ <http://globalreporting.org/AboutGRI/Overview.htm>
- ⁶⁴ Sustainability Reporting Guidelines 2002, GRI
- ⁶⁵ <http://www.aigroup.asn.au/PDFs/mand-enviro.pdf>
- ⁶⁶ www.natural-resources.org/minerals/generalforum/csr/docs/guidelines/Australian%20PER%20Framework.pdf
- ⁶⁷ <http://www.nextstep.co.uk/uploadedfiles/pdf/article4.pdf>
- ⁶⁸ Report on a Survey of Environmental Reporting Costs and Benefits, Environ report prepared for DEFRA, November 2001.
- ⁶⁹ *The Xstrata Listing: An Analysis of Climate Risks*; A report by Claros Consulting For Friends of the Earth, July 2002. The author of that report is responsible for this report.
- ⁷⁰ see the FSMA Act 2000
- ⁷¹ <http://www.sec.gov/divisions/corpfin/forms/regsk.htm#des>
- ⁷² <http://www.sec.gov/divisions/corpfin/forms/20f.htm>
- ⁷³ <http://www.sec.gov/divisions/corpfin/forms/industry.htm#secguide7>
- ⁷⁴ <http://www.sec.gov/rules/final/6949.txt> [Release Nos. 33-6949; 34-30968; 39-2287; FR-39]
- ⁷⁵ 17 CFR Parts 200, 228, 229, 230, 239, 240, 249 and 260; RIN: 3235-AD88
- ⁷⁵ Taken from <http://www.eurosif.info/sriif.shtml>, with some editing. Note this is a translation and should not be taken as a definitive statement of French Law.