

APRIL 14, 2009

## EXECUTIVE SUMMARY

The present global financial crisis offers an historic opportunity to adopt policies encouraging longer-term thinking in financial markets. Given the current context, Eurosif asks that European Institutions consider enhanced regulations that encourage all participants in the European capital markets to focus greater attention towards long-term performance. Within this agenda, Environmental, Social and Governance (“ESG”) issues have an important role to play.

In this position paper, Eurosif recommends that the European Commission adopt three proposals to increase transparency from various segments in the financial chain that would foster a longer-term, more sustainable economy within the EU:

### 1. Transparency from Companies

European institutions should mandate disclosure of ESG data by publicly traded, large corporations. Such reporting would be principles-based and use a limited number of standardised Key Performance Indicators (KPIs), some of them being sector-specific.

### 2. Transparency from Institutional Investors

European institutions should introduce a mandatory Statement of Investment Principles (“SIP”) for Investment Funds in which trustees would state the extent (if at all) to which ESG considerations are taken into account in the selection, retention and realisation of investments; and their policy in relation to the exercise of the rights (including voting rights) attached to investments.

### 3. Shareholders Rights and Transparency

The Commission should adopt measures to allow shareholders to keep control of their rights at all times, improve accountability of service providers within the proxy voting chain, and allow issuers to know who their shareholders are at any moment so that they can communicate to them efficiently.

## INTRODUCTION

The current financial crisis has raised a number of issues related to the financial sector and its role in the healthy fostering of a long-term, sustainable economy within the EU. European Institutions should encourage and reward long-term investing and discourage short-term, speculative bubbles. Major causes of the current financial crisis include short-termism, inadequate use of governance powers by investors, poor/unenforced regulation, misaligned compensation and/or incentive systems and a lack of transparency. While much discussion is currently being focused on governance issues in the crisis, Eurosif and its Member Affiliates assert that financial markets would be much better served by reliable and consistent information on ESG issues.

Business corporations and short term investors have a natural tendency to focus on short-term profit and share price to the detriment of a broader concept of long term sustainable growth that encompasses both long-term shareowner interests, responsible business practices and the imperative of long-term business viability. The difficult, present situation offers an opportunity to adopt transformational policies that address longer-term global systemic issues that directly affect the European capital markets.

Please find in the content that follows recommendations from Eurosif on how to develop greater transparency and accountability in the European capital markets.

## 1. Transparency from Companies: Mandatory ESG Reporting

### Recommendation:

Eurosif recommends that there is mandatory disclosure of ESG data by publicly traded, European large corporations.<sup>1</sup>

As this area has already attracted significant interest from various stakeholders, Eurosif suggests exploring a number of existing initiatives (Global Reporting Initiative, the Carbon Disclosure Project, recent guidelines by the International Corporate Governance Network (ICGN)<sup>2</sup>, and the current work of the Climate Disclosure Standards Board<sup>3</sup>, for instance) and use them to amend existing regulation.

ESG issues differ in relative significance from one sector to the next – a pharmaceutical company for example does not face the same ESG challenges as a utility company. While a detailed prescriptive “one size fits all” reporting approach would not work and would be overloading for companies, Eurosif believes that an approach **based on principles, flexible and simple enough to work for any listed, large companies, should become mandatory.**<sup>4</sup>

Eurosif supports recent work done by the ICGN which details principles under which ESG reporting should:

- Be genuinely informative and include forward-looking elements where this will enhance understanding;
- Be material, relevant and timely;
- Describe the company’s strategy, and associated risks and opportunities, and explain the board’s role in assessing and overseeing strategy and the management of risks and opportunities;
- Be accessible and appropriately integrated with other information that enables investors to obtain a whole picture of the company;
- Use key performance indicators (KPIs) that are linked to strategy and facilitate comparisons;
- Use objective metrics where they apply and evidence-based estimates where they do not;
- Be strengthened where possible by independent assurance that is carried out having regard to established disclosure standards applicable to ‘non-financial’ business reporting, such as those issued by the IASB.

Eurosif recommends that those reporting principles should be integrated into the existing Fourth Council Directive on accounts modernisation so that it appears in the annual reports.

With regards to standardised key performance indicators (KPIs), Eurosif believes that most KPIs would need to be sector-specific. A number of existing initiatives have produced interesting results in terms of KPIs (see the Greenhouse Gas Protocol,<sup>5</sup> the European Federation of Financial Analysts Societies - EFFAS<sup>6</sup>, the non-financial performance lab by the European Alliance for CSR and the sector additions of the GRI). In particular, EFFAS developed sector-specific KPIs for a limited number of industries, as well as a methodology for defining industry-specific KPIs that any third party can use.

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<sup>1</sup> Although the EC’s Fourth Company Law Directive defines a large company as a company with a headcount over 250, and/or a net turnover over €35 million and/or a total balance sheet over €17.5 million, Eurosif is open to discussing what would be the proper definition of large companies around ESG mandatory disclosure.

<sup>2</sup> ICGN Statement and Guidance on Non-financial Business Reporting [www.icgn.org](http://www.icgn.org)

<sup>3</sup> The Climate Disclosure Standards Board is developing a global framework for corporate reporting on climate change, which is at a late stage of development (a draft will be launched publicly in May 2009). [www.cdsb-global.org](http://www.cdsb-global.org)

<sup>4</sup> A principles-based reporting approach provides a conceptual basis to follow instead of a list of detailed rules. Under a principles-based approach, one starts with laying out the key objectives of good reporting in the subject area and then provides guidance explaining the objective and relating it to some common examples.

<sup>5</sup> Developed by the World Business Council for Sustainable Development (WBCSD) and the World Resource Institute (WRI). [www.ghgprotocol.org](http://www.ghgprotocol.org)

<sup>6</sup> EFFAS “KPIs for ESG: A Guideline for the integration of ESG into financial analysis and corporate valuation”

**Eurosif would recommend that the Commission coordinate further collaboration among different stakeholders and initiatives** to reach a common ground. Eurosif will be happy to bring its expertise and that of its Member Affiliates into this type of collaboration.

### Making the case:

Currently, the EU Modernisation Directive states:

*"To the extent necessary for an understanding of the company's development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters;"*

Nevertheless, at the current time, this requirement has not been readily enforced nor have companies disclosed substantive ESG information that could help investors. **Eurosif believes that European institutions should make reporting on ESG data no longer an option subject to interpretation but a requirement.** It is increasingly understood that financial statements capture less than 20% of corporate risks and value creation potential, with the balance deriving from intangible factors such as human capital and resource efficiency. ESG data are relevant, material information that investors should have and increasingly want as a means to better gauge longer term risks and opportunities. It is therefore important that companies provide an overview of all major risks and detail the most important ones.

**The availability of ESG data tracking the sustainability performance of companies could have a beneficial effect on corporate, investment and market performance.** Should investors conclude that companies with thoughtful long-term management of ESG issues are better-run companies, a sort of virtuous circle can be imagined: in this scenario, investors would reward stock prices where sustainability is integrated, and companies would respond by further improving their sustainability performance. Accordingly, a fixation on meeting quarterly earnings estimates and other short-term measures would give way to longer-term thinking as a broader sustainable business agenda is recognised and rewarded by investors. The mandatory disclosure of ESG information by publicly listed, large companies would go a long way towards the creation of a competitive and sustainable European economy.

Without such mandatory disclosure, investors will continue to lack the means of assessing substantial numbers of material factors as they arise. Incomplete data makes for inefficient markets and a lack of transparency leads to unstable financial systems. **Investors require reliable, comparable data on a broad range of potential risks and opportunities.** A purely voluntary disclosure scheme does not guarantee significant, relevant and comparable data from all issuers: information is often provided selectively and very often, with the absence of common standards, the information cannot be compared with other companies, or over time. In addition, adopting a harmonised framework will ease the “questionnaire fatigue” companies sometimes complain about when they receive multiple and diverging information requests from ESG analysts. Finally, the availability of comparable ESG data from European companies will greatly assist the implementation and monitoring of all manner of relevant EU policies and targets.

Currently, regulators and stock exchanges in numerous jurisdictions around the world – including France (loi NRE, article 116), Brazil, Malaysia, South Africa, Sweden and very recently Denmark – have mandated or encouraged the disclosure of such data.<sup>7</sup> In the United States, mandatory disclosure is currently being promoted by investors to the Obama administration<sup>8</sup> and the US Environmental Protection Agency has now proposed a draft mandatory greenhouse gas reporting rule for US corporate facilities.<sup>9</sup> Therefore, the EU would retain its leadership on sustainability issues by mandating disclosure of ESG data by publicly traded large corporations.

<sup>7</sup> For detailed references to case studies, see “*Innovations in Social and Environmental Disclosure Outside the United States*” by Domini Social Investments [http://www.domini.com/common/pdf/Innovations\\_in\\_Disclosure.pdf](http://www.domini.com/common/pdf/Innovations_in_Disclosure.pdf)

<sup>8</sup> See <http://www.ceres.org/Page.aspx?pid=951>.

<sup>9</sup> See <http://www.epa.gov/climatechange/emissions/ghgrulemaking.html>

### 2. Transparency from Institutional Investors: Mandatory Statement of Investment Principles for Investment Funds

#### Recommendation:

Eurosif recommends that the EC introduce a **mandatory EU wide “Statement of Investment Principles (SIP)”** for investment funds, as suggested in the European Parliament resolution of March 13 2007 on Corporate Social Responsibility (2006/2133(INI)). In these SIPs, trustees would state the extent (if at all) to which ESG considerations are taken into account in the selection, retention and realisation of investments; and their policy in relation to the exercise of the rights (including voting rights) attached to investments.

In addition, where institutional investors communicate that they do have an SRI policy,<sup>10</sup> they should provide information on how such policies are being implemented in practice, what results have been obtained so far and what trustees’ expectations are for the future. Thus, Eurosif believes **it is essential that institutional investors report on how their responsible investment policy is implemented in practice** and how they monitor its effectiveness in order to prevent a gap between SRI policies and practices. The notion of independent audit of policy implementation (including exercise of shareholders rights) is worth exploring in this respect.

Where trustees have decided against developing a policy for the integration of ESG issues into investment decisions, they should also be required to report that decision and the rationale for it.

#### Making the case:

Eurosif believes that **the Commission should foster the development of SRI among institutional investors**. Because they represent long-term beneficiaries who have a natural interest in preserving the wealth in their investment portfolios, pension plan trustees tend to focus on longer-term issues. Within the financial arena, institutional and private asset owners determine capital allocation and are therefore crucial to encouraging both corporations and financial institutions to move towards more sustainable behaviour. Progress will require key decision-makers to abandon conventional approaches to investing, which have thus far been based to a large extent on chasing short-term gains. **As holders of some of the largest pools of investment capital with the greatest potential impact on industry practices, pension funds in particular are well-positioned to effect change**. Pension fund trustees must give their asset managers clear mandates to incorporate ESG criteria into their investment decisions, reflecting their need to meet their long-term horizons for pension fund liabilities (i.e. payments to plan participants).

As discussed previously, ESG issues do affect the performance of companies. There is a growing consensus in the financial community that taking ESG issues into consideration is consistent with the fiduciary duty of investors when it impacts profitability, and is further relevant when there is a consensus to do so by participants /members /stakeholders.<sup>11</sup> **Ownership and power imply responsibility from trustees**. ESG issues such as climate change, working conditions at suppliers’ factories, misaligned executive compensation, corruption and human rights have material impacts on stock values and investment portfolio performance. As evidence to this growing consensus, more than 500 financial institutions worldwide are now signatories to the Principles for Responsible Investment (PRI), representing over \$17 trillion.<sup>12</sup>

<sup>10</sup> SRI = Sustainable and Responsible Investment, please see Appendix for detailed definition.

<sup>11</sup> UNEP FI, Freshfields, Bruckhaus, Deringer : a legal framework for the integration of environmental, social and governance issues into institutional investment, October 2005.

<sup>12</sup> The Principles for Responsible Investment (PRI), convened by UNEP FI and the UN Global Compact, was established as a framework to help investors achieve better long-term investment returns and sustainable markets through better analysis of ESG issues in investment process and the exercise of responsible ownership practices. The first principle reads as follows: “We will incorporate ESG issues into investment analysis and decision-making processes.” [www.unpri.org](http://www.unpri.org)

As a result, Eurosif believes that trustees should be required to develop a policy for the integration of ESG issues into investment decisions unless 1) the trustees believe that such issues are not material factors in determining investment outcomes; and/or 2) the trustees believe that there are other reasons which means that such integration is not in the best interest of beneficiaries.

Trustees should be required to document their policy in the SIP for the fund concerned. Similar to the effort to make ESG reporting from companies comparable, any statements of SRI should ideally be harmonised (see the Reporting and Assessment Framework developed by the PRI).

Similar transparency regulations have already been adopted in the United Kingdom (2000), France (2001), Germany (2001), Sweden (2001), Belgium (2004), Norway (2004), Austria (2005) and Italy (2004) and were recommended in a recent OECD consultation on Guidelines for pension fund governance.

### 3. Shareholder Rights and Transparency

Good corporate governance is critical for the successful execution of an SRI agenda: it allows relevant ESG issues to be debated at the highest corporate level, between board directors and shareholders.

#### Recommendation:

As mentioned previously, ownership and power imply responsibility from institutional investors. With a long-term investor perspective, it is fundamental that shareowners can actively exercise their rights to vote and engage with the companies they own. **An investors’ ability to exercise their shareholder rights is essential.** Given the importance of decisions taken during annual general meetings (AGMs), it is deeply disappointing to still see participation rates at AGM’s below 25% of capital. In this respect, Eurosif recommends that the Commission **ensure greater transparency concerning shareholders rights, in particular concerning the identification of the shareholder, the proxy voting chain and stock lending.**

A review of the market transparency regulation is needed.<sup>13</sup> The Commission should adopt measures to:

- Allow shareholders to keep control of their rights at all times.
- Improve accountability of service providers within the proxy voting chain; in particular, require that service providers return confirmation of the vote cast to the agent who has submitted the execution, or an explanation as to why this is not possible.
- Allow issuers to know who their shareholders are at any moment so that they can communicate to them efficiently.

#### Making the case:

As a basic principle, shareholders should not have to compromise their right to trade if they choose to exercise their right to vote. In addition, their right to vote on the balance should not be impinged by choosing to exercise their right to sell some of their shares.

The entire proxy voting chain is complex in its nature, involves a great number of service providers (custodians, sub-custodians, voting service providers, etc.) with limited incentives to upgrade their systems and whose results are not auditable. As a result, if trying to remove share blocking, it is de facto impossible to identify the blocking source. In addition, once a shareowner has cast a vote, there is no trace and no confirmation of what has been done with the vote along the proxy voting chain. The Commission should make it mandatory for service providers (both custodians and voting service providers) to send back confirmation of the vote cast to the agent who has submitted the execution, or an explanation as to why this is not possible: **making the service providers more accountable will allow identifying those that are trustworthy.** If the custodians were also mandated to facilitate the voting

<sup>13</sup> Chapter III “Ongoing information” of the DIRECTIVE 2004/109/EC of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.

service provider of the choice of the client where one is requested, that would then create an incentive for custodians to ensure their systems are up to date and fit for purpose.

In a cross border environment where shareholdings are intermediated, the determination of a person as shareholder depends on a web of complex, sometimes impossible to unravel, financial transactions. **There is a chain of intermediaries between the issuer and the end investor, which is a barrier to the identification of the shareholder.** The need for transparency in this regard rests with the intermediaries, not only in terms of allowing shareholders to properly identify themselves but also in terms of the account structure they offer and its implication on the ability to exercise shareholder rights. It should be mandatory for service providers to inform on the status of a vote at all times (ie how many shares the client can vote, how many shares have been voted, etc.).

In addition, security-based derivatives and securities lending - linking millions of transactions - make it impossible to draw up the shareholder base of a given issuer. Sometimes the custodian is simply unable to relocate its client's shares, preventing the latter to exercise his/her shareholder rights at the general meeting.

**The Commission needs to create clarity and uniformity regarding disclosure of lending/borrowing positions and the effect of lending on the voting rights.** Eurosif believes that the lending process should become subject to the same visibility and safeguards as any other transaction conducted on an owner's or beneficiary's behalf in a securities account.<sup>14</sup> The issuer-shareholder relationship should be preserved and shareholders must be able to enjoy their rights and assume their responsibilities vis-à-vis the company of which they are co-owner.

Lastly, to facilitate the exercise of shareholder rights, the ability to vote by electronic means should be made possible by all issuers and no longer “where applicable” as stated in the Transparency Directive (Art. 17). This would have an immediate impact on the accountability of boards and enable investors to favour long-term value creation through better corporate governance.

This note has been developed as a part of Eurosif's aims to encourage disclosure, transparency and responsible ownership, and to promote the integration of social, environmental and governance issues into European financial services. It does not necessarily reflect the views of all of its Member Affiliates.

Yours sincerely,

A handwritten signature in black ink that reads "Matt Christensen".

Matt Christensen  
Executive Director  
Eurosif (European Sustainable Investment Forum)

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<sup>14</sup> See for more details ICGN Securities Lending Code of Best Practice, July 2007. [www.icgn.org](http://www.icgn.org)

### APPENDIX

#### About Eurosif

EUROSIF, the European Sustainable Investment Forum, is the pan-European network whose mission is to address sustainability through the financial markets. Eurosif works as a partnership of the national Sustainable Investment Forums (SIFs) within the EU and with the support and involvement of Member Affiliates. Recognised as the premier European forum for sustainable investment, Eurosif’s Member Affiliates are drawn from leading pension funds, asset managers, NGO’s, trade unions, academic institutes and research providers, together representing assets totalling over €1 trillion. Eurosif’s work includes a focus across asset classes - equity and fixed income markets, microfinance, renewable energy, property, private equity and hedge funds - all centred around the industry trends and future legislation affecting this space. The key benefits that Eurosif affiliate members receive include EU interfacing, SRI information and European wide initiatives that integrate Environmental, Social and Governance (ESG) issues into the financial services sector. For the full list of Eurosif Member Affiliates, please see [www.eurosif.org](http://www.eurosif.org).

Eurosif has two main roles: (1) to provide an international forum that allows members and member affiliates to work together on issues pertaining to Sustainable & Responsible Investment (SRI, see below for definition of SRI and its market size in Europe) and Corporate Governance in the EU financial services sector, and (2) to collect input from members and member affiliates and then communicate their ideas and initiatives to European policy makers, including the European Commission as well as the European Parliament. Therefore, this note is mainly driven from and by the interest and expertise of our membership.

#### Sustainable and Responsible Investment Definition

Eurosif continues to use the term “SRI” as the most readily acknowledged expression for this field and defines SRI as follows:

SRI, a generic term covering ethical investments, responsible investments, sustainable investments, and any other **investment process that combines investors’ financial objectives with their concerns about environmental, social and governance (ESG) issues.**

To do so, different approaches exist:

- Best-In-Class approach: Selection of the best companies in their sector with regard to sustainable development.
- Thematic approach: Selection of the best companies according to a specific sustainable development theme (renewable energies, water, job creation, etc.).
- Norms-Based approach: Selection of companies according to their observance of the main international treaties/conventions (e.g. ILO).
- Exclusion approach: Exclusion of companies involved in controversial activities or issues (alcohol, gambling, animal testing, etc.).
- Engagement: this includes proxy voting, collaborative engagement, direct private dialogue with companies, and public engagement. Engagement is often considered as an extra overlay to other SRI approaches or traditional management.
- Microfinance approach: financing Microfinance institutions (bonds or equity) favoring economic empowerment.

#### Market Size

Eurosif recently published the latest Sustainable and Responsible Investment (SRI) figures and trends in its “European SRI Study 2008”. This unique study highlights the scale of European SRI as well as European and National trends across thirteen countries, including Spain. Based on a survey of asset managers and self-managed asset owners, we found that total SRI assets under management (AuMs) have reached €2.7 trillion as of December 31, 2007 and represent as much as 17.5% of the asset management industry in Europe. This corresponds to a remarkable growth of 102% since December 31, 2005.