SUSTAINABILITY REPORTING IN CAPITAL MARKETS: A Black Box

1 - Title of research proposal

SUSTAINABILITY REPORTING IN CAPITAL MARKETS: A Black Box.

Abstract

While there is greater demand for sustainability reporting in capital markets, why is it not yet included in the annual reports of listed companies? This could change if both investors and governments incentivize the disclosure of non financial information. How can legal instruments increase transparency, openness and fairness in sustainability reporting of corporations in capital markets? Important steps were taken towards the implementation of sustainability reporting but there is little research about its effectiveness and exact positioning within capital markets. Governments’ growing involvement in capital markets reacting to the financial crisis opens-up a window of opportunity for regulations to improve transparency. More research is needed due the importance to understand which legal instruments are needed, and which lessons can we learn from the development of the current financial accounting standards.

2 - Description of the proposed research

Context

Increasing demands for sustainable development have lead to a greater integration of environmental, social and governance (ESG) factors by a greater number of investors in their market analysis, and to a greater use of sustainability as a new investment tool for future investments. A new type of information is required to allow companies to be duly evaluated according to the triple bottom line principle, which measures corporate performance along three lines: profits, environmental sustainability and social
responsibility.\footnote{The “triple bottom line” has also been described as the “triple-P bottom line,” referring to “profit (‘economic prosperity’), planet (‘ecological quality’) and people (‘well-being’).” Cramer, J. (2002) “From Financial to Sustainable Profit”, Corporate Social Responsibility and Environmental Management, Vol. 9 Issue 2, pp. 99, 102.} In this context, where a rising and competitive globalised market develops, mechanisms to rate sustainability in order to support sustainable development become a clear advantage for the economy, environment and society. An important strategy to improve the level of corporate social responsibility (CSR) is to enforce sustainability reporting in capital markets.\footnote{Accordingly to the European Commission’s Green Paper dated from 18 July 2001 “Promoting a European Framework for Corporate Social Responsibility”, CSR is “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis”.} This is the disclosure of non-financial data to a wide range of stakeholders, among others, rating agencies, investors, sustainability indices and the general public. It is both an academic and business term which refers to reporting on a range of indicators of economic, environmental and social performance.\footnote{These are called the Key Performance Indicators (KPIs) by the EC in the EU Accounts Modernisation Directive.}

In this research we look at how to develop a legal framework for these indicators.

The exhibit provided illustrates the process of public demand for sustainable development. This specific example depicts the public demand for pension funds to invest their money in sustainable companies.

- Companies can provide false or misleading information about their sustainability because there are no legal rules or incentives.
This exhibit shows that, in order to make sustainable investments, there is a need for reliable sustainable ratings. The concern about sustainability starts with the public, 12% of the clients of the pension funds want to invest money responsibly. In this chain, the pension funds are one of the major investors in capital markets. If the public asks pension funds to invest their money in sustainable companies, in order to satisfy their clients’ requirements, the pension funds need to know which companies are sustainable. Given this situation, another important player is called into the chain and begins its role – the Rating Agencies. These organizations attempt to rate companies on their degree of sustainability, either independently or at the request of the pension funds. For this, they need relevant, accurate and comparable information. However, companies and rating agencies have no incentive to deliver trustworthy results. We question if this can only be overcome by legal rules ensuring the information provided is truthful, accurate and comparable. The main objective of the companies is to make profit, for which they need the money from the pension funds to increase their activities. To achieve this, they want to show the pension funds, through the rating agencies, that they are sustainable by getting good ratings, raising a second problem. Since focusing on making money, companies can provide the rating agencies with false information about their sustainability because there are no legal penalties. The same applies to the rating agencies: even though there are strict accountancy rules for financial reporting, fraud is possible. If there is no legal set of uniform rules for sustainability reporting, it becomes even easier to cover the real commitment of a company to CSR. Consequently it is recognized that a new type of information is crucial to the development of sustainability.

[4] In the 2008 study "High Net Worth Individuals & Sustainable Investment", Eurosif estimated that sustainable investments by wealthy individuals will grow to 1 trillion Euros by 2012 and comprise 12% of their portfolios. Now, in the updated September 2010 study, Eurosif estimates the 2010 European HNWI Sustainable Investment market to be approximately €729 billion, representing about 11% of European HNWI portfolios as of December 2009. This represents a growth rate of 35% over the two-year period since 2008, when the data was last collected. Eurosif currently predicts that, by 2013, the share will have increased to 15%, almost reaching the €1.2 trillion mark.
State of the art

Numerous articles, surveys and websites from organizations as Global Reporting Initiative (GRI)\(^5\), European Commission (EC), United Nations (UN), pension funds, rating agencies, companies and others, have shown that there is growing global concern to overcome the obstacles for pursuing sustainable development. Believing in the benefits of an honest, accurate and transparent disclosure of non-financial information, these organizations have developed various instruments aiming to assist those who are interested in this commitment. The instruments are not binding, so voluntarily adopted, and put into practice by their signatories. Most European countries have a voluntary approach to non-financial disclosure. However, there are a few countries with a mandatory approach to non-financial disclosures, like Denmark, France, the Netherlands, Sweden and the United Kingdom (UK). Outside the European Union there are important developments towards non-financial disclosure in, for example, Brazil, South Africa and United States of America (USA). While adopted by numerous signatories, the voluntary instruments have proven not to be effective as there is no control to monitor the activities of the signatories, to measure the extent of their commitment and no legal accountability for breaching these commitments. The lack of regulation triggers an incentive problem between the main players involved in capital markets. With no incentives to act socially responsibly companies will most probably have their main focus on making short-term profit, and with no legal rules, they will not be held accountable for not providing honest, accurate and transparent information they are committed to. Companies want good ratings from rating agencies to become an attractive investment, besides their marketing purposes, while rating agencies want the money of the companies. Both companies and rating agencies, however, have no incentive to deliver trustable results. This can only be overcome by legal rules ensuring that the information provided is truthful, accurate and comparable.

If the International Financial Reporting Standards (IFRS) or United States Generally Accepted Accounting Principles (US-GAAP) did not exist, accountants would probably

\(^5\) GRI is a Multistakeholder non-profit organization that develops and publishes guidelines for reporting on economic, environmental and social performance (sustainability performance). As the world’s most widely-used sustainability reporting framework, the GRI Sustainability Reporting Guidelines are being used by a vast number of different organizations.
write whatever would benefit companies the most. Sustainability reporting is voluntary, not standardized like financial reporting based on uniform standards as the IFRS or US-GAAP. Although very important steps taken towards sustainability reporting have been taken, the information provided to the stakeholders is far from sufficient and accessible for an effective assessment on the companies. Compared to credit rating, sustainability rating is considered a relatively new but urgent phenomenon calling for immediate action and research to find a way to achieve a system of sustainability reporting capable to respond effectively to the current shortcomings.

This research attempts to offer a new insight and development for the future success of sustainability reporting within the capital markets. The main purpose is to explain how legal and non-legal instruments can create more transparency, openness and fairness in sustainability reporting of corporations operating in the capital markets. To answer this question, the underlying gaps are filled in first with an overview of the state of the art and shortcomings of sustainability reporting in capital markets.

Research

Research question: How can legal and non-legal instruments create more transparency, openness and fairness in sustainability reporting of corporations operating in the capital markets?

Sub-questions:

1. What is the state of the art and the shortcomings of sustainability reporting?
2. What is the importance of voluntary rules or guidelines, like the GRI, UN Principles for Responsible Investment (UNPRI), UN Global Compact (UNGC), International Integrated Reporting Committee (IIRC) and the Accounting for Sustainability Project (the Prince’s Accounting for Sustainability Project)? And what do the voluntary frameworks represent for their signatories?
3. Can legal instruments like a directive, codes of conduct, international agreements or instruments and codification of international law on sustainability reporting, force rating agencies and companies to provide honest and comparable information about the sustainability of a company? If so, which
legal framework is the most suitable to contribute to sustainable development? Should these instruments be binding or non-binding? Besides, should the governments take the initiative for drafting and adopting these rules?

4. What are the lessons to be learned from the comparison of the development of the present financial reporting system and the potential start-up development of a sustainability reporting uniform system of rules?

5. Is it possible to create an internationally recognized and uniform system of rules to ensure transparency and accountability in sustainability reporting to give countries a basis for national legislation? If so, how?

6. How sustainable are pension funds? Is there a real commitment of the pension funds to sustainability? What are the criteria for creating a portfolio of sustainable companies?

Approach

The research will be structured as following:

1 – State of the art and shortcomings of sustainability reporting, and country scan
In order to answer the first sub-question of the research, the first chapter of the thesis will start with an explanation of the present context of sustainability reporting on the basis of the existent literature on this subject. It also assembles a country scan, considering the countries with more advancements and potential impact on sustainability reporting, and motivations for choosing four countries for deeper analysis and comparison. After evaluation of the present state of art, the shortcomings in the current sustainability reporting should become clearer and the first sub-question will be answered.

2 – The meaning of voluntary frameworks and initiatives for sustainability reporting
To provide an answer to the second sub-question of the research, the next step of this research will focus on voluntary frameworks and initiatives developed by organizations like the GRI, UNPRI, UNGC, IIRC and the Prince's Accounting for Sustainability Project. In particular, the origins of these organizations and the development of the
underlying principles of the voluntary frameworks developed/under development for sustainability reporting, which companies have signed them and are committed to report in accordance with these frameworks, and the legal status of the referred organizations.

3 – Legal instruments: binding vs. non-binding regulations. Comparative research between countries with a mandatory approach to sustainability reporting and countries with a voluntary approach.

This third chapter will provide the answers to the third sub-question of the research by analysing the sliding scale between binding government regulation on the one hand and non-binding self regulation by companies on the other hand. Looking at this scale, the exact positioning of the legal instruments for sustainability reporting should become clear. How helpful and effective can they be for a sustainability reporting framework. This chapter will also include a comparison between two countries applying legally binding rules for sustainability reporting: The Netherlands and Sweden; and two countries committed to sustainability reporting only on a voluntary basis: Brazil and the USA. It is proposed to measure the results on both groups by comparing the ESG impacts of their activities and consequently compare their performance. At this stage, a detailed comparison between binding and non-binding instruments will take place and will be followed by a reflection - based on the state of the art and shortcomings referred to on the first chapter of this research - on who should take initiative for drafting and adopting sustainability reporting instruments.

Part of the research will be carried out by interviewing officials from government agencies, Non-Governmental Organizations (NGOs), pension funds, companies, banks, rating agencies and other relevant organisations or individuals. There will also be made a comparative analysis between official documents, reports, articles and surveys on environmental, social and economic development.

4 – International standards as a first step to the development of national legislation

Attempting to answer the fourth and fifth sub-questions, the fourth chapter will look at the history of the development and implementation of international standards like the financial accounting rules as a result of international financial regulations like the IFRS or the US-GAAP. The way this development took place can be an example of a successful process of how countries create national legislation. Based on the results obtained by the research made and by studying and analysing the adoption and
successful development of financial standards legislation, recommendations can be made for the future path of sustainability reporting. It will be analysed whether international standards can be a first step for the development of national legislation. Further, an examination of the reasons for the creation of international agreements on financial regulation will take place and it should be considered whether the drivers for domestic financial regulation are the same. The purpose of this analysis and examination is to make a parallel between the development of the financial regulations and the possible development and effective implementation of sustainability reporting regulation worldwide.

5 – How sustainable are Pension Funds and their investments?
A comparative research of sustainable investments between different European pension funds and American pension funds will be conducted to understand the level of commitment to sustainability between them. A comprehensive analysis will be made of the Dutch and Swedish laws regulating pension funds in view of their active involvement and long history in sustainable investment, and the American pension funds, from Brazil and USA, among others is Calpers, a Californian pension fund leading the way of sustainable investments. Furthermore, there will be a legal analysis of these pension funds with regard to sustainability, legal obligations and how the portfolio of sustainable companies is created. The information provided in this fifth chapter will allow answering the sixth sub-question.

6 - Sustainability Indices
The sixth chapter together with the seventh chapter of the thesis will also contribute to answering part of the third sub-question. It will focus on the existing literature on sustainability indices, the reasons why these indices are created, the importance and context of their positioning within the capital markets. An in depth look at Euronext and why it has no sustainability index so far, should be part of this item as an example of a leading European index with no sustainability index. Next, the focus will shift to the legal context. In particular, the legal status of a sustainability index and the applicable rules will be analysed.

[6] Sustainability indices are specialized indices for ethical investment. They encourage socially responsible investment (SRI) and include companies that respect and follow the ESG principles. The socially responsible investors exclude from their portfolio companies that don’t meet certain ethical standards, e.g. the ones involved with tobacco, armament, pornography, alcohol and gambling.
It is necessary to evaluate whether the entity responsible for the creation of a sustainability index should be obliged to be transparent concerning its criteria for evaluating sustainability of companies, how the information collected from companies is weighed, whether the companies which were excluded from an index can appeal against this decision and what legal rules this possibly applies to.

Finally it will be considered whether there should be a proposal for private or public regulation for the creators of a sustainability index, whether the sustainability indices are public or private analysing the legal requirements for both and finally whether sustainability ratings help investors in making their investment decisions more sustainable.

7 - Rating Agencies

The seventh part of the research will look at the importance of the sustainability rating agencies and will examine the relevance of the information on the sustainable positioning of companies on both national and international markets, and the primary means by which investors make investment decisions. Following the study of these issues, answers will be provided to a broad range of questions related to the way rating agencies work in practice, where they get their information from, which kind of information they can use, whether they have a legal right to have their questions to the companies answered, the applicable legal rules, conflicts of interest, legal restrictions, criteria and methods for such restrictions.

8 - Results

The outcome of this thesis will give an overview of the state of the art of sustainability reporting in different jurisdictions and consequent shortcomings. Looking at how pension funds create portfolios of sustainable companies and how investors make investment decisions based on sustainability indices and ratings, there will be an analysis of the stakeholders’ current behaviour towards sustainability. In addition, the research will result in an oversight of possible frameworks that can change positively the behaviour of the stakeholders. If there is a legal framework that contributes to sustainability reporting, the thesis will go deeper into the possibilities of an international

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[7] Sustainability rating agencies measure the company’s performance economically, environmentally and socially and evaluate if a company not only satisfy the financial criteria but also meet the SRI.

Research Proposal

and uniform system of rules. Furthermore, recommendations will be given on how to develop an international and uniform system based on the lessons learned from the development of the present financial uniform standards.

Concluding with the importance of the subject researched for the future of sustainability reporting and what are the implications of the findings for theory and practice it will possibly lead to recommendations for the future in a clear course of action, proposing questions for further study.

Methodology

The methodology chosen is composed by three interdependent levels of research. Each of the levels is dependent on each other. The results of one will most likely influence the results of the other levels, in particular between the second and third levels of the research.

The first level, and to answer the first sub-question, includes desk research and literature review based on relevant and comprehensive background information on sustainability reporting. As supportive information for the research non-legal sources will be used as literature, reports and articles. Besides, a doctrinal research will be conducted together with (modern) hermeneutical interpretation of the development of the financial accounting standards. We will look not only at written texts but also to the financial and economic context in which these rules were developed. This first level of the research will provide an overview of the state of the art and of the shortcomings of the current system of sustainability reporting, and through a country scan will introduce the countries in which the research will focus. From here we should have a solid basis to work towards answering the main research question.

The second level of the research encompasses a comparative legal research and legal analysis. At this point, the second sub-question (second chapter) will be answered with the outcome of an analysis of the data collected on the organizations responsible for developing voluntary frameworks.
The work towards answering the third sub-question (third chapter) will be conducted through an extensive and detailed legal analysis and comparison of the existent binding government regulations and non binding self regulation by companies. This method should contribute to determine their effectiveness and whether ones are more effective than the others. To determine the effects of mandatory and voluntary non-financial reporting we compare two European jurisdictions with a mandatory approach to non-financial reporting, the Netherlands and Sweden, with two countries with a voluntary approach to non-financial reporting, Brazil and the USA. Aiming to establish which of these jurisdictions is the most successful in implementing effectively sustainability reporting, we compare case studies, statutes, codes, treatises and regulations. Using the comparison as a policy tool helps explain and test theories about the way legal jurisdictions work, the legal dynamics, why the law changed and what the prior motivations were. At this phase, with the answers provided while completing the first, second and third chapters of the thesis on the state of the art and consequent shortcomings, should be possible to address the responsibility of taking the initiative for drafting and adopting sustainability reporting instruments.

To answer the third, fourth and fifth sub-questions (third and fourth chapters) of the research, there will be an analysis of the financial information contained in the EU Modernisation Directive, US-GAAP, IFRS and a research on the GRI key performance indicators. This information will be used as a tool to explain whether it is possible to develop a legal framework for sustainability reporting, which framework is the most suitable to increase transparency and accountability in capital markets, if these instruments should be binding or non-binding and who should be responsible for taking the initiative for drafting and adopting these rules. The fourth chapter provides a comparison between the successful evolution of the financial accounting regulations and the potential development of a legal framework for sustainability reporting. Furthermore, we analyze if it is possible to develop an internationally recognized and uniform system of rules to ensure transparency and accountability in sustainability reporting to give countries a basis for national legislation, and how is this possible.

With the results of the comparative legal research between European and American pension funds we will answer the sixth sub-question (fifth chapter) of the research.
Their level of commitment to sustainability, legal obligations and criteria for creating a portfolio of sustainable companies will be compared.

The following and last steps will be a legal research and description of the laws applicable to sustainability indices and rating agencies (sixth and seventh chapters), explaining how they work in respect of sustainability issues and provide examples. The most salient factors will be extracted from public available information, as their websites and other institutions.

On the third and last level of the research (eighth chapter), to acquire in-depth information of the knowledge, goals and motivations of the stakeholders we will conduct a qualitative research through semi-structured and open interviews, depending on the research objectives. These interviews are expected to take between one and two hours, they can be either in person, via telephone or e-mail. The semi-structured interviews can also provide an important outcome as quantitative research, as questionnaires and surveys are used as tools. The interviewees will be chosen for their particular professional positioning, work among others, in sustainability indices, rating agencies, pension funds, government and banks. At this stage, knowing the state of the art, what is generally known about the subject, what legal measures are there and which ones are and are not working, what the stakeholders think and how they act, it will be then possible to fill in the gaps of information between the three levels of research. Filling in these gaps must lead to answering the main research question. It should now be clear how and why did it happen as it did and what is important to look at in a future research. This research is expected to offer a new insight and development for the future success of sustainability reporting within the capital markets.
3 - Literature references

Books


Articles

Reports


Legislation and other communications from the European Union