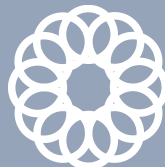
State of the Debate

Capital Markets and Sustainability

Investing in a sustainable future



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Investing in a sustainable future

State of the Debate Report

February 2007

Mandate

About Us

The National Round Table on the Environment and the Economy (NRTEE) is dedicated to exploring new opportunities to integrate environmental conservation and economic development, in order to sustain Canada's prosperity and secure its future.

Drawing on the wealth of insight and experience represented by our diverse membership, our mission is to generate and promote innovative ways to advance Canada's environmental and economic interests in combination, rather than in isolation. In this capacity, it examines the environmental and economic implications of priority issues and offers advice on how best to reconcile the sometimes competing interests of economic prosperity and environmental conservation.

The NRTEE was created by the government in October 1988. Its independent role and mandate were enshrined in the *National Round Table on the Environment and Economy Act*, which was passed by the House of Commons in May 1993. Appointed by Governor in Council, our members are distinguished leaders in business and labour, universities, environmental organizations, Aboriginal communities and municipalities.

How We Work

The NRTEE is structured as a round table in order to facilitate the unfettered exchange of ideas. By offering our members a safe haven for discussion, the NRTEE helps reconcile positions that have traditionally been at odds.

The NRTEE is also a coalition builder, reaching out to organizations that share our vision for sustainable development. We believe that affiliation with like-minded partners will spark creativity and generate the momentum needed for success.

And finally, the NRTEE acts as an advocate for positive change, raising awareness among Canadians and their governments about the challenges of sustainable development and promoting viable solutions.

We also maintain a secretariat, which commissions and analyses the research required by our members in their work. The secretariat also furnishes administrative, promotional and communications support to the NRTEE.

The NRTEE's *State of the Debate* reports synthesize the results of stakeholder consultations on potential opportunities for sustainable development. They summarize the extent of consensus and reasons for disagreements, review the consequences of action or inaction, and recommend steps specific stakeholders can take to promote sustainability.

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Toronto, June 17, 2005
Toronto, October 3, 2005

Note: Although there is broad agreement on the main report, the two Task Force members whose names are marked with an asterisk (*) above wish to express their disagreement with the inclusion of the Foreword. Disclosing this is in keeping with the National Round Table on the Environment and the Economy's "state of the debate" process, with its tradition of embracing and acknowledging the importance of both consensus and divergent views in its reports.

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A Message from the Co-Chairs

We are very proud to present the final report of the Capital Markets and Sustainability Task Force.

The work of the Task Force has greatly enhanced our understanding of how sustainable development issues interact with the activities of the business world and how they affect long-term competitiveness not only of the individual enterprise, but of the economy as a whole.

Our work was greatly enhanced by the insights of some of Canada's leading thinkers who helped us explore the links between corporate responsibility and business competitiveness. This has allowed us to define "win-win" opportunities in the capital markets that can benefit society as a whole.

Canadian companies have begun to recognize the importance of social drivers for change — including, among others, stakeholder expectations and the public's perceptions of an enterprise's commitment to the environment and to broader social and community values.

It became clear to us that the other side of the capital market — the providers of capital — are listening to what the marketplace is saying. They understand the importance of integrating environmental, social and governance factors into their shareholder counsel and their investment decisions. Their voices are having a major impact in redefining how the capital markets work.

One example is the Carbon Disclosure Project (CDP), which now encompasses over US$31 trillion in managed funds around the world. Participants in the CDP make explicit the fact that climate risk awareness and responsible corporate management are key factors in investment decision making.

Another example is the Global Reporting Initiative (GRI). Companies that adhere to the reporting standards of the GRI globally comprise approximately 26 percent of the S&P 100 Index and approximately 24 percent of the S&P 1200 Index (2006).

In developing this report we were able to identify and explain many of the market barriers that until now have clouded the analysis of how environmental, social and governance factors influence the world of capital investment. We have articulated these barriers, including short-termism, as they relate to the application of fiduciary duty and materiality, and have provided several recommendations that will help to provide greater transparency and disclosure in the corporate sector.

We share the view of our Foreword authors that innovation and productivity are enhanced through Canadian corporations and capital markets taking leadership over environmental, social and governance issues. Our overarching goal was to enhance the understanding of the factors that link the world of business with the broader social dimensions of the nation, thereby equipping capital market issuers and providers with better tools in the formulation of their investment decisions.

We would like to thank the Task Force, the NRTEE, as well as all those in business, government, academia who gave unstintingly of their time and energy to assist us in developing this report. It was a tremendous learning experience, one which we hope will assist in shaping the strategic choices to be made in defining Canada's competitive future.

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Co-Chair, Capital Markets & Sustainability Task Force

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Foreword[1]

We see no necessary contradiction between a competitive and innovation-driven Canadian economy and the desirability of enhancing the "sustainability" of Canadian firms.[i] Nor do we need to be convinced of the potential salience of environmental, social, ethical, and governance risks to the reputation of Canadian firms, and the relevance of such risks to both domestic and international investors.[ii] However, in pursuing win-win scenarios in this area, we do not see the need for increased regulation, increased taxation, or increased interference in the normal value-creating activities of Canadian businesses.

In our deliberations on the issues raised by the work of the Capital Markets and Sustainability Task Force of the National Round Table on the Environment and the Economy, three principal themes emerged as central to achieving optimal outcomes for the economic competitiveness of Canadian industry, the sustainable development policies of all levels of Canadian government, and the values of Canadians. These were (a) the need for regulatory efficiency of financial services — in particular, the need to remove perceived and actual barriers to capital flows represented by jurisdictional complexity; (b) the need to improve the fiscal environment so as to foster corporate investment in technology and efficiency, as well as for enterprise growth; and (c) the importance of enhanced disclosure and transparency on what is becoming recognized by legal, accounting, and regulatory authorities, as well as by the capital markets, as sources of novel risk, including social and environmental issues, to corporations and their investors.

Special factors for Canada

We have taken several contextual factors specific to the Canadian situation into account in framing our commentary for this Foreword. They are the following:

- Canadian stock exchanges are heavily weighted toward natural resources and financial industries. Canadian exchanges are a world-leading destination for investments in resources and are, therefore, uniquely exposed to public policy and public sentiment on extractive industries and issues such as climate change.[iii] Meanwhile, our financial services sector has experienced its fair share of exposure to recent governance scandals.
- Canadian systems for financial regulation — including the pension fund, securities, banking, and insurance regulation areas — are uniquely fragmented compared to other countries' regulatory regimes.[iv] The regulators have differing rules, making it time-consuming for companies and investors to navigate. This is particularly confusing to external (i.e., international) investors.
- Canadian micro and small cap companies comprise a disproportionately large number of all listed companies. This factor has a number of implications for public policy and requires particular sensitivity in discussions of the reporting and other resource-intensive requirements to be expected of such companies.
- A very low proportion of Canadian pension plans are active in venture financing, especially in comparison to US pension plans. Indeed, there is a generally perceived low tolerance for risk among Canadian investors — both individual and institutional.

[1] The views expressed in the Foreword are those of its contributors and do not necessarily reflect those of the Task Force or the National Round Table on the Environment and the Economy.

- Canada's spending on research and development (R&D), as a proportion of GDP, is relatively low compared to that of the other Organization for Economic Co-operation and Development (OECD) countries — despite some of the fiscal incentives that exist in Canada for R&D.

The following discussion of our three principal themes — regulatory efficiency, improvement of fiscal incentives, and enhanced disclosure — will lead to several key opportunities for Canada to explore.

Regulatory efficiency

We are convinced that the current fragmented and confusing nature of financial regulation in Canada acts as a net cost to Canadian firms and their investors and is thus a de facto drag on the efficiency and, in turn, the sustainability of those firms. For example, it is not controversial to assert that natural resource-based companies are important to Canada's competitiveness and productivity and that they represent a significant source of inward investment. We can also assert that Canada's mining and oil and gas companies are adopting world-leading technological innovations that promote both efficiency and long-term sustainability.

Consequently, it makes little sense to confuse foreign investors with competing provincial listings and unaligned regulatory requirements for those firms; in effect, that will only act as a drag on capital flows. We therefore agree with Bank of Canada Governor David Dodge's view that "there is no need for Canada to have different securities regulation for different provinces."[v] The report "Blueprint for a Canadian Securities Commission"[vi] put together by a national group chaired by Purdy Crawford, helps to move the debate beyond the need for a national system by making recommendations for actually designing and implementing a single securities regulator.

Similarly, we recognize that pension plans represent a large, somewhat untapped resource for venture capital and small- and medium-sized enterprise (SME) financing. We recognize, too, that there are opportunities to link such financing to sustainability issues of interest to pension plans and their trustees. It is noteworthy, here, that Canadian institutional investors are significantly less exposed than their US counterparts to the private equity market.[vii] This has been attributed to institutional barriers, both perceived (for example, due to lack of experience and memories of poor performance in the 1980s) and real (for example, the capital adequacy rules from the Office of the Superintendent of Financial Institutions that specify capital set-asides that are far greater for private equity relative to private debt). Institutional investors should not be discouraged from engaging in the private equity market.

We note the researchers' identification — in a study conducted by York University (Canada) and Kingston University (U.K.) on the comparative virtues of UK and Canadian public policy regarding pension plans and transparency on sustainability questions — of one of the key barriers to reform as being the fragmented nature of pension regulation in Canada.[viii] Again, this finding demonstrates how the interests of investors with respect to both transparency and sustainability may be hindered, or even negated, by regulatory inefficiency.

It is worth pointing out that Canada is internationally unique in not streamlining its financial services regulation. Clearly, this represents a significant and, potentially, a growing and very material impediment to our country's economic competitiveness and sustainability. We are in grave danger of being non-strategic and parochial in a world that requires a much more strategic policy formation.[ix]

Improving fiscal incentives

Canada is a highly competitive and relatively rich country in global terms — indeed, the second most prosperous after the U.S.[x] However, the gap between US and Canadian prosperity persists. Indeed, the prosperity gap, which stood at $3,200 in per capita GDP in 1981, grew to $8,700 in per capita GDP in 2004.[xi] This jump has been attributed mostly to lower productivity and partly

to matters related to capital markets. We acknowledge that there is no general shortage of capital in Canada. But Canada's cost of capital has, at times, been high, and its availability has failed to stimulate large-scale enterprise growth.[xii]

Compared to the U.S., Canada's marginal effective tax rates for both capital and labour are almost twice as high. Thus there is a particular disincentive for capital investment by Canadian firms, meaning that companies are more likely to purchase more labour than to invest in new machinery or equipment.[xiii] We agree with David Emerson, Minister of International Trade and Minister for the Pacific Gateway and the Vancouver-Whistler Olympics, who, in September 2005, drew attention to the uncompetitive nature of Canada's corporate tax system. One way to address this challenge would be to lower the fiscal penalties applied to capital investment — specifically, to ensure that corporate and capital taxation, including capital gains tax, remains competitive[xiv] and, especially, to encourage the growth of innovative young firms and competitive transitions for traditional firms with respect to the U.S.[xv]

Enhanced disclosure

Research commissioned by the Task Force from the Canadian Institute of Chartered Accountants (CICA) identified the Management's Discussion and Analysis (MD&A) section of annual reports as the most appropriate vehicle for identifying and highlighting sources of novel risk to firms and their investors, including those risks related to social and environmental issues.[xvi] We note, too, that the CICA recommended a range of policy options that might promote changes in corporate disclosure. In our view, however, what is needed for firms and their investors is a clearer and better disclosure of novel risks, not more. Empirical evidence exists that firm valuation can be affected by social and environmental performance;[xvii] investors are also explicitly factoring in these risks in their investment portfolios.[xviii] So the real question is how to ensure that the information on which these phenomena are based is both accurate and material. There may be awareness and outreach opportunities for both analysts and their clients in recognizing and responding effectively to novel sources of risk. This could enhance the efficient functioning of markets and, indeed, would not contradict the existing duty of financial advisors to advise clients on factors that may affect their portfolios.

We do understand that there is evidence that when individual investors begin to take a greater interest in personal investments and the management of their portfolios, they also take a greater interest in the nature of the companies in which they invest. We suggest, however, that enhancing the flow of salient information about the sources of novel risks and opportunities represented by Canadian investments may have an intrinsically positive impact on the availability of capital to more sustainable firms in the future.

Key opportunities

We believe that the main point of connection between the competitiveness of the Canadian economy, today and in the future, and the issues of sustainability relates to innovation. We refer, here, to innovation with respect to efficiency and productivity, as well as to the best use of technology and capital investment.

Many of Canada's leading companies are already active in the realm of efficiency and best practices that lead to positive economic, social, and environmental outcomes. These companies are featured in a variety of stock market and other rankings that recognize high performance in sustainability and economic value-added terms. But this is a long-term agenda that is also about creating the conditions that would allow for the emergence of tomorrow's products and services. Happily, some of our very best companies today are actively exploring the sustainable enterprise opportunities of the future, including alternative energy technologies, biotechnology, or nanotechnology.

There is a special category of industrial activity that also needs to be nurtured and facilitated by Canadian capital markets. We refer to the start-ups, new ventures, and high-technology "sustainable enterprises" of the future. One of Canada's biggest challenges is to ensure that the growth of this third category is not undermined because of the structural impediments identified earlier in this Foreword.

We believe that initiatives in the following key opportunity areas would help to promote the competitiveness, innovativeness, and sustainability of the Canadian economy and Canadian firms:

1) For regulatory efficiency

We suggest the streamlining of financial services regulation across Canada into a single market conduct regulator and a single prudential regulator. This would enhance the efficiency of Canadian capital markets generally and, therefore, the economic sustainability of Canadian firms.

2) For improved fiscal incentives

We suggest improved tax incentives for investment, especially with regard to the targeting of enterprise growth, but also in the areas of research and development, information technology, and human capital for all businesses. This would include the reduction of corporate tax and capital tax, faster depreciation on capital investments to enhance competitiveness, as well as an increase in the likelihood of investments in environmentally and socially beneficial technologies and skills.

3) For enhanced disclosure

We would suggest a requirement for clearer and better disclosure of novel risks in the MD&A section of annual reports, which might, in turn, facilitate greater transparency regarding social and environmental issues with respect to individual investors, and more effective disclosure of sustainability issues management by pension plans and other institutional investors.

4) For future research

More research on the detailed effects of all our recommendations would be welcome. We would also suggest that further research be conducted into the impacts of legitimate market-enhancing interventions by government. For example, is there a role for government procurement policy in this area? As well, there is a need to better understand how capital markets respond to new sources of information on novel risk so that information can be factored into stock prices.

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Investing in a sustainable future

1 Executive Summary

For some time now, Canadian corporations have been responding to calls from various stakeholders for improved performance and greater transparency on issues related to environmental sustainability, social justice, and rigorous and ethical corporate governance. While the trend to better performance and greater accountability is well underway, it has in no way become the norm. Whereas some companies have begun to engage stakeholders, implement recognized international norms and standards, and improve their public disclosure, the majority of large publicly traded Canadian corporations have *not* yet integrated sustainability policies, programs, standards, indicators, or audited reporting into their normal operating procedures, although an increasing number of FT500 corporations are doing just that.

There are significant risks associated with not recognizing, measuring, or managing these issues for individual companies, and for industry sectors as a whole, including questions of shorter-term competitiveness and longer-term viability. Indeed, the remaining gaps are significant. We must therefore ask ourselves: What is missing?

Although progress in responsible investment on the business front versus that of the investor should not be exaggerated, it is clear that, in the second instance, the missing element is institutional investors able to handle sustainability in a manner equivalent to that of the corporate sector. While some companies have begun to see the benefits of sustainability, institutional investors can still make short-term returns the "old-fashioned" way. To the extent that investors are not rewarding companies for integrating environmental, social, and governance (ESG) issues into their business decisions, they effectively discourage companies from going any further. This cycle is extended when certain institutional investors are or feel precluded from even taking into account ESG factors in their assessment process. Ultimately, who will pay? Perhaps the sustainability of Canada's future economy.

Meanwhile, economic and social forces are mounting, with the mainstreaming of socially responsible investment and consumer activism being good examples. They have not yet overcome, however, the existing inertia and countervailing forces.

Despite the recent legal clarification that was provided in a 2005 study by the large and well-known City of London law firm Freshfields Bruckhaus Deringer,[1] many fiduciaries in Canada continue to be advised by counsel that consideration of ESG factors is in general conflict with their fiduciary duty. Clearly, pension fund trustees must be made aware — perhaps via regulators issuing guidelines or, where appropriate, enacting regulations and/or legal changes by government — that considering ESG factors in capital allocation decisions is not *in conflict* with established fiduciary duties and that, in fact, not considering them may actually be a potential breach of such duty. Beyond this, we need a broad political and societal consensus for increasing the transparency of pension fund investment, as well as a voluntary or regulatory framework that ensures the inclusion of ESG factors in capital allocation decisions pertaining to pension plans and proxy voting.

Recent work by the Canadian Institute of Chartered Accountants (CICA) helps to provide some direction on corporate disclosure of ESG factors in Canada. The CICA's October 2005 Discussion Brief, *MD&A Disclosure about the Financial Impact of Climate Change and Other Environmental Issues*, pointed out that certain environmental (and social) disclosures are already required by securities regulators' rules[2] and, therefore, are, in fact, mandatory where likely to be material to investors.[3] The CICA's MD&A Guidance reinforces this principle.[4] Relevant securities regulators' mandatory disclosure requirements are also discussed in the CICA's November 2004 paper for the NRTEE,[5] which presented a range of policy options for consideration by the NRTEE Task Force to improve MD&A disclosure about ESG issues material to investors.

Without development of further rigorous guidance, the definition and consideration of materiality of ESG issues amongst capital providers could well be given a wide berth. But investors, particularly pension plans, need to understand the current and future risks associated with ESG issues. As well, such investors should agree on a common framework for disclosure of ESG factors; in short, they need to be able to measure the extent to which material issues are being identified and addressed. It is also important that disclosure of such material information (at least as presently defined) be enforced by securities regulators.

Finally, in order to temper investors' obsession with short-termism, which can run counter to the consideration and rewarding of sound ESG performance, signals must be created in today's capital markets to permit and encourage long-term sustainability considerations. Accounting, actuarial, and regulatory practices — including reporting — need to be changed to address the obsession with short-term earnings' performance and valuation. And improved incentives should be instituted for corporate and investor management of long-term cash flow.

Overcoming these challenges will require not only adopting proven international standards and practices, but also going beyond them. Creating a competitive advantage will mean taking a leadership role at the investor, corporate, and political levels. It will mean providing current and future investors as well as business people with the information and professional skills they need to integrate ESG factors into their decisions, now and in the future. Undoubtedly, sustaining our economic prosperity in a rapidly evolving global economy, one in which declining natural resources and growing population levels are the reality, will require innovation.

Canada is a recognized world leader in the capital markets for the financing and developing of global natural resources. Canadian corporations and capital markets can either continue in this leadership role, or let the international markets govern the terms with which we must ultimately comply. Indeed, current environmental, social, and governance issues are dividing leaders and followers alike.

The Task Force has made recommendations that it believes will encourage the integration of ESG factors into capital allocation decisions and contribute to a new and strengthened vision for investing in Canada's sustainable future. The recommendations of the Task Force are set out below and also at the end of the relevant chapters.

Recommendation 1.1

That the federal, provincial, and territorial governments adopt, in their respective jurisdictions, regulations that require pension plans:

a) to disclose on a recurring basis, at a minimum annually, the extent to which environmental, social, and governance considerations are taken into account in the selection, retention, and realization of investments; and
b) to disclose the extent to which environmental, social, and governance considerations are taken into account in proxy voting and corporate governance engagement activities, and to require pension plans to disclose their proxy voting activity.

Recommendation 1.2

That all fiduciaries, including institutional investors, money managers, and fund trustees, adopt voluntary practices to disclose (a) ESG considerations and (b) investment policy, and that they be encouraged to sign on to the UN-sponsored *Principles for Responsible Investment*.

Recommendation 2

That federal, provincial, and territorial governments or regulators enact guidelines or, where appropriate, regulations to clarify that the fiduciary obligation of the trustee includes the consideration of ESG issues that are financially material to investment decisions.

Recommendation 3

That the federal government lead by example and actively integrate ESG factors in

a) federal funding of grants and projects related to capital markets; and
b) federal pension plans.

Recommendation 4

That ESG issues be integrated into the education requirements of academic and professional institutions and programs

a) granting MBA degrees and CFA accreditation;
b) offering director education courses and certification; and
c) offering trustee education courses and certification.

Recommendation 5.1

That the Canadian Institute of Chartered Accountants (CICA) and the Canadian Securities Administrators, in consultation with the federal and provincial governments, establish an outreach and education program for capital issuers so as to increase understanding of the material ESG issues that should form part of the Management Discussion and Analysis (MD&A) section of annual reports.

Recommendation 5.2

That institutional investors, money managers, and trustees engage capital issuers (companies) on the potential materiality of ESG issues, adopt a policy regarding ways of addressing ESG factors in the decision-making process, and encourage the refinement and use of standardized ESG reporting.

Recommendation 5.3

That the Canadian Securities Administrators encourage the disclosure of financially material ESG issues through publication of a guidance or interpretation statement and encourage Canadian firms to be guided by established reporting frameworks such as the Global Reporting Initiative (GRI).

Recommendation 5.4

That securities regulators support the existing MD&A disclosure requirements as they relate to ESG considerations and, when required, enforce the ESG disclosure requirement.

Recommendation 6

That federal and provincial laws and regulations as well as the standards set out by professional bodies such as the Canadian Institute of Chartered Accountants (CICA) and the Canadian Institute of Actuaries (CIA) regarding accounting, actuarial valuation, and pension fund governance be assessed for their impact on sustainability and amended where necessary to address the needs of sustainable capital allocation.

Recommendation 7

That institutional investors assess the impact on sustainability of their investment policies and practices, paying particular attention to the quality of the investment research and the alignment of fund manager compensation practices with long-term performance.

2 Premise

Information is important to the proper functioning of capital markets. The quality of the decision to allocate capital — whether to invest or divest — depends on the quality and availability of the information relevant to the decision at hand. Choices between investment options rely to a large extent, too, on the comparability of the information. Given the short- and long-term consequences of these decisions — to the capital provider and issuer as well as to the individual decision-maker — the question of motivation also becomes paramount. What, then, are the incentives or penalties associated with these decisions? What are the core criteria for making these decisions? Are they short- or long-term factors? Are they financial? And do they take into account the social or environmental risk factors or values?

Financial stewardship

Private and public institutional investors, in general, and pension plans, in particular, invest large pools of capital on behalf of shareholders and employee beneficiaries. Their decisions and the criteria upon which the decisions are based can have broad economic, social, and environmental consequences. For publicly held corporations, pension plans often represent the single-largest share ownership positions. For those individuals relying on pension plans for their retirement income, the ways in which the plans are managed can also have serious personal impacts. In fact, the nature and prospects of the Canadian economy and competitiveness depend to a large extent on the choices made by the managers of these plans. The managers, for their part, ultimately make their choices based on established criteria, regulations, and traditional practices. All of this is driven by the expectations of pension fund stakeholders, including policy-makers and the public at large. And in the end, we Canadians get the financial stewardship we deserve.

> *We get the financial stewardship we deserve.*

Risks and rewards

For an economy such as Canada's — one that relies so heavily on natural resources and export markets — it is crucial to be keenly aware of both the sustainability issues here at home and the competitive innovations abroad. Other regions such as Europe and Japan, less blessed with natural resources, have invested more effort and money in environmentally sustainable business and investment practices. In much the same way, investors and companies that do business in those places and are faced with the difficult social consequences related to economic decisions — particularly in developing countries — have learned how to integrate such factors as human and labour rights into their decision-making processes. In Canada, we are faced with similar challenges, particularly now that we realize more clearly that our resources are finite, that the carrying capacity of many of the planet's ecosystems may be less than previously thought, and that the growing internationalization of trade has deep social consequences.[6]

What is working? What is holding us back?

The ultimate question for this report, then, is: What can Canada do to encourage capital markets so that we not only catch up with our European and other counterparts in integrating environmental, social, and governance (ESG) factors (or sustainability factors) into economic decisions, but also gain a sustainable competitive advantage?

Sustainable advantage

It is becoming clear to Canadian corporate executives, members of boards of directors, investment trustees, employees, pensioners, customers, activists, and voters that Canada's collective future depends on the extent to which we are able to leverage our advantages in human, capital, and natural resources to serve present and future generations. Ignoring issues such as human rights or climate change within new international regulatory regimes is no longer an option. Acting as if our resources are unlimited will not make them so. Pretending that we do not rely on foreign financial and consumer markets will not make us any the less dependent. If we ignore the global trend to include "non-financial" risk factors in investment decision-making, we do so at our peril.

We must now ask ourselves the following questions: Are we gaining a sustainable advantage or disadvantage in the way we invest the resources at our disposal? What is working in our favour? What is holding us back? And what can we do about the situation?

3 Capital Markets & Sustainability

Drawing on the diversity of its members' wealth of insight and experience, the NRTEE seeks to generate and promote innovative ways to advance Canada's environmental and economic interests — co-operatively rather than in isolation. In this capacity, it examines the implications of priority issues and offers advice on how best to reconcile the sometimes competing interests of economic prosperity and environmental conservation.

Capital Markets and Sustainability Program

With the Capital Markets and Sustainability Program, the NRTEE undertook to explore the relationship between capital markets, financial performance, and sustainability in Canada.

Over a period of two years, the members appointed to guide the Task Force on Capital Markets and Sustainability and its program met with approximately 200 participants from the private, public, and civil society sectors. A series of five regional and multi-stakeholder meetings were conducted across the country, during which the parameters of the project were "scoped-out." Six background papers[7] were subsequently commissioned, four of which were used in ten further consultation meetings held across Canada. At each session, participants were asked to consider the extent to which sustainability factors are being incorporated into capital allocation decisions by both providers (investors) and issuers (companies).

The goal was to determine the nature and scope of the associated barriers and to identify opportunities for Canadians to "get ahead of the curve." While the format was designed to capture a range of ideas and experiences related to this question, the overarching objective was to distill the findings into a set of actionable recommendations for policy-makers and capital market participants.

The consideration of commissioned research and the deliberations of the Task Force on Capital Markets and Sustainability — a body composed of prominent executives or representatives drawn from business, labour, government, academia, and other multi-stakeholder backgrounds from Canada and abroad, and assisted day-to-day by its policy advisor[8] — led to the development of this research process. A further dimension to the multi-stakeholder process was the participation of the Task Force's co-chairs and policy advisor in the Experts' Meetings of the UN's Principals of Responsible Investment initiative, a project convened by the UN Secretary General Kofi Annan and implemented by the UN Environment Programme Finance Initiative, as well as the UN Global Compact. The first Experts' Meeting was sponsored in April 2005 in Paris by the French Government's Caisse des dépôts et consignations; a follow-up meeting was co-sponsored by the NRTEE and the Toronto Stock Exchange (TSX) in September 2005. The meetings of the Experts[9] on the Principles for Responsible Investment, held in Paris and Toronto, worked in an iterative manner (during the second half of 2005) with a group of investment professionals in London and New York

> ***Progress to date has not been due to the "pull" of investors.***

City representing 20 large institutional investors in 12 countries. The outcome of this work, the *Principles for Responsible Investment*,[10] was released in final form at a ceremony at the New York Stock Exchange April 27, 2006 (for North America) and at the old Paris Bourse on May 2, 2006 (for Europe).

Addressing two key questions

By both facilitating a strong, neutral, independent multi-stakeholder debate on responsible investment and corporate responsibility and exploring the links between sustainability (comprising environmental and social issues) and financial performance in Canada, the Round Table strove to address two key questions:

- *Is there a financial return to business in pursuing corporate responsibility (CR) policies?*
- *Is the pursuit of such policies rewarded through the investment allocation decisions of fund managers in the capital markets?*

With regard to the first question, the Task Force heard anecdotally that pursuing good CR policies is not rewarded by the market, but that, by the same token, a company that ignores the pursuit of good CR policies is often punished by the market. Thus in a sense, the market places a premium on good CR, although not in the manner initially supposed; that is, it punishes companies with poor CR performance and only indirectly, in relative terms, rewards companies with good CR performance. The Task Force also heard that one of the reasons for the disconnect between good CR and no (apparent) returns was that the metrics were not yet sufficiently developed. However, a modest contribution to establishing the links between sustainable development (SD) disclosure and return was subsequently provided by a report commissioned by the NRTEE.[11] The report provides a pilot framework that comprises ten worked examples of the conversion of sustainable development disclosures of five major Canadian mining companies,[12] using standard valuation techniques,[13] into financial values. It is hoped that this work will provide examples to mainstream financial analysts as to how they might begin applying sustainable development disclosures in their daily analytical work for investment advice.

At the same time, the Task Force noted the existence of anecdotal soundings taken from the mainstream business community. It also heard about substantial academic investigations, as well as reviews of groups of studies showing medium (and stronger) correlations between good CR and financial performance. The Task Force notes that, setting aside the question of the link between disclosure and financial returns, there are now more than 80 empirical investigations examining the link between corporate social (and environmental) performance and financial performance.[14]

With regard to the second question, the Task Force heard that the pursuit of good CR policies is not rewarded via the investment allocation decisions of fund managers in the capital markets. However, evidence does show that this situation is beginning to change with, for example, the development, in 2005, by a huge domestic capital provider, the Canada Pension Plan Investment Board, of a Policy on Responsible Investment, and its pursuit of this policy beginning in 2006. Additionally, the board of British Columbia Investment Management Corp (BCIMC), one of the largest pension funds in Western Canada and a recognized leader in global infrastructure investments, has introduced the early-stage notion of using "triple bottom-line" investment guidelines in the consideration of investments. As well, the Caisse de dépôt et placement du Québec pursues CR policies in investee corporations via engagement practices.

As the Task Force's work progressed, however, the two initial, key questions of the report (and their answers) were eventually used only as guidelines for the fuller development of the Task Force's public consultations and deliberations.

State of the Debate Report

Besides presenting the program's key findings and providing policy recommendations to the federal government, this *State of the Debate (SoD)* report is intended to shine a light on issues that go to the heart of Canada's future economic prosperity, competitiveness, environmental protection, and social justice. For this reason, it is less of an end point and more of a point of departure for a broader societal dialogue about how to create sustainable value.

As such, the Task Force report discusses various barriers and addresses several key areas with regard to incorporating environmental, social, and governance issues into the investment process. The general themes and intended recommendations fall under the broad categories of *fiduciary duty*, *materiality*, and *short-termism*.

The *State of the Debate* report begins with a brief summary of the state of corporate sustainability in Canada. It looks at the key drivers for change, including protection of reputations and access to resources, consequences related to disclosure, stakeholder engagement, and the application of international standards. Notably, most of the progress to date in Canada has stemmed from the "push" of consumers and retail investors, rather than from the "pull" of institutional investors seeking a change in behaviour.

Recognizing this lack of engagement by institutional investors, the *SoD* report probes both the causes and significance of this lack. For the most part, the report focuses its attention on capital providers in general, and on pension plans more specifically; these institutions hold the reins of investment capital, and by their action or inaction have considerable impact on how the Canadian economy evolves to meet the needs of current and future generations. In fact, it was only recently that institutional investors paid attention to the environmental and social risk factors that affect financial performance. Witness such initiatives as the Carbon Disclosure Project,[15] a US$31-trillion investor-led coalition involving 225 institutional investors, and the United Nations Environment Program Finance Initiative (UNEP FI), a global partnership with the financial sector. Finally, in what is essentially the last third of the report (chapters 7, 8, and 9), we consider several key barriers to, and desired outcomes for, increased corporate sustainability in Canada.

Actions for a sustainable future

It became clear during the round table discussions that there are many ways to encourage capital markets to further integrate environmental and social factors into decisions related to capital allocation, or at least to remove some of the barriers to doing so. Some of these ways relate to promoting incremental improvements, such as the disclosure of sustainability factors in the Management Discussion and Analysis (MD&A) sections of annual reports to shareholders, as discussed in the 2004 paper prepared by the Canadian Institute of Chartered Accountants for the NRTEE, *Financial Reporting Disclosures about Social, Environmental and Ethical (SEE) Issues*.[16] It should be noted that while there is no statutory or regulatory requirement for companies to prepare annual reports to shareholders, the MD&A is a regulatory filing that is typically included in companies' annual reports. Other ways relate to developments that occurred during the round table process itself, such as the publication of the report on trustee law[17] by the City of London-based law firm, Freshfields Bruckhaus Deringer, which, when it was submitted to UNEP FI, finally cleared the air on whether fiduciaries, including pension fund trustees, may legally consider certain factors. It also became increasingly clear during the round table discussions that narrow recommendations that apply to incremental improvements, while beneficial, will not have the deep impacts required in the face of Canada's broad, global competitive challenges.

For all these reasons, the Task Force decided to present a series of high-level, long-term recommendations that would inspire not only further debate, but immediate action. These recommendations are presented in the final chapters of the report.

4 Sustainable Corporations

Economist Milton Friedman's famous 1970s quip — that "a business's social responsibility is to increase its profits"[18] — has been a truism for private enterprise since at least the beginning of the Industrial Revolution. As recently as the 1940s, companies' expectations were as limited as the number and type of stakeholders. For example, getting good financial results was generally more important than worrying about how the results were achieved. Workplace health and safety was an inexact science. Dumping waste was as common as treating it. Community investment[19] was about supplying softball uniforms. Certainly no one talked about responsibility for future generations. Last but not least, shareholders were king.

If you are not part of the solution, you are part of the problem.

A number of factors have changed these rules. A series of environmental disasters, various breaches of ethics, human rights abuses, the evolution of sustainable development and corporate responsibility, the development of instant access to information via the Internet and 24-hour newscasts, and the rise of stakeholder engagement have all had a part to play. Non-governmental organizations (NGOs) in every industry and every domain (environmental, labour, human rights, etc.) now hold the high ground in terms of public credibility. In fact, today, long-time activist investors such as the New York City Office of the Comptroller and the US-based Interfaith Center on Corporate Responsibility (which coordinates religious investors with assets of $110 billion) have been joined by an increasing number of mainstream investors. At the same time, the reputations of corporations have generally suffered, with poll after poll in recent years showing that trust in corporations and CEOs is at an all-time low. Indeed, according to the public, if you are not part of the solution, you are part of the problem.

And so calls for action continued to grow. Today, the forces that gathered over these past three decades have culminated in the expectation that corporate performance and well-being cannot be separated from the larger social and environmental context. For any business to establish itself — to grow, prosper, and sustain itself — various long-term (if not eternal) inputs, such as human, financial, and natural resources, including material and energy, are required.

Corporate responsibility and sustainability

While perhaps self-evident, the goal of organizations is to ensure their own, long-term viability by maintaining continual access to, natural, human, social, and investment capital. This requires that organizations clearly define their roles and responsibilities vis-à-vis society and a wide range of stakeholders (not just shareholders) with whom they share mutual interests. Not only must they understand stakeholder expectations, they must also know what is at stake. In the recent

The early business case: this hurts, let's fix it.

past, many companies began to embrace the principles of corporate responsibility and sustainability as a reaction to negative forces (i.e., consumer boycotts). These corporate efforts, often driven by a perceived need to protect a brand, were usually superficial or short-term initiatives that tended to focus on image rather than substantive change, and they persisted until (and unless) a clear gap arose between the company's promise and its practices — one that threatened the company's core business. What might initially have been viewed as a communications problem had now become a strategic management issue.

The following drivers are among those most often identified by corporate social responsibility advocates attempting to make the business case for sustainability: reducing business risk; improving a corporation's reputation (which, in turn, enhances the corporation's social licence to operate or grow, and includes improving relations with regulators); and, linked to that last driver, enhancing brand image.

As well, or so the argument goes, pursuing corporate sustainability policies can also, in some instances, increase the productivity and efficiency that lead to innovation. It can lead to cost savings and an improved bottom line. It can attract and retain skilled employees and customers through increased employee morale. It can also attract capital, thanks to an improved reputation with investors, bond agencies, and banks, and facilitate access to new markets.

But actually measuring these outcomes is a more complicated matter. In the extractive sectors, in which protection of the "societal licence to operate" cuts to the core of the business model, the case for investing in environmental protection was quite easy to make. That same phenomenon of vulnerability applied to avoiding the "not in my backyard" syndrome, in which major projects get delayed or refused. Suddenly, community consultations and investment made good business sense.

Other corporations with well-known consumer brands quickly figured out that increasingly sophisticated and well-informed citizen activists could cause significant impacts on market share. The business case became essentially: this hurts, let's fix it.

More and more, then, companies began to realize that there is a link between good corporate citizenship and good, or even better, financial performance. Much like the initially expensive

Ethical performance is a proxy for good management.

investments in quality control, many operators soon realized that good corporate citizenship paid off in increased efficiency, lower costs, and greater market share. Those committed to established international principles, policies, and measurable corporate responsibility programs learned that their operations benefit from better employee relations, recruiting, and retention (through reputation); lower costs (through eco-efficiency); innovative products (through Design for Environment, or Life Cycle Analysis); and increased market share (through green products or labour-rights monitoring).

Most recently, true stakeholder engagement (especially with former adversaries) has led to better facility management — especially in cases where the NGOs know what's happening in the factories even before the CEOs do. Companies have begun conducting stakeholder research and consultations well in advance of seeking project approvals. Multi-stakeholder coalitions are increasingly prevalent, well-known examples being the Forest Stewardship Council (bringing together the World Wildlife Fund, trade unions, and corporations), the Global Reporting Initiative, and the Carbon Disclosure Project. First Nations accords and joint ventures are now common in the energy sector, while multi-stakeholder associations are more and more the norm in corporate life (e.g., the Coalition for Economically Responsible Economics [Ceres][20]). Today, companies that were initially screened out by socially responsible and ethical investors are now responding to questionnaires to

facilitate their inclusion in key indexes; they are entering into constructive dialogues as a result of shareholder resolutions. For their part, international NGOs such as Greenpeace and the Sierra Club are moving toward collaborative models based on strategies that differentiate corporate behaviour.

But the cause and effect relationship between action/inaction and benefits/penalties remains hard to prove. At the very least, good ethical performance is a proxy for good management — as witnessed by the Institute of Business Ethics when it found that companies with a public commitment to ethics perform better, on three of four measures, than those without such a commitment. As well, leaders tend to outperform their laggard competitors in terms of financial results, as seen by the performance of the Dow Jones Sustainability Index and the Jantzi Social Index. Or take the ethical, or socially responsible, investors who have long used screening to decide which sectors to invest in (i.e., not tobacco) and engagement to address concerns about companies in their portfolios. Still more recently, an increasing number of large, mainstream institutional investor counterparts have added engagement strategies to influence corporate behaviour. These take the form of public communication with other shareholders (i.e., through the formation of investor coalitions on issues such as HIV/Aids and climate change) as well as the use of social and environmental evaluation criteria. Interestingly, most mainstream capital providers (such as the Canada Pension Plan Investment Board [CPPIB] in its "Policy on Responsible Investing"[21]) who reject positive and negative screening as suitable investment strategies[22] have now turned to publishing various policies dealing with corporate responsibility and to developing systems that model the associated risks and volatility, which, if managed properly, can mean profit. It seems that consideration of ESG issues is leading more and more corporations to modify their relationships with investors, not to mention their operational decisions and public disclosures.

Public disclosure

The efficient functioning of capital markets requires a full and timely disclosure of material information, particularly as it relates to investment risk. When it comes to identifying and evaluating non-financial risks, which are often loaded with externalities (as are environmental issues), the result can be an asymmetrical market. Indeed, some companies are not rewarded appropriately for sound environmental performance, even as some poor performers are penalized. Publicly traded companies in Canada have long been required to report material information via a variety of vehicles, including the Management Discussion and Analysis (MD&A) section of annual reports, the Annual Information Form (AIF) and, in short form, the Prospectus. Yet even with all this, the disclosure of environmental and social risk factors is not widespread.

In March 2004, the Canadian Securities Administrators (CSA) put into force National Instrument 51-102. This was a set of new rules that amended financial reporting requirements and affected financial statements, MD&As, and AIFs. These changes served to harmonize continuous disclosure requirements across Canada. To some extent, the coming into force of NI 51-102 also enhanced social and environmental disclosure requirements. The new rules required "social and environmental policies of the reporting issuers" to be described in the issuer's description of their business if such policies were "fundamental to the issuer's operations."[23] However, this represented an enhancement of social and environmental disclosure rather than an innovation, as the AIF, long before 2004, had called for specific disclosures regarding environmental and social policies and various risks.

Meanwhile, work continued on various fronts with respect to expanding the role of the Management's Discussion and Analysis in highlighting social and environmental risks. While the MD&A appears in the annual report of a company listed on the stock exchange, the corporate annual report (as such) is not in itself a required disclosure. Rather it is the

financial statements, the MD&A, and the AIF that constitute the disclosures required by the CSA to be filed, annually and quarterly, and distributed to shareholders upon request.

In the new post-Enron environment, company directors must ensure that their organizations have well thought-out and articulated financial and non-financial risk management policies in place.[24] But while the conventional corporate governance model seeks to ensure long-term shareholder value, there ought to be a new approach to incorporating social and environmental risks and impacts. Potentially, this could be developed at a later date to take into account the realities of director liability.

A key trend in US and international capital markets is greater disclosure. For instance, the American *Sarbanes-Oxley Act of 2002* seeks to enhance investor confidence through greater disclosure and increased director liability apropos insufficient corporate disclosure. In effect, US chief executives and chief financial officers now have to sign-off personally on their company's financial statements. There is some corollary to this in Canada. While the CSA's 2004 National Instrument 51-102 on continuous disclosure obligations does not cover CEO and CFO certification, the CSA's Multi-national Instrument 52-109 does require a sign-off covering not only the financial statements but also the MD&As and AIFs, thereby potentially containing disclosure of environmental and social policy. However, in fact, the certification speaks more to the reliability and timeliness of the disclosures than to the actual nature of what is disclosed. In Great Britain, all pension plans must disclose the extent to which social, environmental, or ethical considerations have been taken into account in the selection, retention, and realization of investments. In France, firms are required to report on social and environmental issues in their financial reports. As for South Africa, companies listed on the Johannesburg Stock Exchange must comply with the King II Report, which includes references to issuing sustainability reports based on the Global Reporting Initiative (GRI) guidelines.[25] With respect to financial reporting and auditing, these include regulations for CEO and CFO certification of financial statements, as well as rules concerning the role of audit committees and auditor accountability.

Here in Canada, Canadian corporate disclosure of ESG factors is on the rise, with the number of Canadian companies that report according to GRI Principles having grown from just 6 companies in 2004, to 23 in 2005 (representing about one-third of the TSX Composite Index in 2005), and to 35 in 2006.[26] The take-up of the GRI approach among large capital issuers in the United States has also shown growth. For example, the number of S&P 100 index companies that report using GRI principles grew from 26 (or 26%) in 2005 to 31 (or 31%) in 2006. As for the S&P 1200 index, the percentage of GRI-reporting companies grew from 21 percent (or 256 of 1200) in 2005 to 24 percent (or 292 of 1200) in 2006.[27]

The investor case

Corporate actions in support of CR have been undertaken primarily in the face of operational and reputational challenges and without any motivating, substantive, positive incentives from the financial community. Although the idea of socially responsible investors (SRI) continues to gain acceptance, it is intended more as a vehicle for aligning investors' values and their investment practices, or for social change using negative pressure, than as a way of identifying investments that will outperform the market. Indeed, vehicles such as the Equator Principles limit access to project financing unless certain social and environmental factors are addressed. For most Canadian companies, however, this has little relevance.

Clearly, although some leading companies and mainstream investors have begun to evaluate the financial risks associated with issues such as climate change, corporate behaviour is still largely driven by incentives. In effect, corporations continue to inquire how, beyond avoiding punishment from their stakeholders and investors, they can be rewarded for decisions that incorporate environmental and social factors into their decision-making. "How," they ask, "can we ensure that investors are aware of these issues, understand our actions, and are able to evaluate our progress and competitive positioning?"

5 Sustainable Pension Plans

Some Canadian corporations, much like their major international counterparts, have begun to see the benefits of incorporating environmental, social, and governance factors into their decision-making. Many are working to increase shareholder value by better managing risks, protecting and accessing markets, developing new products, ensuring access to critical human and natural resources, and anticipating or mitigating the impact of regulations. Many have also committed themselves to contributing to the sustainable development of the economies in which they operate.

Pension plans are currently driven by narrow, short-term financial criteria.

Finance industry players such as chartered banks and insurance companies now have systems in place to consider environmental, social, and governance factors in lending and insurance decisions, as well as mechanisms to improve transparency (i.e., public accountability statements), which may include adoption of Global Reporting Initiative (GRI) standards. As well, signatories to the Equator Principles, for example, require the integration of ESG factors in project-financing decisions. However, the coordinated, consistent, and pervasive evaluation of environmental, social, and governance factors by Canada's other mainstream institutional investors has yet to happen. There is, though, an international collaboration between asset owners and asset managers, the Enhanced Analytics Initiative (EAI), which is aimed at encouraging better investment research through an innovative approach to promoting better ESG disclosure. Although based primarily in Europe, the EAI has also been making headway in its approach in Canada by building links with Canadian pension plans.

Capital allocation decisions by trustees of pension plans continue to be driven primarily by narrow, short-term financial criteria. While ESG factors may get indirectly factored in — if, for example, a boycott is hurting sales — corporations that take the lead in this area are sometimes left wondering how they will be rewarded by investors. As for those who continue to ignore or avoid integrating ESG factors into their operations — yet still receive investment capital — they are often left pondering what the fuss is all about. For the Canadian public, then, the question remains: What has to happen to ensure that these factors are leveraged to increase Canada's long-term productivity and competitiveness?

Pension plans

Pension funds, by their very nature, should be oriented to generating real financial returns over the long term in order to ensure pension payouts. Indeed, pension plan profiles evince a natural fit with sustainability considerations, which are also oriented to the long term. In fact, given the long-term nature of their liabilities, pension funds should be — and often are — the long-term investors *par excellence*. As David Dodge, the Governor of the Bank of Canada, indicated in a speech delivered to the Association of MBAs in Montreal, pension plans are important to the economic and financial efficiency of the country, and play a key role as long-term investors:

Pension plans generate important benefits in terms of economic efficiency. By transferring risk from individuals to collectives, pension plans help achieve a more efficient allocation of savings. Pension plans — particularly the very large ones — tend to have sophisticated asset managers. These large plans have the incentive and the ability to invest pools of contributions across appropriately varied asset classes. Further, they invest over very long time horizons, so they can finance large investment projects at competitive rates of return. All of this contributes significantly to economic efficiency by transferring risk to those investors that are best able to bear it …[28]

The Governor of the Bank of Canada's comments make the point that the very fact of being long-term investors allows pension plans to be efficient investors. The comments, incidentally, help to draw some of the links between taking the long-term view, obtaining more efficient returns, and achieving sustainability.

The three largest pools of capital in Canada's pension system are (i) the Canada Pension Plan (CPP) and the Quebec Pension Plan (QPP); (ii) the private pension plans; and (iii) the employer-sponsored pension plans. Across the Canadian pension system, more than 13,800 registered pension plans are in place. There has also been considerable growth in dollar terms in institutional investments over the past 20 years, with similar growth anticipated over the next 20 years. Indeed, the Organization for Economic Co-operation and Development (OECD), which tracks this growth worldwide, notes that Canadian pension plans as a subset of institutional investments increased more than 800 percent between 1980 and 2000.[29]

The current size of the Canadian pension systems is considerable. Estimates for 2004 assess total assets held by employer-sponsored pensions at about $594 billion.[30] The figures, while large in themselves, also show substantial growth. For example, the figures for total assets under administration of the CPPIB in recent years are $70.5 billion (for 2004), $81.3 billion (2005), and $98.0 billion (2006).[31] Similarly, for the Quebec Pension Plan, available recent equivalent figures for assets under administration are $175.5 billion (for 2004) and $216.1 billion (2005).[32] These plans, which together form one of the largest pools of investment capital in Canada, in recent years owned about 20 percent of the stock of Canada's big-name, publicly traded companies.

In addition to their role as a significant participant in capital markets, pension plans are key drivers of change. Pension plans are also dependent on the Canadian economy and are, themselves, significant economic players. For example, as whole-economy investors, these plans must concern themselves with more than the business case for sustainability on a corporation-by-corporation basis. Certainly, pension plans are long-term investors, but their size and global diversification also make them universal owners,[33] a term which implies that what is an "externality" at the level of one firm can end up as an "internality" and a material factor in terms of their global portfolios. Both the long-term issues and the universal investor implications allude to the fact that the best interests of the plan members and the beneficiaries — the test of fiduciary duty — are best served when ESG factors are taken into account.

Public plans

No pension plans are as dependent on the economic prosperity of Canada as are the Canada and Quebec Pension plans.[34] In both cases, little in the way of pension benefits will be coming out of the reserves in the near future; most payouts will emanate directly from the contributions of active workers. For example, at the time of writing (October 2006) the Canada Pension Plan Investment Board website reports that "income from the money that we invest today will be used by the Canada Pension Plan to help pay pensions beginning in 2022."[35] As for the Quebec Pension Plan, the last triennial actuarial report (dated December 31, 2003)[36] indicated that 100 percent of pension benefits would emanate from the active workers' contributions until 2015 "when investment income from the reserve will be used to fund the expected cash outflows, after all contribution income has been applied."[37] For the QPP, if one projects forward to nearly mid-century, the

actuarial projection is that "investment income will be used to bridge the gap between income from contributions and cash outflows until 2042,"[38] and that from 2043 "withdrawals from the reserve [will] accelerate the narrowing of the ratio between the reserve and cash outflows."[39] Clearly, these public plans are highly susceptible to the performance of the economy, most notably the employment and productivity levels. Because sustainability issues are critical for Canada, perhaps the case could be made that these public plans should be most proactive in promoting sustainability.

Initially, numerous large pension plans, as well as investors such as the California Public Employees' Retirement System (CalPERS) among others, demonstrated an interest in screening investments; more recently, they have shown an interest in more comprehensive, responsible investment engagement strategies. Another case in point is the Fonds de solidarité FTQ, which, although not a pension plan, acts as an investment fund controlled by the Quebec Federation of Labour and invests venture capital with social objectives in Quebec's small and medium enterprises (SMEs). Some major Canadian capital providers, however, are beginning to prefer engagement techniques (with companies) rather than screening techniques. As for the Quebec Pension Plan, the Caisse de dépôt et placement du Québec, in January 2005, introduced a new, responsible investing policy that advocates active engagement as part of its tools to promote good CR. An extract from a press release by one of the Caisse's affiliates concerning the new policy on socially responsible investment illustrates the interest of the Caisse in engagement techniques:

The Caisse intends to maximize its influence in the area of socially responsible investment. For this reason it favours an interventionist approach through a specific policy guiding it in exercising its proxy voting rights and by preferring to engage in dialogue with the companies in which it invests.[40]

Interestingly, on October 13, 2005, the CPP Investment Board introduced a Policy on Responsible Investing[41] that is generally aligned with the key findings in this SoD report, including its preference for engagement. Moreover, three major institutions in Canada have now signed on to the Principles for Responsible Investment (PRI) — the Caisse and the CPP Investment Board, both as asset owners; and the BC Investment Management Corporation (BCIM), as investment managers[42] — in a sense, leading the way for Canada's other major fiduciaries.

Barriers to change

The Task Force identified three key barriers to integrating ESG factors into the capital allocation decisions of pension plans. These barriers constitute the basis for the Task Force's recommendations on guiding capital markets and policy makers. The three barriers and their attendant questions are as follows:

- **Fiduciary duty:** Are there perceptions and practices among pension fund trustees vis-à-vis their fiduciary duty that limit the inclusion of ESG factors in investment decisions? If so, how can they be overcome?
- **Materiality:** Is there alignment or disagreement between what capital providers and companies deem to be material? If so, what does this mean to the nature and scope of information sought, provided, and integrated?
- **Short-termism:** Are there short-term behaviours that go against the inclusion of longer-term investment criteria? What can be done to change them?

6 Fiduciary Duty

The traditional approach of fiduciaries in Canada incorporates two main views: (a) that the consideration of ESG or non-financial factors in conjunction with capital allocation decision-making is in general conflict with the fiduciary duty of these groups or individuals; and (b) that although their duty requires maximizing financial returns, fiduciaries' duties are actually more about exercising prudence.

Failure to account for ESG factors may be a breach of fiduciary duty

This approach may reveal an overly rigid interpretation of fiduciary duty or a lack of clarity as to legal limits. It may also belie the lack of appreciation for the highly material nature of many ESG issues, such as diminishing ecological services, decreasing natural resources, and increasing social unrest, among others. In fact, doing away with the ambiguity of whether or not a consideration of ESG issues falls within the scope of fiduciary duty may actually turn the tables to such a degree that not considering ESG issues becomes perceived as a potential breach of fiduciary responsibility. For example, lead advocates of the Carbon Disclosure Project are now actively participating in the growing camp that supports making hard market evidence of higher returns demonstrably available and, thus, the lack of consideration of ESG issues (such as carbon risk) a real, not just a perceived, breach of fiduciary responsibility.

Legal limits

The overview of a recent study by the large and well-known City of London law firm Freshfields Bruckhaus Deringer (which reviewed the legal parameters defining fiduciary duty in nine different international jurisdictions including the U.S. and Canada) has essentially put this question to rest — at least from a legal perspective. The central finding of this UN FI-sponsored report confirmed that a failure to take ESG issues into consideration in investment decision-making is, in itself, a breach of fiduciary duty. Since ESG issues can be material, the report states that it is mandatory for investment decision-makers to treat ESG issues as relevant, although the weight attributed to each such consideration would lie with the decision-makers themselves. In effect, the decision-makers are directed into a process in which they must consider the ESG issues, although the actual weighting is up to them. Note that the Task Force decided not to define "materiality" *per se* because it varies according to the investor.

Another important finding of the Freshfields Bruckhaus Deringer review is that, all else being equal, a financially neutral ESG consideration can be used as a tie-breaker in an investment decision. This finding may eventually serve as an important link between value-based and *values*-based investment decision-making.

Non-financial issues

Recently, because of the associated risks, institutional investors have publicly expressed concerns about the disclosure of "non-financial" issues — such as climate change (e.g., the Institutional Investors Group on Climate Change), corporate

governance (e.g., the Canadian Coalition for Good Governance), and HIV/AIDS. While Canadian law has seemingly not yet caught up with today's operating environment, similar sentiments have also been expressed by legal experts in the U.S. This is still, however, an area with little legal or practical clarity. Indeed, investors' ability to take this information into account remains limited by the nature and scope of corporate disclosure, as well as by the current inadequate reporting on social and environmental issues. In addition, the situation is exacerbated by the lack of pertinent information — whether in legal, business, or securities-orientated academic courses or in professional training.

Proxy voting, engagement, and sustainability

Pension plans are collectively significant shareholders of public corporations. The very voting of shares and engaging with corporations on social responsibility and sustainability issues has permitted pension plans to address these issues without having to confront fiduciary issues — or at least not to the same extent as must a "screened" portfolio. For many pension plans, especially medium-sized and larger, proxy voting has meant a learning curve for managers dealing with ESG factors; indeed, some fund managers have taken note of this trend as they broaden their proxy-voting policies as well as their discretionary powers in order to interact with the companies in which they invest. Also, shareholder activism is now reinforcing exchanges between social and environmental activists, pension plans, and other institutions, thus contributing to the building of a culture in which ESG factors are viewed as key to assessing the performance, or risk, of individual firms.

UK reform

The pension fund reform experience in the United Kingdom regarding these issues is relevant. In the U.K., pension regulations since 2000 have required plans to disclose (a) the extent (if at all) to which ESG considerations are taken into account in the selection, retention, and realization of investments; and (b) the policy (if any) that directs the exercise of the rights (including voting rights) associated with investments.

First of all, just as in Canada, the UK legal and regulatory framework for pension plans was (and is) complex, embracing trust law, contract law, tax law, social security law, employment law, and the *Financial Services Act*. Second, despite this complexity, effective political leadership, combined with active consultation with stakeholders, was sufficient to establish a broad political and social consensus for including policies on social, environmental, and ethical issues in formal statements of investment policy — thus increasing the transparency of pension fund administration in the U.K. A key step in the consultation was the government's signalling that the reforms were consistent with established practice in fiduciary duty, thus removing the "regulatory chill" that had previously applied to pension trustee duties. Third, there is no evidence that the UK reforms have resulted in negative impacts on costs or efficiency. Indeed, these apparently threat-free UK reforms are currently being adopted elsewhere in the world, consistent with the general desire for more transparency and accountability in corporate governance and performance now being promoted by the OECD and other bodies. Fourth, pension fund reform requires active engagement by fund managers, pension professionals, pension forums, and civil society actors. Clearly, however, although legal parameters should no longer be considered a barrier, misunderstandings still occur in this general area with regard to the trustee's entitlement to take ESG considerations into account. The United Kingdom's experience with trustees taking ESG considerations into account, as well as the experiences of other countries, should provide fruitful models for Canada to consider.

FIDUCIARY DUTY: BARRIERS/CONSIDERATIONS	DESIRED OUTCOMES
Despite recent legal clarification, many fiduciaries in Canada continue to feel that consideration of ESG factors is in general conflict with their fiduciary duty. While the U.K. has legislated disclosure of the consideration of ESG factors, it has not required integration of these factors into investment decisions. Given the highly material nature of many such issues (e.g., diminishing ecological services, depletion of natural resources, social unrest), this remains an important barrier to a full consideration of all risk factors.	That, in light of the recent Freshfields Bruckhaus Deringer law firm study, pension fund trustees should be aware (a) that considering ESG factors in capital allocation decisions is not in conflict with established fiduciary duties; and (b) that not considering these factors may, in fact, be a potential breach of such duty.
The U.K. has taken an early lead in encouraging the disclosure of environmental, social, and governance considerations in investment decision-making. It has also encouraged the development of the practice of proxy voting to reflect investors' consideration of ESG issues in investment decision-making. In Canada, the enhanced disclosure and transparency of non-traditional sources of risk (including environmental, social, and governance issues) by corporations to their investors would be critical to pursuing optimal outcomes for the competitiveness of Canada's industry and the overall sustainability and well-being of Canada's economy — indeed, to Canadians everywhere. Both capital issuers and capital providers have a role to play in enabling transparency and disclosure. While part of this role can be discharged through voluntary actions, the other part may require light-handed regulation in order to close the gap and shift behaviours.	That Canadian political leadership should be combined with active consultation with stakeholders, in order to establish a broad political and societal consensus for increasing the transparency of pension fund administration with respect to policies on social, environmental, and governance issues included in formal statements of investment policy. That a Made in Canada framework should be established whereby governments or regulators create guidelines to ensure the inclusion of ESG factors in capital allocation decisions of pension plans, their corporate governance engagement activities, and proxy voting activities.

Continued

FIDUCIARY DUTY: BARRIERS/CONSIDERATIONS	DESIRED OUTCOMES
The Task Force has taken account of current, positive international developments in the work that parallels that of the Task Force (i.e., the development of the voluntary Principles for Responsible Investment, stewarded in part by the UN, as well as the release of the UN-commissioned legal opinion from the U.K. law firm of Freshfields Bruckhaus Deringer). These developments have enhanced the Task Force's work on trustee fiduciary obligations regarding ESG in investment decision-making; they have also made clear that the consideration of financially material ESG issues is not only possible for fiduciaries, but is also an essential part of the discharge of the fiduciary obligation.	That all players be fully aware of, and understand the importance of, their fiduciary duty to consider ESG factors in their capital allocation decisions, and that all fiduciaries be encouraged to support the voluntary UN-led Principles for Responsible Investment.
Since ESG factors may be material, it is now clear that the proper discharge of fiduciary duty includes a consideration of these factors. Yet among key capital market players, cultural inertia continues to propagate cynicism as to the material significance of ESG factors to corporations and their investors. This trend may serve to deter corporations from pursuing progressive and strategically sound ESG practices. Education may be an efficient transmitter of culture in this respect. During its consultations with stakeholders representing the full array of capital markets players, the Task Force noted the repeated mention of a general lack of ESG content in MBA, CFA, directors, and trustee courses, as well as in securities management programs.	That all players have the necessary analytical tools and skills at their disposal to meet their fiduciary duty of evaluating and integrating ESG factors into their capital allocation decisions, and that this be addressed through professional education. That government help to address the present cultural inertia as to the inclusion of ESG factors by leading, by example, in integrating ESG factors into areas such as the federal funding of grants and projects and also in federal pension plans.

Fiduciary Duty: Recommendations

Recommendation 1.1

That the federal, provincial, and territorial governments adopt, in their respective jurisdictions, regulations that require pension plans:

a) to disclose on a recurring basis, at a minimum annually, the extent to which environmental, social, and governance considerations are taken into account in the selection, retention, and realization of investments; and
b) to disclose the extent to which environmental, social, and governance considerations are taken into account in proxy voting and corporate governance engagement activities, and to require pension plans to disclose their proxy voting activity.

Recommendation 1.2

That all fiduciaries, including institutional investors, money managers, and fund trustees, adopt voluntary practices to disclose (a) ESG considerations and (b) investment policy, and that they be encouraged to sign on to the UN-sponsored Principles for Responsible Investment.

Recommendation 2

That federal, provincial, and territorial governments or regulators enact guidelines or, where appropriate, regulations to clarify that the fiduciary obligation of the trustee includes the consideration of ESG issues that are financially material to investment decisions.

Recommendation 3

That the federal government lead by example and actively integrate ESG factors in
a) federal funding of grants and projects related to capital markets; and
b) federal pension plans.

Recommendation 4

That ESG issues be integrated into the education requirements of academic and professional institutions and programs
a) granting MBA degrees and CFA accreditation;
b) offering director education courses and certification; and
c) offering trustee education courses and certification.

7 Materiality

Materiality is an important concept for the disclosure of information upon which investment decisions are to be made. The definition of materiality can vary substantially because its meaning can differ greatly between stakeholders. Also, consideration can be material merely because a large stakeholder (e.g., a large pension fund) considers the given issue to be "material." As mentioned earlier, although the Task Force decided not to define materiality itself, it noted the traditional approach to materiality as that of information being material if its omission or misstatement could influence the decision of a reasonable investor to invest, or continue to invest, in a company. Thus if risks associated with ESG issues are material to companies, current security requirements would call for disclosures in the MD&A and/or Annual Information Form. Note that if companies are not making disclosures about ESG issues, this may be because they do not consider them material (e.g., "energy" discloses emissions, "apparel" discloses labour practices), or they may consider them relevant but would prefer to leave them unreported. That being said, because large capital providers such as pension plans invest across multiple industry sectors, and because issues such as climate change and human rights can crosscut each other, the definition of materiality for pension plans and other large institutions with fiduciary responsibility can be very broad indeed.

Sarbanes-Oxley does not deal with environmental and social risk disclosure.

To take the discussion still further, "financial materiality" may be used to qualify the general principal of materiality when used in the context of financial reporting and users of financial reporting — typically investors and financial analysts. However, what is material in reporting to other stakeholders or users of broader types of company reporting, especially regarding environmental and social issues, may be determined by criteria other than just "financial."

In addition to the growing body of legislation and regulation that seeks to address these issues in Canada, the U.S., and the U.K., there are a number of important international initiatives that have been undertaken to define — or at least to facilitate a definition of — material disclosure for their participants. These include normative frameworks (i.e., the chemical industry's Responsible Care program, the Forest Stewardship Council's forest certification programs); process guidelines (i.e., the Global Reporting Initiative); assurance guidelines (i.e., the AA 1000 Framework); and management systems (i.e., the Social Accountability SA8000, the ISO 14000).

Canada

In Canada, where the securities industry is regulated at the provincial level, specific requirements call for the disclosure of information concerning a company's social and environmental affairs through its published documents. The fundamental criterion for reporting is *financial materiality*. As for the reporting of social and environmental information, it is required to the extent that it is deemed to be financially material. In Ontario, the *Securities Act* requires the timely disclosure of information about any "material change" in the affairs of a company.[43]

As well, the Toronto Stock Exchange (TSX) has established disclosure guidelines in line with the *Securities Act (Ontario)*, although its definition of "material information" is broader than "material change"; specifically, the TSX definition includes information concerning rumours and speculation that may also have a financial impact on a company.[44]

United States

In the U.S., based on federal securities legislation including the *Securities Act of 1933* and the *Securities Exchange Act of 1934*, the Securities and Exchange Commission (SEC) has established an extensive set of rules and guidelines for public disclosure by publicly traded companies. As in Canada, financial materiality is the fundamental criterion for determining specific reporting requirements. The SEC requires the Management's Discussion and Analysis section of the annual report to detail current conditions that may have a material impact on a company's financial performance, including specific information 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."[45] Furthermore, to the extent that social and environmental issues or events may constitute such "uncertainties," they must be reported. The SEC regulations differ from Canadian regulations

The UK has social- and labour-issue reporting requirements.

in that specific reference is made to possible events and uncertainties related to a company's environmental affairs. For example, the SEC regulations require that a company briefly describe any material and pending legal proceedings with respect to environmental issues, including administrative or judicial proceedings.

In July 2002, the *Sarbanes-Oxley Act of 2002* became law. Among the host of requirements is one that states that the CEO and CFO of each SEC reporting company must (a) certify that, based on the officers' knowledge, no periodic report contains materially false statements or omissions and that financial statements are a fair representation of the financial condition of the company; and (b) certify as to the adequacy of, and any deficiencies in, the internal financial controls. The Act does not deal separately with the issues of environmental and social risk disclosure.

United Kingdom

In comparison, the United Kingdom has specific reporting requirements that are not based on the notion of financial materiality. Schedule 7 of the *Companies Act* (1985)[46] includes a number of reporting requirements relevant to social and labour issues. One such requirement, Part IV, obliges the company to describe the arrangements in force in the financial year for securing the health, safety, and welfare at work of the employees of the company and its subsidiaries, and for protecting other persons against risks to health or safety arising out of, or in connection with, the activities at work of these employees. In March 1998, the British government's Department of Trade and Industry launched a major review of legislation governing the private sector in the U.K.

The final report of the review, *Modern Company Law for a Competitive Economy — Final Report*, was published in July 2001. It proposed that most public companies and large private companies should be required to publish an operating and financial review (OFR) as part of the annual report. The OFR was meant to review the performance, plans and prospects of the business and include information on direction, performance, and dynamics and any information which the directors judge necessary for an understanding of the business. This latter would include matters such as key relationship with employees, suppliers and customers, environmental and community impact, corporate governance and management of risk. The OFR would be subject to review by the auditors.[47]

The report also recommended that mandatory reporting requirements be modified in certain ways to include the reporting, among other things, of "risks, opportunities and related responses in

connection with … health and safety [and] environmental costs and liabilities."[48] Discretionary reporting items included:

Policies and performance on environmental, community, social, ethical and reputational issues including compliance with relevant laws and regulations: including any social or community programmes, policies for the business on ethical and environmental issues and their impact for the business, policies on international trade and human rights issues and any political and charitable contributions.[49]

The Company Law Reform Bill finally brought before the UK Parliament in mid-2006 calls for a Business Review (not an operating and financial review, the proposal for which was dropped late in 2005) to be included in the Directors' Report in UK company annual reports; this review would inform shareholders and other stakeholders about the company and help them assess how the directors have performed their duty to promote the success of the company. Under clause 399 of the bill, the Business Review must contain a description of the principal risks and uncertainties facing the company, as well as a balanced and comprehensive analysis of the development and performance of the company's business during the past year and of its position at the end of the year. To the extent necessary for an understanding of the development, performance, or position of the company's business, the Business Review of a quoted company must include information about environmental matters, the company's employees, and social and community issues, including information about any policies of the company regarding these matters and the effectiveness of the policies.[50]

A difficult decision

In addition to definitional and other challenges, the situation is made more difficult due to the classic "chicken and egg" scenario affecting the

MATERIALITY: BARRIERS/CONSIDERATIONS	DESIRED OUTCOMES
Information is material if its omission or misstatement could influence the decision of a "reasonable" investor to invest, or continue to invest, in a company. The current criterion for reporting is financial materiality, and the reporting of environmental and social information is required to the extent that it is deemed to be financially material. If ESG issues are material, then corporations should disclose that in their Management's Discussion and Analysis (MD&A).[51]	That pension plans have a common understanding of the present and future risks associated with ESG issues.
The Canadian Securities Administrators' rules and the recent work of the Canadian Institute of Chartered Accountants (CICA) help to provide some direction on corporate disclosure of ESG factors in Canada. In October 2005, the CICA's Canadian Performance Reporting Board published a Discussion Brief on MD&A Disclosure.[52] Although it addresses only the ESG issues related to climate change and other environmental issues, it points out that certain environmental (and social) disclosures are already required by securities regulators' rules and, therefore, are in fact mandatory where likely to be material to investors.[53] The CICA's Guidance document on preparation and disclosure of management's discussion and analysis, in fact, reinforces this principle.[54]	That pension plans and other fiduciaries have a process for measuring both the extent to which material issues are being identified and the ways in which they are being addressed in the companies in which they invest.

Continued

MATERIALITY: BARRIERS/CONSIDERATIONS	DESIRED OUTCOMES
Furthermore, while the Discussion Brief does not assert that any specific sustainability issue is necessarily material and therefore must be disclosed, it does reinforce the regulators' requirements that matters including known trends, events, risks, and uncertainties that are expected to, or could materially, affect financial results and conditions are to be disclosed in the MD&A. It is worth noting that the Annual Information Form (AIF) that companies must complete requires disclosures about environmental and social policies fundamental to a company's business. Relevant mandatory disclosure requirements on the part of securities regulators are also discussed in the CICA's November 2004 paper for the NRTEE.[55] The securities regulators' rules and the documents produced by the CICA, cited above, have contributed to the understanding of the materiality of ESG issues, but more work on these areas still needs to be done.	That securities regulators gain a greater understanding that would enable them to enforce the appropriate level of disclosure of material information. (The MD&A is too narrow; e.g., there is no MD&A in a Prospectus, which is one of the primary "risk delineation" documents available. In effect, the MD&A is read after investors buy, when they read the annual report.)
Companies need to be encouraged or motivated to improve MD&A disclosure about ESG matters material to investors. Research prepared by the Canadian Institute of Chartered Accountants for the Task Force provided options for bringing about changes in corporate disclosure about social, environmental, and ethical matters. Task Force deliberations on this matter also raised the need to address transparency, disclosure, and the reporting of ESG issues from the capital issuer side (that is, the companies that parties were assessing for investment purposes) in the MD&A. Developments in these areas may in turn, facilitate greater transparency regarding social and environmental issues with respect to individual investors, as well as more effective disclosure of sustainability issue management by pension plans and other institutional investors. The Task Force deliberations considered that this could be achieved through engagement by investors with capital issuers, improved disclosure of ESG issues in the MD&A, and the enforcement of existing MD&A disclosure requirements where the failure to disclose has caused damage to investors.	That Canadian pension plans agree on a common framework for disclosure of ESG factors. That all players have the necessary analytical tools and skills at their disposal to evaluate and integrate ESG factors into their capital allocation decisions.

disclosure of ESG factors considered material by investors. Most institutional fund managers in Canada have yet to develop sufficient analytical capabilities to document, analyze, and thereby integrate ESG factors into their financial analysis for investments. Indeed, there is no perceived demand from Canadian institutional investors, and the pension plans will be much less likely to consider such an approach if no fund manager is proposing it. Moreover, in contrast to their European counterparts, Canadian fund managers are not entirely sure how to respond to the growing demand for information concerning the extent to which social and environmental factors are considered in investment decisions.

Materiality: Recommendations

Recommendation 5.1

That the Canadian Institute of Chartered Accountants (CICA) and the Canadian Securities Administrators, in consultation with the federal and provincial governments, establish an outreach and education program for capital issuers so as to increase understanding of the material ESG issues that should form part of the Management Discussion and Analysis (MD&A) section of annual reports.

Recommendation 5.2

That institutional investors, money managers, and trustees engage capital issuers (companies) on the potential materiality of ESG issues, adopt a policy regarding ways of addressing ESG factors in the decision-making process, and encourage the refinement and use of standardized ESG reporting.

Recommendation 5.3

That the Canadian Securities Administrators encourage the disclosure of financially material ESG issues through publication of a guidance or interpretation statement and encourage Canadian firms to be guided by established reporting frameworks such as the Global Reporting Initiative (GRI).

Recommendation 5.4

That securities regulators support the existing MD&A disclosure requirements as they relate to ESG considerations and, when required, enforce the ESG disclosure requirement.

8 Short-termism

Since many environmental, social, and governance factors become material only in the long-term, an obsession with short-term performance may profoundly mask the extent to which such factors can play a meaningful role in investment decision-making. Over time, a lack of consideration and, hence, an undervaluation of ESG factors will undermine economic efficiency, productivity, and growth through the erosion of the competitive advantage as well as the human, societal, and natural capital upon which industry depends. On a more dramatic note, these are potential losses that will likely never be recaptured. In short, the short-term focus of the business cycle, including investment decisions being measured on a quarterly basis, goes against the long-term focus of sustainability practices (where, in some cases, the environmental benefits may not be realized for a number of years).

Investment managers commonly pick their stocks based on short-term earnings and financial indicators.

The market may already account for sustainability issues — especially those that have an immediate financial impact, such as a boycott, on share prices. To paraphrase Warren Buffet: The market is a voting machine in the short term and a weighing machine in the long term; it doesn't ignore companies that act responsibly, it rewards them in the long term. However, investors are not homogenous. So, while Buffet reportedly looks at companies and the risks they are taking, systematically and company by company, other investors may not do so. Indeed, some investors may not care about individual companies and may choose to invest in broadly defined asset classes instead.

Investor culture

Nonetheless, as mentioned in the discussion on fiduciary duty, the fund manager's job is usually focused on getting the best possible real return within the term of his or her mandate (three to five years); other issues are often considered insignificant. There is a close parallel on the corporate management side as well. Simply put, if a company is to survive in the "vibrant market," it must generate short-term returns. The issue, of course, is that a company's value to its owners is ultimately based on its ability to continue generating cash to finance future growth, shareholder dividends, and future obligations such as employee pensions. In fact, the company's survival depends on its ability to generate value on a sustained basis and to anticipate shifts in resource supplies, market demand, technology change, industry growth potential, and regulatory change. However, investment managers commonly pick their stocks based on short-term earnings and financial indicators (which can be exaggerated by many factors – accounting practices, for one) as well as technical criteria, rather than on discounted cash flows or business fundamentals. Of course, everyone is familiar with the sudden surges or drops in the price of a security when quarterly financial results exceed, or fall below, analysts' expectations. The vicious cycle is complete when company management aligns its decisions with this investor approach — and is rewarded through compensation — instead of maximizing long-term value for continuing shareholders.

Fundamentally, the tendency of pension plans to allow short-term investment considerations to drive investment decisions runs counter to the consideration of many ESG factors; moreover, the practice is not in keeping with the long-term financial interest of beneficiaries with a long-duration liability. When a pension plan is managed with the sole purpose of paying benefits, it invests in those asset classes according to a time span in line with the liability stream. This means that when one considers only the average pension liability cycle of 15 to 22 years, asset classes such as long-term bonds, private equity, real estate, and so on become potential areas of investment. In effect, the long-term allocation of capital stands to generate favourable financial results for the pension plan and its beneficiaries, since risk-return benefits are greater for longer-term asset classes.

A pension plan's access to the full range of asset classes enhances its efficiency of returns (per unit of risk) in a way that a purely short-term outlook cannot. Clearly, the "long term" is not a succession of short-term spans, while a short-term investment approach will not necessarily pay off over the long run. In addition, although a short-term approach aligns with the expectations of short-term stock traders, it does not fit well with the long-term interests of pension funds. This situation is made worse by the emerging national and/or international standards and practices of three key sets of actors — accountants, actuaries, and regulators — all of which will have an impact on the drive to more sustainable investments in Canada.

Accountants

The job of accountants is to track assets and liabilities. Where corporations are concerned, company pension plans are essentially treated as a liability. Over the years, a methodology was developed that provided management with the flexibility to recognize the potential impact of pension plans on the liability of the firm, but without risking overexposure to the volatility induced by changes in the interest rates or the market value of the pension plan assets. "Asset smoothing" and some flexibility in selecting the appropriate discount rates were both well-accepted practices in the 1990s, mainly because pension plans were in a state of surplus and the outcome was considered to be a source of income, not an expense. With the economic slow-down of the early 2000s, however, pension plans, in terms of accounting, began to appear as expenses in companies' income statements. At that point, the accounting profession, against a backdrop of heightened demand for transparency and application of mark-to-market valuation principles (see definition[56]), began to criticize the practice of smoothing, claiming that it led to an inaccurate reflection of the severity of actual losses.

This mark-to-market approach, espoused in particular by the international (mainly European) accounting standards boards, is becoming a main driver of short-termism. And its impact may increase, as Canadian accounting standards move closer to European and international standards in the search for a greater harmonization of accounting standards. Understandably, pension fund fiduciaries and investment managers are being increasingly pressured by company boards and management to manage so as to reduce the volatility of the pension expenses and liabilities in the company's financial statements. In other words, managers want company annual balance sheets to show a minimal divergence between pension liabilities and assets, a goal that requires a disproportionate focus on investments that minimize the mismatch between assets and liabilities on an *annual* basis. This, in turn, means moving away from assets that could provide a more sustainable performance on a long-term basis.

Actuaries

Pension plans in Canada now undergo an actuarial valuation at least every three years. In essence, the review entails an assessment of the degree to which a fund's current assets can provide future pension benefits for members' liabilities arising from past and current service; it takes a long-term view of

demographic factors (retirement age, age at death, etc.) and economic factors (return on assets, inflation, wage increases, etc.). Although there is a debate as to whether actuarial norms on an ongoing basis encourage the use of overly optimistic assumptions, the increased reliance on solvency valuations in a low-interest environment, the strong mark-to-market bias of these solvency norms, and the short period for amortizing deficits, compounded by the introduction of new actuarial norms in 2005 that reinforce the mark-to-market bias, have exacerbated the contribution volatility — sometimes beyond the risk tolerance of plan sponsors. These factors have also accentuated the extent to which short-term considerations affect investment decision-making. In short, changes in actuarial methodology and requirements may effectively lead to the avoidance by pension fund investment managers of long-term asset classes, the disadvantaging of members interested in long-term returns, and the sidelining of any potential ESG considerations.

The changes in actuarial norms — especially for solvency valuations — introduced by the Canadian Institute of Actuaries, and the likely harmonization of North American accounting norms with the international (European) standards, both of which are aligned on a "mark-to-market" approach, will force pension plans to substantially shorten their time horizon. At least that will be the case if they want to avoid an excessive contribution or an excessive volatility in the plan sponsors' balance sheet or income statement. To the extent that these changes would, in fact, force pension plans to shorten their time horizons to one or three years, the case for taking into account ESG factors, not to mention the case for long-duration assets and investments, is suddenly much less pressing.[57]

The experience in some countries, notably the United Kingdom, is that these changes may accelerate the move from defined benefit (DB) plans to defined contribution (DC) plans, or at least close the DB plans to new members. Apart from the negative consequences in terms of income security for future cohorts of retirees (both in terms of risk transfer and because DB plans are known to be more efficient investment vehicles than DC plans), the move from defined benefit plans to defined contribution plans would have similar consequences in terms of sustainability issues. The reason for this — and it is well documented — is that the behaviour of DC plans tends to be much more short-term in outlook.

Regulators

Apart from the five-year amortization rule, which comes directly from the regulators, the responsibility of regulators vis-à-vis encouraging short-termism stems mostly from their general acceptance of the accounting and actuarial norms. (This five-year rule, however, is not the case everywhere; for instance, in New Brunswick a 15-year period was recently embraced.) Although regulators in the 1990s were able to provide room for asset smoothing, they disallowed the practice in the 2000s, in effect pushing pension-fund investment considerations to the short-term time horizon. The model pension law of the Canadian Association of Pension Supervisory Authorities[58] has suggested that pension-fund fiduciary duty be structured to include, among other things, the pursuit of "the maximum rate of return."[59] Such an approach, should it make its way into pension legislation, would be a significant departure from the current thinking that pension plans should be concerned with obtaining an adequate or reasonable rate of return within accepted levels of risk, and over an appropriate time frame, given the duration of their liabilities.

SHORT-TERMISM: BARRIERS/CONSIDERATIONS	DESIRED OUTCOMES
While an understanding of legal requirements and materiality is key to encouraging the integration of ESG factors, understanding the impact of how capital markets actually operate is also crucial. Although some participants in the capital markets consider three years to be long term, pension plans may still have to deliver pension cheques in seventy years. The issue is how to mix the different time perspectives. Macroeconomic issues also need to be considered, given that the economy must be able to work effectively to sustain companies and to enable them to meet their long-term pension obligations. To achieve fundamental change, signals must be created in today's capital markets to permit and encourage sustainability considerations. That would include the design of accounting practices for assessing the true impact of accruals on future cash flow and of compensation systems that encourage a longer view.	That all players be fully aware of the impact that current incentives, cultures, and practices promoting short-termism have on the integration of ESG factors in capital allocation decisions, especially as related to long-term liabilities. That accounting, actuarial, and regulatory practices — including reporting — be changed to encourage optional practices based on a long-term view of pensions rather than on short-term considerations.
Investors' capital allocation decisions are affected by the short-term or long-term perspectives held. Sustainability factors are long-term value drivers. A sustainable environment and economy depend upon the integration of long-term considerations into the investment decision-making process. When an investment culture is focused on short-term outcomes, it may produce investment analysis that fails to uncover relationships between financial success and social and environmental sustainability. Or it may simply not consider the relationships to be material and relevant, leading to the misallocation of capital. The regulatory framework within which capital markets operate also affects sustainability outcomes.	That improved incentives be instituted for corporate management of long-term cash flow.
Investment managers respond to their clients' mandates. When clients motivate their managers to take long-term considerations into account, the prospects for sustainability improve. Many investors, such as defined benefit pension plans, have long-term liabilities. As such, they depend on long-term economic performance to fulfill their mandate. Various issues affect the degree to which investment decisions lead to positive sustainability outcomes: the way in which pension assets and liabilities are valued by accountants and actuaries, the governance and benefit structures of pension plans, and the way in which investment mandates and manager hiring and compensation practices are designed.	That improved incentives be instituted for investment managers' consideration of long-term performance.
To paraphrase the Bank of Canada Governor David Dodge's remarks to the Association des MBA du Québec: It is by their ability to pool risks and their long time horizon that "pension plans generate important benefits in terms of economic efficiency"; we must therefore "allow these pools to be accumulated and invested so that they not only maximise returns to support future pensioners, but also maximise the future growth of the economy's production capacity."[60]	

Short-termism: Recommendations

Recommendation 6

That federal and provincial laws and regulations as well as the standards set out by professional bodies such as the Canadian Institute of Chartered Accountants (CICA) and the Canadian Institute of Actuaries (CIA) regarding accounting, actuarial valuation, and pension fund governance be assessed for their impact on sustainability and amended where necessary to address the needs of sustainable capital allocation.

Recommendation 7

That institutional investors assess the impact on sustainability of their investment policies and practices, paying particular attention to the quality of the investment research and the alignment of fund manager compensation practices with long-term performance.

9 A Final Word

Today, corporate stakeholders are calling on Canadian companies to identify, understand, and act upon social, environmental, and governance risk factors and to disclose their performances in an effort to ensure transparency and accountability.

Increasingly, companies are responding with improved stakeholder engagement, application of internationally recognized process and performance standards, more comprehensive and rigorous management systems, and reporting mechanisms validated through third-party assurance.

Institutional investors, beginning with socially responsible investors (SRI), are responding by employing investment screens and engagement tactics. More recently, they have responded with requests for increased disclosure of ESG factors and performance.

However, the situation within and between both "sides" remains a work in progress. Whereas some companies continue to implement narrow compliance initiatives or remain in a defensive, reactive mode, others are transforming their business models to gain a competitive advantage.

Although the SRI segment continues to expand, many mainstream institutional investors continue to believe that they are actually precluded from taking ESG factors into account in their assessment process. Moreover, such an approach is often reinforced by professional practices and incentive structures.

As the Capital Markets and Sustainability Program discovered through its consultations with approximately 200 participants from the private, public, and civil society sectors, not only is there a financial return to business in pursuing corporate responsibility, but the pursuit of such policies *should*, *can*, and *must* be rewarded through the investment allocation decisions of fund managers in the capital markets.

In short, creating a competitive advantage for the Canadian economy will require investor, corporate, and political leadership to ensure integration of ESG factors into capital allocation decisions.

Recognizing this, the Task Force's recommendations are directly aimed at encouraging a commitment to a new and strengthened vision for investing in Canada's sustainable future.

Appendix A – Summary of Commissioned Research Papers

Comparative Study of U.K. and Canadian Pension Fund Transparency Practices

Executive Summary

This report was commissioned by Canada's National Round Table on the Environment and the Economy to explore how pension fund transparency practices with respect to social, environmental, and ethical (SEE) issues in the United Kingdom differ from those in Canada.

In particular, we address the antecedents and impact of U.K. policies mandating the inclusion of a fund's approach to SEE issues in its statement of investment principles (SIP). And we explore the possible relationship between reforms to the 1995 Pensions Act and the subsequent growth of socially responsible investment (SRI or RI) in the U.K.

We examine what such reforms might require in Canada and recommend how such reforms might be pursued. Finally, we suggest further areas for research in order to determine the case (or the absence of a case) for such reforms.

The main body of the report includes the following substantive sections:

- Relevant U.K. Law Regarding the SEE Issue Disclosure Requirement in the SIP
- Social and Political Drivers Leading to the SEE Issue Disclosure Requirement in Amendments to the U.K. Pensions Act
- Impact on the U.K. Pension Fund Industry of the SIP Disclosure Regulation
- Implications of Introducing a SEE Issue Disclosure Requirement in Canada
- Recommendations and Future Research

Our six principal recommendations (including recommendations for further research) are listed below.

For the Attention of Federal and Provincial Governments

i) The need for Canada to adopt legislation similar to the U.K. requirement for pension funds *to disclose the extent (if at all) to which social, environmental, and/or ethical (SEE) considerations are taken into account in the selection, retention, and realization of investments; and the policy (if any) directing the exercise of the rights (including voting rights) attaching to investments*[1] in both the statement of investment policies and procedures (SIPP) and the annual reports to members. This legislation should be accompanied by active clarification of the fact that exploration of SEE issues in investment decision-making for the purposes of risk minimization and/or long-term value maximization is not in conflict with the established fiduciary duties of pension fund managers and trustees.

ii) The need for a broader public policy and civil society debate on the effective management and supervision of Canadian pension funds (to include such issues as general transparency [including SEE criteria], representation of pensioners and deferred pensioners on boards of trustees, protection of pensioners and deferred pensioners from underfunding, impacts of bankruptcy, etc.).

[1] *This language (italics) comes from the disclosure requirement contained in the UK's amended 1995 Pensions Act.*

For the Attention of the Pension Regulators and Pension Fund Associations[2]

iii) The need for Canadian financial institutions to become more broadly familiar with both mandatory and voluntary pension fund transparency practices — particularly in relation to SEE criteria — in Europe and elsewhere in order to ensure that best-practice standards are observed in Canada.

iv) The need for the promulgation of model pension fund laws consistent with international best practice on transparency that may require the inclusion of policy statements on SEE criteria in Canadian statements of investment policies and procedures for pension funds, recognizing that there is no evidence of negative impacts arising from such transparency.

For the Attention of the Research Community

v) The need for further research to determine the case (or absence of a case) for legislative reform (e.g., the streamlining of federal and provincial pension fund laws and regulations within the context of SEE criteria and more effective financial regulation generally).

vi) The need for further research to determine the case (or absence of a case) for consideration of SEE criteria as a way to protect the interests of pensioners and deferred pensioners with respect to portfolio risk minimization and/or long-term value maximization.

To download a copy of this paper, visit http://www.nrtee-trnee.ca/UK-Canada-Pension_E

Corporate Disclosure and Capital Markets
Demand and Supply of Financially Relevant Corporate Responsibility Information

Executive Summary

This study was commissioned by the Capital Markets and Sustainability Program of the National Round Table on the Environment and the Economy (NRTEE) to provide a characterization of the current demand for and supply of sustainability or corporate responsibility (CR) information. Its focus is on Canadian practice, but the study also draws on leading practices and guidance developed in Europe and at the international level.

The study addresses two main questions:

- What role can corporate disclosure play in capital markets to link corporate sustainability and financial performance in Canada?
- How can public policy best promote the kind of corporate disclosure that will help capital markets value responsible corporate practices in Canada and therefore encourage responsible investment?

For the purpose of this study, capital markets are divided into six segments: commercial banking, investment banking, investment management, pension fund management, insurance and re-insurance, and indices.

Demand Side Findings

On the demand side, the study draws several conclusions:

- Demand for CR information is evolving rapidly in scope in certain capital market segments but growing relatively slowly among mainstream elements of the capital markets.
- Leading organizations in all segments of the capital markets are requiring or seeking a broad range of financially relevant environmental, social, and ethical information from investment targets; they have systematic processes for analyzing, at least

[2] *Such associations include the Canadian Association of Pension Supervisory Authorities, the Pension Investment Association of Canada, and the Association of Canadian Pension Management.*

qualitatively and in some cases quantitatively, the environmental management and performance information of companies they invest in or lend to.
- The depth of this capacity in each segment of the capital markets is limited, and interest in these issues varies significantly even among organizations in similar capital market segments and lines of business.
- Most segments of the capital markets pay at least some attention to specific environmental issues faced by a company or project and how prepared the company is to manage these, where they can see the link to shareholder value.
- Environmental or social issues of corporate performance are important only in terms of risk to the company's financial health, and therefore to capital market financial decision-making. High risk is discounted, but business opportunity from good CR performance is not given a premium in mainstream decision-making.

Among the most important factors limiting the mainstreaming of the demand for and use of CR information is the prevailing emphasis within the capital markets on short-term considerations such as quarterly results, and the strong belief that CR management is primarily relevant to the long-term value of a company. Where the markets do pay attention to CR issues, a premium for good environmental or social performance is not paid, but penalties may be delivered for not managing risks in these areas. Limited awareness of the potential links between CR and business value; poorly developed analytical techniques; and a lack of consistent, financially relevant CR metrics also hinder the use of and demand for CR information.

Supply Side Findings

On the supply side, the study reviewed the disclosure of 15 Canadian companies (five companies in each of three sectors) listed on the Toronto Stock Exchange (TSX), with a focus on key "representative" CR issues selected to permit more in-depth analysis. These issues are not intended to indicate that other CR risks do not bear on capital-market decision-making for these sectors. The issue–sector combinations are as follows:

- oil and gas — climate change disclosure;
- mining — biodiversity disclosure;
- financial services — disclosure of environmental and social risk considerations for lending and project financing; and
- compliance disclosure across the sectors.

OIL AND GAS	MINING	FINANCIAL SERVICES
Imperial Oil	Barrick Gold	Bank of Montreal
Nexen	Falconbridge-Noranda	Bank of Nova Scotia
Petro-Canada	Inco	Canadian Imperial Bank of Commerce
Shell Canada	Inmet Mining	Royal Bank of Canada
Suncor Energy	Teck Cominco	Toronto-Dominion Bank

OIL AND GAS		
Company	**Stock Symbol**	**Web site**
Imperial Oil	IMO	http://www.imperialoil.ca
Nexen	NXY	http://www.nexeninc.com
Petro-Canada	PCA	http://www.petro-canada.ca
Shell Canada	SHC	http://www.shell.ca
Suncor Energy	SU	http://www.suncor.com

Oil and Gas: The five large oil and gas companies reviewed for this study all publicly disclose a considerable amount of information related both to their positions on climate change and to the steps they are taking to reduce their emissions. They disclose this information using such vehicles as sustainability reports, annual reports (including Management's Discussion and Analysis [MD&A]), annual information forms, corporate Web sites, investor information briefings, and executive speeches. Each of the companies recognizes that climate change poses some type of risk to their ongoing sustainability. Overall, however, they present very different strategies for addressing climate change, and provide considerably more detail about their internal greenhouse gas (GHG) reduction and offsetting activities and performance than about strategic plans to assess investments or other actions relating to the potential long-term implications of a carbon-constrained future.[1]

MINING		
Company	**Stock Symbol**	**Web site**
Barrick Gold	ABX	http://www.barrick.com
Falconbridge-Noranda	FL NRD	http://www.falconbridge.com http://www.noranda.com
Inco	N	http://www.inco.com
Inmet Mining	IMN	http://www.inmetmining.com/
Teck Cominco	TEK	http://www.teckcominco.com

Mining: Each of the reviewed mining companies emphasizes the importance of environmental issues to their ongoing success. They all describe environmental governance processes, management systems, monitoring, and audit or assurance processes. In some cases the companies represent leading current practice in the disclosure of risks related to environmental liabilities. In general, however, there is only limited disclosure of information on biodiversity risks in the public information provided by the companies. Indeed, none of them provides a detailed description of how the potential significance of biodiversity issues is assessed and managed. This contrasts to the practices of some of the leading multinational mining companies, which are starting to report extensively on biodiversity impacts and management.

FINANCIAL SERVICES		
Company	**Stock Symbol**	**Web site**
Bank of Montreal	BMO	http://www4.bmo.com/
Bank of Nova Scotia	BNS	http://www.scotiabank.com
Canadian Imperial Bank of Commerce	CM	http://www.cibc.com
Royal Bank of Canada	RY	http://www.royalbank.com
Toronto-Dominion Bank	TD	http://www.td.com

Financial Services: All the banks reviewed have policy commitments that relate to the environmental risk assessment of their lending practices, and state that they have standards or procedures in place to assess existing or potential exposure to environmental liability. Some have also adhered to commitments related to the management of environmental and social risks under various international and domestic initiatives (the Equator Principles, the United Nations Environment Programme Finance Initiative [UNEP FI], the International Chamber of Commerce [ICC] Business Charter for Sustainable Development, and the work of the Canadian Bankers Association's Environmental Issues Group). However, the almost complete lack of disclosure by the five reviewed banks about how they are managing social risks in their financial services and products invites the conclusion that they are not addressing CR in a systematic manner. This contrasts with the information gathered from leading banks in the demand side analysis of this report.

Compliance as a Cross-cutting CR Risk Measure: There is a strong focus on compliance, reinforced by detailed disclosure, primarily by the resource sector companies reviewed in this study. The major focus of compliance disclosure is environmental, health, and safety (EH&S) issues, with little or no disclosure on compliance with social regulations or obligations, such as those contained in regulatory approvals or benefit-sharing agreements. Even with respect to EH&S, the companies reviewed use a range of indicators, inhibiting efforts to compare performance.

Recommendations

Materiality is a central concept linking capital markets with corporate responsibility. The interpretation of what is material—what is considered important in making investment decisions—is expanding rapidly through the progressive disclosure practices of some companies, and through guidance provided by professional bodies such as the Canadian Institute of Chartered Accountants (CICA). Companies should consider this broader definition of materiality in their disclosure practices, and regulators should enforce the disclosure of material risks.

Capital Markets

- Learn from and adapt the recommendations of international bodies and initiatives, including the UNEP FI Asset Management Working Group process.
- Broaden the use of international guidance such as the Equator Principles, through financial industry associations and corporate leadership.
- Build CR awareness and tools for investment professionals.

Disclosure by Companies

- Provide full disclosure of material risks.
- Develop statement of business value in CR.
- Standardize formats and metrics to meet the needs of investment analysts.
- Ensure transparency of performance related to environmental, broader economic, social, and ethical risks.
- Consider application of the Global Reporting Initiative as an emerging international standard.

Public Policy

- Stimulate demand for CR information through measures such as:
  - a survey of capital market analysts on their current level of understanding and application of non-financial risk analysis;
  - improved communication between environmental and financial regulators; and
  - a review of legal or guidance constraints such as prevailing interpretations of fiduciary duties.
- Facilitate CR disclosure through measures such as:
  - stricter enforcement of existing environmental disclosure requirements by securities regulators; and
  - promotion of the development and adoption of standardized or commonly accepted financially relevant CR metrics.
- Mandate disclosure by encouraging capital market bodies to provide clear CR disclosure practice standards.
- Mandate CR disclosure by regulation.

To download a copy of this paper visit http://www.nrtee-trnee.ca/Corporate-Disclosure_E

Financial Reporting Disclosures about Social, Environmental, and Ethical (SEE) Issues

Executive Summary

This paper was prepared for the National Round Table on the Environment and the Economy (NRTEE), as part of its program and Task Force on Capital Markets and Sustainability (CM&S). It provides background information to a multi-stakeholder readership about current financial reporting and corporate disclosure requirements for public companies in Canada and the extent to which these requirements may be expected to provide disclosures about social, environmental, and ethical (SEE) issues. The paper also suggests strategies and options for consideration that could result in companies providing more relevant, reliable, and timely information to capital markets about SEE issues.

The structure and content of typical corporate annual reports are explained, and the mandatory parts pointed out. The source and purpose of accounting standards are described, indicating what financial statements can and cannot be expected to provide regarding SEE disclosures. The use of existing regulatory filings and related oversight provisions, specifically the Management's Discussion and Analysis (MD&A), Annual Information Form (AIF) and Information Circular, are discussed as they relate to SEE disclosures. The potential role of the MD&A is indicated as the most appropriate vehicle, outside financial statements, for companies to make relevant, reliable disclosures about SEE issues to capital markets. The purpose and content of the MD&A, particularly if prepared and presented in accordance with the recommendations in the Canadian Institute of Chartered Accountants' (CICA's) MD&A guidance, readily accommodate the SEE disclosures that reasonable mainstream investors may sooner or later find necessary to incorporate in their decision-making. The MD&A is also subject to important oversight provisions and processes.

Oversight processes that support the reliability of reported information and filings are discussed, including the roles of the external auditor, audit committee, and board of directors; the recently introduced requirements for CEO and CFO certifications about annual and interim regulatory filings and related disclosure controls and procedures; and the continuous disclosure review process instituted by the securities regulators.

An overview is provided of recent developments and studies of note relevant to SEE disclosures, such as shareholder activism and submissions to securities regulators in Canada and the U.S. about the need for clearer and more complete SEE disclosures and better enforcement of existing disclosure requirements. Relevant background information is provided in an appendix about securities law and the roles of securities regulators in Canada.

In conclusion, options for bringing about changes in corporate disclosure about SEE matters are discussed under three broad strategic approaches, referred to in the paper as

- Research and outreach – "Let the facts speak for themselves";
- Engagement and enforcement – "Make better use of existing disclosure requirements"; and
- Regulatory initiatives – "Research and assess cost-effective policy solutions."

Some combination of these approaches, implemented in concert, would be the most likely way to cause desired change in corporate SEE disclosure practices. That is to say, mainstream institutional investors, motivated by "persuasive evidence" and arguments for the importance of factoring SEE issues into investment decisions, could over time influence leading companies to voluntarily enhance their disclosure of SEE matters (primarily through the MD&A), while steps would be taken by investors and securities regulators to promote better enforcement of existing disclosure requirements.

Existing disclosure requirements would only be added to or revised if necessary to ensure that information about relevant SEE issues is communicated in the most effective way to capital markets. Any such changes would need to be justified through cost-benefit analysis.

Other possible ideas for disclosure-related regulatory initiatives are indicated, but these would require careful consideration of the accountabilities and responsibilities of companies and institutional investors within the context of broader public policy and legal and regulatory frameworks.

Note: This paper draws upon ongoing research carried out by the CICA about SEE reporting practices and capital market expectations for such information, as well as the CICA's ongoing work in monitoring corporate reporting practices, regulatory disclosure requirements, and the publication of guidance about MD&A and business reporting issues. The information, views, options, and conclusions expressed in this paper are, however, the responsibility of its author, and do not represent official positions of the National Round Table on the Environment and the Economy, or of the Canadian Institute of Chartered Accountants or any of its committees and boards involved in standards setting and disclosure publications.

To download a copy of this paper, visit http://www.nrtee-trnee.ca/CICA-SEE-Issues_E

Measuring What Counts

Establishing a best practice approach for the management, valuation and performance measurement of corporate contributions to the sustainability of Canadian communities

Executive Summary

This paper is the second in a series commissioned by the National Round Table on the Environment and the Economy (NRTEE) to examine the role of community investment in leveraging sustainability in Canadian communities. The first paper, *Scan of the Community Investment Sector in Canada,*[1] examined the potential of the fledgling Canadian community investment sector to advance sustainability at a very local level. In that case, community investing was defined as "investment for the purposes of financing deep-seated needs of local communities not addressed by mainstream finance." According to that first paper, community investing practices sought to generate both social returns (to the community) and financial returns (to the investor), thereby improving the sustainability of Canadian communities.

This second paper, *Measuring What Counts*, focuses on the current practices of corporate community involvement in Canada, with a view to assessing the contribution of corporate programs to the sustainability of communities. In this instance, there is also an expectation of social return to the community. In addition, *Measuring What Counts* examines how results-oriented corporate community involvement can generate business benefits, some of which are direct to the bottom line and some of which are indirect. These indirect financial benefits are also worth tracking.

Measuring What Counts explores the need for a management framework to enable Canadian companies to optimize their voluntary contributions to the sustainability of communities. These contributions typically occur under the auspices of corporate community involvement programs, but some are also being made from business units directly. References are made to the London Benchmarking Group Model from Britain (LBG-UK Model), as the success of its approach is the foundation for a Canadian corporate community involvement management framework entitled LBG Canada.

The term *corporate community involvement* is used throughout this paper and is a general reference to the breadth of voluntary corporate activity in communities. It includes philanthropic gifts, social investment,[2] and commercial initiatives that generate an obvious community benefit. The term *investment* is used in its historical sense; that is, it refers to a commitment of time, money, or a gift in-kind toward achieving a desired outcome.

[1] *Coro Strandberg and Brenda Plant,* Scan of the Community Investment Sector in Canada *(on-line) (NRTEE, September 2004). www.nrtee-trnee.ca.*

[2] *Long-term strategic involvement in community partnerships to address a limited range of social issues chosen by the company in order to protect its long-term corporate interests and to enhance its reputation. www.lbg-online.net.*

As readers will note, it is the opinion of the author that all financial resources committed to achieving a specific social, environmental, or financial outcome are investments seeking a return — that return is the goal driving the commitment of the resource. Moreover, as Canadian companies become more creative in leveraging additional corporate resources — such as gifts in-kind, employee time, in-house expertise, and associated management resources — toward achieving specific social and environmental goals, those non-cash resources can also be considered investments toward achieving a desired return.

Measuring What Counts illustrates that the motivation driving a corporate contribution in the community can be philanthropy, enlightened self-interest, or commercial considerations. All three motivations are legitimate drivers for community investments if the return (or benefit) to the community is clear and the corporate decision to invest is voluntary. As the LBG Model illustrates, clearly identifying motivation will ensure the relevance of indicators chosen to assess business benefits. Clarity of program goals will also influence the choice of performance measures used to assess community benefits. Together, both sets of performance measures will indicate whether the investment in the community was a worthwhile endeavour.

A results-based approach enables the community involvement manager to demonstrate how corporate programs are contributing to sustainability, evidence that most Canadian companies are not providing at this time. Without performance data, program value may not be evident to the community partner or to other key stakeholders, such as government, shareholders, or the executive board.

A corporate community involvement management framework for Canada that is based upon the LBG-UK Model would value all forms of investment in the community. At present, Canadian companies are primarily focused on the amount of cash donated, with some valuation of gifts in-kind. There is a tendency to overlook the value of other resources such as employee time (during working hours), expertise, and associated management costs. In addition, the non-cash valuation that does occur runs the risk of inconsistency, as the methodology is not standardized across programs, companies, or sectors.

When all program investments are valued and performance is measured, the real value of corporate contributions to the sustainability of communities becomes clear. Corporations, as well as their community partners and other key stakeholders, come to understand that corporate contributions are more valuable than they had previously realized. This enhances the reputation of the corporate sponsor, which in turn contributes to achieving other business benefits.

Some Canadian companies are choosing to report publicly on their investments in the sustainability of communities, but not all do so. The Canada Revenue Agency reports that Canadian companies invest $1.3 billion in charitable support of communities each year. But beyond that cash figure, there is no record of non-charitable support by companies or evidence of what that investment actually achieves. As such, there is little public recognition of the role companies play in communities beyond job creation.

Clearly, Canadian companies need a management framework that encourages results-based community program activity and measurement of the benefits achieved through their programs. This would enhance recognition of their community activities, which would increase the possibility of generating business benefits and in turn encourage more corporate community involvement. As the UK experience has shown us, using the LBG approach creates a mutually reinforcing process.

To download a copy of this report, visit http://www.nrtee-trnee.ca/Measuring-What-Counts_E

Scan of the Community Investment Sector in Canada

Executive Summary

Most of the attention and strategizing around whether and how capital markets can lever sustainability — improved social and environmental conditions in Canadian communities — goes to considerations of whether there are links between sustainability and financial performance. Relatively little attention is placed on the potential of the fledgling Canadian community investment sector — one of the three pillars of socially responsible investment — to advance sustainability at much more local levels. This paper is a beginning attempt to bridge the gap in awareness of the community investment sector as a sustainability driver and to identify the operating constraints confronting the sector in today's marketplace.

Community investing (CI) is defined as investment for the purposes of financing deep-seated needs of local communities not addressed by mainstream finance, including poverty alleviation, community and cooperative development, and environmental regeneration. For the purposes of this paper, CI includes economically targeted investing and sustainable venture capital — additional investment strategies that generate double and triple bottom line returns for investors and communities.

This paper takes a unique perspective in its analysis — that of the investor or fund manager, who is called upon to consider the track record of the American CI experience where market and near-market rates of return are possible. The US track record has proved that many CI investments are non-concessionary, low- to no-risk, and viable asset allocation strategies. It is generally concluded that while the CI sector is very small in Canada, if supports similar to those in the U.S. were available, its scale and impact could increase considerably. Specifically, a leadership role by the federal government (including a favourable tax and regulatory regime, operating and capital programs, and other supports), as well as strengthened industrial infrastructure (such as intermediaries, networks, product standardization, investor education, and awareness), could go a long way to significantly scaling up the sector. Following the American lead, a Canadian version of the Community Reinvestment Act could provide similar impetus for the sector's development.

The paper notes that sub-markets such as those found in Aboriginal communities, where opportunities go unexplored because of the lingering perceptions of risk and security constraints, languish for lack of better information of the gaps and opportunities. In the U.S. such underserved markets, often perceived as high-risk, are proving themselves to be viable investment niches.

Within the paper, these underserved markets, which are not well understood by the traditional financial sector, are placed within a social capital market framework. Located on the investment continuum between traditional finance and philanthropy, the social capital market is viewed as generating both a social and financial return, that is, a "blended return." The paper touches on the potential of advances in the understanding of social (including environmental) returns on investment and social value creation to attract further interest in the CI sector as a means of levering sustainability benefits over the long term.

This paper, admittedly, raises more questions than it answers regarding the community investment sector in Canada. But if it has also served to raise awareness and interest among readers as to the role CI might play as a capital market strategy for advancing sustainability, it will have met its objectives.

To download a copy of this paper, visit http://www.nrtee-trnee.ca/Community-Investment_E

The sdEffect™: Translating Sustainable Development into Financial Valuation Measures
A Pilot Analytical Framework

Executive Summary

There is growing interest among corporations, governments, non-governmental organizations, and financial analysts in the quantitative and financial links between corporate sustainable development (SD) performance and financial performance.

To identify the influence of corporate SD on financial performance, its effect must be isolated from that of other business variables and expressed in quantitative and financial terms. Few studies have addressed this challenge.

This report sets out a Pilot Analytical Framework for using traditional financial valuation techniques to isolate the potential impact of SD on company valuation and share price performance. By isolating the valuation effects of corporate SD in financial language, the report provides a basis for engaging the financial community in better integrating SD considerations into financial analyses and investment decision making.

More specifically, this report uses company-specific SD performance metrics from the Canadian mining sector to:

- Assess and identify metrics that are predisposed to translation into financial valuation;
- Translate these metrics into financial valuation employing five commonly used financial valuation techniques — ratio analysis, discounted cash flow analysis, rules of thumb valuation, economic value added analysis and option pricing; and
- Isolate the additive value of SD in financial terms including on overall corporate valuation.

Ten worked examples of translating SD into financial valuation, based on seven SD metrics, have been developed. These examples and the associated results are presented in the Table.

EXAMPLES AND ASSOCIATED RESULTS		
sd Metric	**Translated into**	**Results**
INCO solid waste diversion	Discounted cash flow (DCF) Valuation price to cash flow per share ratio (P/CFPS)	Waste diversion at INCO saves the company $2.4 million per year, which is equivalent to just over $0.01 per share. These savings are worth $31 million in total shareholder value (using DCF) or between $0.06 and $0.16 per share in total value (using P/CFPS and DCF).
Noranda/Falconbridge energy savings (greenhouse gas emissions reductions)	DCF P/CFPS	The energy savings (greenhouse gas emissions reductions) program increases the per share value of Noranda/Falconbridge by $1.62 to $2.44. This is equivalent to an improvement in nickel prices of US$0.19/lb. or an improvement in copper prices of US$0.05/lb.

sd Metric	Translated into	Results
Placer Dome community involvement	DCF	If the community involvement program can fast-track the Cerro Casale project by one year, it will add value to Placer Dome stock estimated at US$0.81 per share. This is a 5.5% valuation lift from its current trading price of US$14.70 per share.
Teck Cominco community and employee relations	Rules of thumb (price to net asset value)	The value of the risk reduction associated with Teck Cominco's enhanced community and employee relations is estimated at $859 million or $4.24 per share.
INCO SD awards/recognition	Option pricing valuation	INCO's SD track record makes it possible for the company to open a new operation in Voisey's Bay, even though the operation may initially have a negative net present value (NPV) (-$400 million). This is because INCO's SD track record results in it being given an option, which would not otherwise exist, of great enough value ($712 million) to make the operation economically viable (NPV of $312 million with mine, smelter and pre-approved option to expand).
Noranda/Falconbridge safety/improved reportable injury frequency	Economic value added	The safety program at Noranda/Falconbridge created economic value added of approximately $8.2 million per year (not including insurance claims or long-term disability payments) for the period 2002 to 2004. If sustained, this improvement alone translates to an incremental value of $65 million or $0.21 per share.
Noranda/Falconbridge Six Sigma projects	DCF P/CFPS	Noranda/Falconbridge's Six Sigma projects are equivalent to a US$0.14/lb. price improvement in nickel, a US$0.02/lb. price improvement in copper, or a US$0.03/lb price improvement in zinc.

This project demonstrates that it is possible to translate the impact of corporate SD practices into financial valuation measures using traditional financial analyses. In so doing, it goes beyond simply supporting the business case for SD and takes the next logical step, which is to translate specialized operating information into usable financial data.

Research for this project reveals limitations in the suitability of existing publicly reported corporate SD metrics data for translation purposes. Based on an analysis of sustainability reports from the Canadian mining sector, two key findings are that:

- Reports are characterized by an absence of specific and quantitative information that limits valuation of 80% to 90% of a company's reported SD practices; and
- Relevant SD data are often scattered and thereby difficult to assemble and analyze for the purposes of ascertaining general additive value and translation into valuation.

It is recommended that companies report key SD metrics and related valuation information in a single summary table, preferably including this material early in their SD reports and related communications.

Regarding further research, two directions are required to advance this field over the immediate term. These include (1) conducting comparable analyses for other sectors and related additional SD metrics, and (2) working with companies to apply the framework.

Further work is also required in the area of communication. The results of this framework, and related future research, must be communicated to the broader financial community and other stakeholders.

To download a copy of this report, visit http://www.nrtee-trnee.ca/sdEffect_E

Appendix B – National Consultation: Participants

Note: As this program was carried out over a number of years, some participants' titles and/or organizations may have changed during that time. The titles and organizations cited reflect those of the participants at the time of these meetings.

Meetings Convened during the Program

Program Scoping Group Meetings

September 16, 2003 – Ottawa, ON
November 19, 2003 – Toronto, ON
January 6, 2004 – Calgary, AB
January 8, 2004 – Vancouver, BC
January 13, 2004 – Montréal, QC

Focus Group Meetings

Pension Research:

July 9, 2004 – Toronto; October 8, 2004 – Vancouver; March 14, 2005 – Calgary; March 31, 2005 – Halifax

Community Investment Research:

October 7, 2004 – Vancouver; November 24 – 2004, Ottawa; March 30, 2005 – Halifax

Research on MD&A:

December 17, 2004 – Toronto; March 15, 2005 – Calgary; March 30, 2005 – Halifax

Participants

Shona Adamson
Senior Consultant, IndEco

Darin Ahing
Counsel, Manulife Financial

Jane Ambachtsheer
Principal, Mercer Investment Consulting

Keith Ambachtsheer
President, K.P.A. Advisory Services Ltd.

Leah Anderson
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Joan Andrew
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Louis Archambault
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President and CEO, Co-operators Group Limited

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Director, Financial Planning and Treasury, City of Vancouver

Jean Bélanger
Member, NRTEE

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Vice-President, Sales, 4th Generation Capital

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President, Underdog Ventures, LLC

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Robert Bertram
Chief Investment Officer and Executive Vice-President, Investments, Ontario Teachers' Pension Plan Board

Guy L. Boucher
Vice-President, Environment, Domtar Inc.

Gilles Bourque
Economist, Fondaction

Zoë Bowie
Program Co-ordinator, Executive Education Haskayne School of Business

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Ronald Yachnin
Senior Research Associate, The Conference Board of Canada

Gil Yaron
Director of Law & Policy, Shareholder Association for Research and Education (SHARE)

Bill Young
President, Social Capital Partners

NRTEE Presentations to Groups

April 1, 2004 – Vancouver, BC
GLOBE 2004 Conference
NRTEE Session/Presentation

September 22, 2004 – Ottawa, ON
EXCEL Tele Conference
NRTEE Presentation

February 11, 2005 – Toronto, ON
Royal Bank of Canada (RBC) & United Nations Environment Programme (UNEP) – Toronto, ON
NRTEE Presentation

September 15-16, 2005 – Toronto, ON
UNEP Meeting
NRTEE Presentation

October 28, 2005 – Toronto, ON
Canadian Society for Ecological Economics (CANSEE) Conference
York University
NRTEE Presentation

Relevant Conferences attended by NRTEE and/or Task Force Members

April 5-6, 2005 – Paris, France
United Nations Environment Program – Principles for Responsible Investment

April 8, 2005 – Toronto, ON
Corporate Citizenship: What's A CEO To Do?
Rotman School of Management

May 10, 2005 – New York, NY
Institutional Investor Summit on Climate Risk

June 1, 2005 – Toronto, ON
21st Century Strategies for Sustainability and Profit Integration
3rd Annual Corporate Knights Roundtable

June 23, 2005 – Toronto, ON
Second Annual Meeting of the Canadian Coalition for Good Governance

Notes and Bibliography

Endnotes to the Foreword

[i] This point has been made consistently by many business leaders in North America and Europe, as well as by distinguished academics such as, for example, Professor Michael Porter of Harvard University in his speech, "The Competitive Advantage of Corporate Citizenship," presented at the Rotman School of Management, University of Toronto, April 8, 2005. See also M. Porter and R. Martin, "Canadian Competitiveness: Nine Years after the Crossroads," presented at the CSLS Conference on Canada, January 21-22, 2000, available at **http://www.rotman.utoronto.ca/research/competitive.htm**; and M. Porter et al., *The Global Competitiveness Report 2000*, World Economic Forum (Geneva, Switzerland), 2000, available at: **http://www.cid.harvard.edu/cidglobal/pdf/GCR_2000%20Front%20matter.pdf**

[ii] See, for example, Roger Martin, "The Virtue Matrix: Calculating the Return on Corporate Responsibility," Harvard Business Review, Vol.80, No. 3 (March, 2002); and J.D. Margolis, and J.P. Walsh, *People and Profits? The Search for a Link between a Company's Social and Financial Performance* (Mahwah, NJ: Erlbaum), 2001.

[iii] Analysts and investors are starting to ask for better disclosure on climate change risk; for example, through the Carbon Disclosure Project, which represents a coalition of 211 institutional investors with assets totalling more than US$31 trillion. See **http://www.cdproject.net**

[iv] For example, the U.K. adopted a single integrated financial services regulator, the Financial Services Authority (FSA), in 2000. Between 2002 and 2004, Australia transitioned from a fragmented regulatory regime to what is commonly referred to as the "twin peaks" model with one market conduct regulator (in this case the Australian Securities & Investments Commission) and one prudential regulator (the Australian Prudential Regulation Authority). France has also adopted the "twin peaks" model in recent years.

[v] Canadian Press. "Dodge Backs Single Regulator." *Globe and Mail*. September 22, 2005. **http://www.theglobeandmail.com/ servlet/Page/document/v4/sub/MarketingPage?user_URL=http://www.theglobeandmail.com%2Fservlet%2Fstory%2FRTGAM.20050922.wdodge0922%2FBNStory%2FBusiness%2F&ord=1159975666922&brand=theglobeandmail&force_login=true**.

[vi] Crawford Panel on A Single Canadian Securities Regulator, "*Blueprint for a Canadian Securities Commission*" (Purdy Crawford, Chairman) Final Paper, Toronto, June 7, 2006, at **http://www.crawfordpanel.ca/Crawford_Panel_final_paper.pdf#search=%22Blueprint%20for%20a%20Canadian%20Securities%20commission%22**. Accessed September 25, 2006.

[vii] See MacDonald and Associates, *Finding the Key: Canadian Institutional Investors and Private Equity* (Ottawa: Industry Canada), 2004. **http://www.cvca.ca/files/Finding_the_Key_Report-_June_2004.pdf#search=%22MacDonald%20and%20Associates.%20Finding%20the%20Key%3A%20Canadian%20Institutional%20Investors%22**

[viii] Wheeler et al., *Comparative Study of UK and Canadian Pension Fund Transparency Practices*, prepared for the NRTEE Capital Markets and Sustainability Task Force, 2004. **http://www.nrtee-trnee.ca/UK-Canada-Pension_E**

[ix] This issue also adversely affects the individual investor through weak enforcement and disciplinary measures for reprobate brokers. See Dan Leger, "Bad Brokers a $1-billion Problem for Investors," *The Chronicle Herald*, Halifax, Nova Scotia, October 17, 2005. **http://www.canadianjusticereviewboard.ca/article-bad_brokers_billion_dollar_problem.htm**

[x] Second to the United States, not including countries with populations of less than 10 million such as Norway, Luxembourg, and Ireland.

[xi] These dollar figures are in constant 2004 Canadian dollars using Purchasing Power Parity (PPP) rates. See Institute for Competitiveness and Prosperity, *Rebalancing Priorities for Canada's Prosperity: Report on Canada 2006* (Toronto, 2006). Available at: **http://www.competeprosper.ca/public/ott06.pdf**

[xii] If one takes the Toronto Stock Exchange (TSX) and the TSX Venture Exchange together, Canada ranks seventh in terms of market capitalization. But in terms of the number of publicly listed companies, Canada ranks second in the world, after the United States. This divergence reflects the high number of small firms accessing public markets in Canada (which are an expensive place to raise capital), possibly due to a lack of capital available elsewhere; e.g., from commercial banks or venture capital. See Sheryl. Kennedy, "Canada's Capital Markets: How Do They Measure Up?" *Bank of Canada Review* (Summer 2004). Available at **http://www.bankofcanada.ca/en/ review/rev_summer2004.html**

See also Canadian Federation of Independent Business, Canadian Manufacturers & Exporters, and RBC Financial Group, *The Path to Prosperity: Canada's Small- and Medium- sized Enterprises* (October 2002). Available at: **http://www.rbc.com/economics/market/pdf/sme.pdf**

[xiii] Institute for Competitiveness and Prosperity, *Rebalancing Priorities for Canada's Prosperity: Report on Canada 2006* (Toronto, 2006). **http://www.competeprosper.ca/public/ott06.pdf**

[xiv] Notably in other jurisdictions, the European Commission is creating a new high-level group on competitiveness, energy, and environment to be active by the end of 2005 as part of a new industrial policy for Europe.

[xv] There are existing incentives to promote SMEs, but disincentives for SME growth are due in part to higher tax rates incurred when annual business income grows above a set threshold. See Canadian Federation of Independent Business et al., *The Path to Prosperity: Canada's Small- and Medium- sized Enterprises* (October 2002). Available at: **http://www.rbc.com/economics/market/pdf/sme.pdf**

[xvi] Canadian Institute of Chartered Accountants, *Financial Reporting Disclosures about Social, Environmental and Ethical Issues*, prepared for the NRTEE Capital Markets and Sustainability Task Force, 2004. Available at: **http://www.nrtee-trnee.ca/CICA-SEE-Issues_E**

[xvii] Konar and Cohen have shown this in Shameek. Konar and Mark A. Cohen, "Does the Market Value Environmental Performance?" *The Review of Economics and Statistics* 83, 2 (May 2001): 281-289. Available at: **http://www.mitpressjournals.org/loi/rest.Orlitzky** et al have also observed this phenomenon. See Marc Orlitzky, Frank.L. Schmidt, and Sara L. Rynes, "Corporate Social and Financial Performance: A Meta Analysis." *Organization Studies* 24, 3 (May-June 2003): 403-441. Available at: **http://business.auckland.ac.nz/newstaffnet/profile/publications_upload/000000556_orlitzkyschmidtrynes2003os.pdf**

[xviii] CPP has recently announced plans to take an active role in corporate disclosure on environmental and social risks; see DeCloet, Derek, "CPP to Take Major Role in Corporate Disclosure," *Globe and Mail*, October 20, 2005. Goldman Sachs is actively developing products for its clients that explicitly address social and environmental risks; see Goldman Sachs, *The Growing Interest in Environmental Issues Is Important to both Socially Responsible and Fundamental Investors*," Goldman Sachs Global Strategy Research, August 26, 2005. Available at: **http://www2.goldmansachs.com/insight/research/reports/ docs/environ-interest.pdf**. Ernst & Young research indicates that 82 percent of investors will pay a premium for a company with good risk management and 61 percent will apply a penalty in the absence of risk management; it also indicates that 69 percent of respondents will rank transparency as the top priority in their investment decision-making — ahead of the business model or company track record. Ernst & Young. Press Release (Toronto: November 8, 2005) at: **http://www.ey.com/global/content.nsf/ Canada/Media_-_2005_-_Risk_Management**

Endnotes to the Report

[1] Freshfields Bruckhaus Deringer, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*, produced for the Asset Management Working Group of the United Nations Environment Program Finance Initiative, Geneva, October 2005. See: **http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf#search=%22UNEP%20FI%20Freshfields%22**

[2] CICA, Canadian Performance Reporting Board, Discussion Brief: "MD&A Disclosure about the Financial Impact of Climate Change and Other Environmental Issues", October 2005. See **http://www.cica.ca/multimedia/Download_Library/ Research_Guidance/MDandA_Business_Reporting/English/E_CPRB_Discussion_Brief_2005.pdf#search=%22CICA%2C%20Canadian%20Performance%20Reporting%20Board%2C%20Discussion%20Brief%3A%20%E2%80%9CMD%26A%20Disclosure%20about%20the%20Financial%20Impact%20of%20Climate%20Change%20%22**

[3] See Canadian Securities Administrators, National Instrument 51-102, Forms F1 and F2.

[4] For an Executive Summary of the CICA's Guidance on MD&A Preparation and Disclosure see **http://www.cica.ca/multimedia/Download_Library/Research_Guidance/MDandA_Business_Reporting/E_MDASum.pdf**

[5] National Round Table on the Environment and the Economy (NRTEE), "Financial Reporting Disclosures about Social, Environmental and Ethical (SEE) Issues" (prepared for the NRTEE Task Force on Capital Markets and Sustainability by the Canadian Institute of Chartered Accountants, Toronto, Canada, November 2004). See **http://www.nrtee-trnee.ca/CICA-SEE-Issues_E**

[6] Here the Task Force is making reference, in broad terms, to one of the Millennium Ecosystem Assessment synthesis reports: Millenium Ecosystem Assessment. Synthesis report. *Ecosystems & Human Well-being: Opportunities & Challenges for Business & Industry* (World Resources Institute: Washington, D.C., March 2005) at: **http://www.millenniumassessment.org//proxy/document.353.aspx**. This report provides the take-home message for the business community of the larger Millenium Assessment, a four-year international scientific project that assesses the consequences of ecosystem changes for humanity's well-being. The Millenium Assessment, led by a multi-sectoral board of directors, was launched by UN Secretary General Kofi Annan in June 2001 and completed in March 2005. See: **www.MAWeb.org** for further information.

[7] These six background papers are summarized in the currently posted Capital Markets portion of the NRTEE website: **www.nrtee-trnee.ca**. A literature review was also commissioned, but it was used internally for program development by the Secretariat; some of the NRTEE's background papers made reference to the literature review.

[8] David Myers

[9] The Experts Group was a multi-stakeholder group of 70 experts from academia, civil society, intergovernmental and governmental organizations, and the investment industry.

[10] See The Principles for Responsible Investment, Geneva, May 2005, at **http://www.unpri.org/principles/**. A pdf version of the Principles for Responsible Investment may be obtained at **http://www.unpri.org/files/pri.pdf**

[11] Yachnin & Associates, Sustainable Investment Group Ltd., and Corporate Knights Inc., *The sdEffect: Translating Sustainable Development into Financial Valuation Measures* (2006), prepared with the financial support of the National Round Table on the Environment and the Economy. See: **http://www.nrtee-trnee.ca/sdEffect_E**

[12] Alcan, Inco, Noranda/Falconbridge, Teck Cominco, and Placer Dome.

[13] Ratio Analysis, Discounted Cash Flow (DCF) Analysis, Rules of Thumb Valuations, Economic Value Added (EVA) Analysis, and Option Pricing.

[14] For example, see: J.D. Margolis and J.P. Walsh, *People and Profits? The Search for a Link between a Company's Social and Financial Performance* (Mahwah, NJ: Lawrence Erlbaum Associates), 2001.This study described 80 empirical investigations, approximately half of which provided direct evidence of a correlation between financial performance and CSP (as the independent variable) while only 5 percent of such studies indicated a negative relationship. No relationship or a mixed relationship was found in the rest. Also see: Marc. Orlitzky, Frank.L. Schmidt, and Sara L. Rynes (2003), who, in their meta-analysis of past studies of corporate social performance, found a statistically significant positive association with corporate financial performance. *This study can be found at http://business.auckland.ac.nz/newstaffnet/profile/publications_upload/000000556_orlitzkyschmidtrynes2003os.pdf.*

[15] For further information see the website of the Carbon Disclosure Project at **http://www.cdproject.net/**

[16] This report is downloadable from the Capital Markets section of the NRTEE website, see: **http://www.nrtee-trnee.ca/CICA-SEE-Issues_E**

[17] Freshfields Bruckhaus Deringer, "A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment" (produced by Freshfields for the Asset Management Working Group of the UNEP Finance Initiative, London, October, 2005) is a pro-bono legal opinion provided to the United Nations that covers nine major countries (Australia, Canada, France, Germany, Italy, Japan, Spain, the United Kingdom, and the United States), with the local legal research done by leading law firms in each country. In Canada, the legal research was completed by the firm McCarthy-Tétrault LLP. The report is downloadable at: **http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf#search=%22UNEP%20FI%20Freshfields%22**

[18] He then goes on to say "so long as it stays within the rules of the game." For context, the full quote is: "There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud." From Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press) 1962.

[19] Two of the six background papers that NRTEE commissioned on behalf of the Task Force were papers on community investment. One, entitled "Scan of the Community Investment Sector in Canada" by Coro Strandberg, Strandberg Consulting, Vancouver, B.C., and Brenda Plant, Brenda Plant Consulting, Montreal, Quebec. September 2004, provided a thumb-nail sketch of the CI sector in Canada and focused on the potential commercial role of capital providers in addressing the deep-seated needs of communities. This paper is downloadable from the capital markets section of the NRTEE website at: http://www.nrtee-trnee.ca/eng/programs/current_Programs/Capital-Markets/Documents/Community-Investment/Community-Investment_E.pdf.The second, entitled "Measuring What Counts" by Stephanie Robertson, Simpact Strategies, Calgary, Alberta December 2005 (downloadable from the Capital Markets section of the NRTEE website at: **http://www.nrtee-trnee.ca/Measuring-What-Counts_E**) focused on corporate community investment; that is, investment in which corporations match the nature of community investment (CI) and charitable donations with corporate strategic goals. Although the Task Force held consultations on the first paper, it did not in the end see CI as central to the message of this report. The Task Force notes, however, that a substantial survey of the nascent CI sector in Canada might be a useful point of departure for a future stand-alone study in this field.

[20] The website reference for CERES is **www.ceres.org**

[21] See Canada Pension Plan Investment Board, "Policy on Responsible Investing" at **http://www.cppib.ca/Corporate_Governance/**

[22] Investors tend to consider that screening reduces the universe of investment alternatives, while increasing portfolio risk.

[23] Stikeman Elliott LLP, "NI-102 – Continuous Disclosure Obligations will Harmonize Reporting Requirements Throughout Canada." *Securities Law Update* (February 2004), see: **http://www.stikeman.com/newslett/SeFeb04.htm**, accessed, September 24, 2006.

[24] It should be noted, however, that the management of most companies had, along with oversight of the board of directors, financial and non-financial risk management policies in place well before the collapse of Enron in 2001.

[25] King Committee on Corporate Governance, Secretariat (Mervyn King, Committee Chair), *King Report on Corporate Governance for South Africa* (Institute of Directors in Southern Africa, Parktown, Johannesburg, Republic of South Africa, March, 2002), known as "King II," provides key guidelines for good corporate governance practice in South Africa. All South African-based companies are urged to adhere to this practice via the Code of Corporate Practices and Conduct. A decision by the Johannesburg Stock Exchange (JSE) requires all listed companies to comply with The King II Code of Conduct. Section 5 of the code, which is directly relevant to GRI, covers integrated sustainability reporting. It states: "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...." This is the first time a major stock exchange has recognized sustainability reporting according to the GRI guidelines. The King II Report replaces the original report published in 1994: King Committee on Corporate Governance, Secretariat (Mervyn King, Committee Chair), *The King Report on Corporate Governance* (Institute of Directors in Southern Africa, Parktown, Johannesburg, Republic of South Africa, November 1994). Both reports are available from the Institute of Directors in South Africa, see: **http://www.iodsa.co.za/reports.asp?ShowWhat=CodeBlock**

[26] The source is a direct communication with the Global Reporting Initiative: e-mail from Sean Gilbert (Global Reporting Initiative) to David Myers (Task Force policy advisor), "Information on GRI," September 10, 2006.

[27] Ibid, Global Reporting Initiative, e-mail from Sean Gilbert to David Myers, September 10, 2006.

[28] David Dodge. "Remarks by David Dodge, Governor of the Bank of Canada, to the Association des MBA du Québec (AMBAQ)." Montreal, Quebec. November 9, 2005. **http://www.bankofcanada.ca/en/speeches/2005/sp05-14.html** See: speech of David Dodge, Governor of the Bank of Canada to the Association of MBAs of Quebec (AMBAQ), Montreal, November 9, 2005, **http://www.bankofcanada.ca/ en/speeches/2005/sp05-14.html**

29 This paragraph was largely derived from David Wheeler, Jane Thomson, Théresé Woodward, and Priti Shokeen, *UK and Canadian Pension Fund Transparency Practices*. Prepared for the NRTEE by the Schulich School of Business & York Institute for Research and Innovation in Sustainability with Kingston Business School, Kingston University, UK. May 2004, p.29, posted in the Capital Markets section of the NRTEE website: **See http://www.nrtee-trnee.ca/UK-Canada-Pension_E**

30 See Statistics Canada (2004) in Wheeler et al (2004), p.29.

31 See the CPPIB website: **http://www.cppib.ca/Results/Financial_Highlights/default.html**

32 See **http://www.lacaisse.com/Profile/RapportAnnuel.aspx#graph2**

33 A universal owner is "a large financial institution (such as a pension or mutual fund) that owns securities in a broad cross-section of the global economy." See: Jane Ambachtsheer, Mercer Investment Consulting, "Responsible Investment: What Is It All About?"[slides], April 18, 2006, at **http://www.pensionsatwork.ca/english/pdfs/lectures/AmbachtsheerSlides.pdf**, accessed September 12, 2006.

34 The Canada Pension Plan covers all jurisdictions in Canada — apart from the Province of Quebec, which runs its own pension plan.

35 See Canada Pension Plan Investment Board, website at **http://www.cppib.ca/About_Us/**, accessed September 25, 2006.

36 Régie des Rentes du Québec, Actuarial report of the Quebec Pension Plan as at 31 December 2003 (Executive Summary in English), section 2C, "Projection of the Reserve," at: **http://www.rrq.gouv.qc.ca/en/programmes/regime_rentes/analyse_actuarielle_sommaire.htm**, accessed September 25, 2006.

37 Régie des Rentes du Québec, ibid.

38 Régie des Rentes du Québec, ibid.

39 Régie des Rentes du Québec, ibid.

40 Caisse de dépôt et placement du Québec, "Policy on Socially Responsible Investment," Quebec, January 2005, See: **http://www.cdpcapital.com/media/Politique_ISR_ang.pdf**. Accessed September 25, 2006. The policy appears on the website of CDP Capital, an affiliate.

41 See Canada Pension Plan Investment Board, "Responsible Investing Policy," October 13, 2005 at **http://www.cppib.ca/files/PDF/policies/policies/Responsible_Investing_Policy.pdf**

42 See: **http://www.unpri.org/signatories/#im**. Accessed September 13, 2006. The Vancouver-based Shareholder Association for Research and Education (SHARE) is also a signatory to GRI under the Professional Service Partner category for PRI signatories.

43 *The Securities Act* (Ontario), see: Part XVIII, Continuous Disclosure, Section 75, "Publication of Material Change" at **http://www.e-laws.gov.on.ca/DBLaws/Statutes/English/90s05_e.htm#BK111**

44 See Toronto Stock Exchange "Company Manual," Sections 407 and 414 at **http://www.tsx.com/en/pdf/CompanyManual_Part4.pdf#search=%22Toronto%20Stock%20Exchange%20(TSX)%20has%20established%20disclosure%20guidelines%20in%20line%20with%20the%20Securities%20Act%20(Ontario)%2C%20although%20its%20definition%20of%20%E2%80%9Cmaterial%20information%E2%80%9D%20%22**

45 See: US Securities and Exchange Commission, Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations [Release Nos. 33-8056; 34-45321; FR-61], endnote 9, at **http://www.sec.gov/rules/other/33-8056.htm**

46 HM Government, *The Companies Act* 1985 (as revised), HMSO, London.

47 Company Law Review Steering Committee, *Modern Company Law for a Competitive Economy — Final Report*, Company Law Review, Department of Trade and Industry, London, July 2001, substantially derived from pp. 49-52.

48 Ibid, Company Law Review Steering Committee, *Modern Company Law*, Ibid, Volume 1, p.183.

49 Ibid, Company Law Review Steering Committee, *Modern Company Law*, Ibid, Volume 1, Ibid, p. 184.

50 The summary provided in this paragraph was kindly provided by Alan Willis of Alan Willis and Associates to the NRTEE, in an e-mail to David Myers, Task Force policy advisor, July 17, 2006.

51 The CICA's MD&A guidance provides a structured approach to MD&A reporting. Quoting from the CICA website: "The CICA guidance on MD&A disclosure sets out six principles and a five-part framework of recommended disclosure practices to assist companies in enhancing the usefulness of their MD&A reports." At **http://www.cica.ca/index.cfm/ci_id/10383/la_id/1.htm**, accessed on September 26, 2006.

52 CICA, Canadian Performance Reporting Board, Discussion Brief: "MD&A Disclosure about the Financial Impact of Climate Change and Other Environmental Issues," October 2005, at **http://www.cica.ca/multimedia/Download_Library/Research_Guidance/MDandA_Business_Reporting/English/E_CPRB_Discussion_Brief_2005.pdf#search=%22CICA%2C%20Canadian%20Performance%20Reporting%20Board%2C%20Discussion%20Brief%3A%20%E2%80%9CMD%26A%20Disclosure%20about%20the%20Financial%20Impact%20of%20Climate%20Change%20%22**

53 Canadian Securities Administrators, National Instrument 51-102, Forms F1 and F2. For Form F1 (re: Management's Discussion and Analysis), see: **http://www.sfsc.gov.sk.ca/ ssc/files/nat-inst/51-102formf1.pdf**. For Form F2 (re: Annual Information Form), see: **http://www.sfsc.gov.sk.ca/ ssc/ files/nat-inst/51-102formf2-consolidatedamendments-asof-dec30-05.pdf**

54 For an Executive Summary of the CICA's Guidance on MD&A Preparation and Disclosure see: **http://www.cica.ca/multimedia/Download_Library/Research_Guidance/MDandA_Business_Reporting/E_MDASum.pdf**

[55] National Round Table on the Environment and the Economy (NRTEE), "Financial Reporting Disclosures about Social, Environmental and Ethical (SEE) Issues" (prepared for the NRTEE Task Force on Capital Markets and Sustainability by the Canadian Institute of Chartered Accountants, Toronto, Canada, November 2004), at **http://www.nrtee-trnee.ca/CICA-SEE-Issues_E**

[56] *Marking to market* means the practice of computing the value of an asset (or a liability) based strictly on current market conditions and prices. In the case of an asset, it refers to the value at which one can buy or sell the asset at today's prices. In the case of a liability, it requires the use of the current interest rate in the bond market (long Government of Canada bonds for a pension plan, for instance) as the discount rate, in order to compute the "true" economic cost of the liability based on market rates.

[57] Three recent studies on long-term versus short-term horizons include i) the *UN Global Compact, Conference Report: Investing for Long-Term Value; Integrating Environmental, Social and Governance Value Drivers in Asset Management and Financial Research – A State of the Art Assessment* (conference hosted by UN Global Compact, International Finance Corporation, and the Federal Department of Foreign Affairs, Switzerland, at the SWX Swiss Exchange, Convention Point, Zurich, Switzerland, August 25, 2005). The report, prepared by onValues Investment Strategies and Research Ltd, Zurich and published October 26, 2005, can be found at: **http://www.unglobalcompact.net/Issues/financial_markets/zurich_rep.pdf#search=%22The%20Global%20Compact%2C%20International%20Finance%20Corporation%2C%20and%20Switzerland%3A%20the%20Federal%20Department%20of%20Foreign%20Affairs%2C%20Investing%20for%20Long-Term%20Value%22;** ii) NAPF/IMA, *Short-Termism Study Report*, (London: National Association of Pension Funds and the Investment Management Association), September 13, 2004; at **http://www.napf.co.uk/publications/Downloads/ PolicyPapers/SectionI/2004/ShortTermisimRep.pdf**; and iii) Marathon Club, *Long-term, Long-Only Investing: A Consultation Paper* (London: Marathon Club), March 16, 2006, at **http://www.marathonclub.co.uk/Docs/Guidance%20Note%20-%20FINAL%20DRAFT%206a%20March%2006.pdf**.

All three papers were accessed September 25, 2006.

[58] See: Canadian Association of Pension Supervisory Authorities (CAPSA), *Proposed Regulatory Principles for a Model Pension Law: A Report by the Canadian Association of Pension Supervisory Authorities (CAPSA)* (North York, Ontario), January 2004, at **http://www.capsa-acor.org/capsa-newhome.nsf/257bb0033af16a0a85256c1a00754637/ c3d9a6e25544270a85256e200054c961/$FILE/ML-ConsultDoc-Eng.pdf**, accessed September 26, 2006.

[59] Ibid, CAPSA, *Model Pension Law*.

[60] Quotations are from the Remarks by David Dodge, Governor of the Bank of Canada, to the Association des MBA du Québec (AMBAQ), Montreal, Quebec, 9 November 2005: **ihttp://www.bankofcanada.ca/en/speeches/2005/sp05-14.html**, accessed on September 13, 2006.

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