SOCIAL INVESTMENT ORGANIZATION

The Canadian Association for Socially Responsible Investment

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Pat Hoy, MPP
Chair, Standing Committee on Finance and Economic Affairs
Room 105, Whitney Block
Queen's Park
Toronto ON M7A 1A2

Attn: Trevor Day, Clerk

Dear Mr. Hoy and members of the Committee:

Re: Comments on the Five Year Review of the Ontario Securities Act

I am writing on behalf of the members of the Social Investment Organization, the national association for socially responsible investment. Our members include more than 400 staff and directors of financial institutions, asset management firms and fund companies, as well as financial advisors and investors. Our members are committed to the development of socially responsible investment, which is the application of social and environmental analysis to investment selection and management. Our members serve more than half a million Canadian depositors and investors.

We want to thank the Committee for giving us the opportunity to present our views on the Five Year Review Committee and the Ontario Securities Act.

We would like to confine our comments to three issues raised by the Committee Report; specifically, the need for a national securities regulator, improved corporate disclosure and enhanced corporate governance.

By way of introduction, let me commend the Five Year Review Committee Report for raising important issues such as the need for a national securities regulator, and for supporting current initiatives, such as the Ontario 2002 amendments calling for CEO and CFO certification of financial statements.

We also support adoption of the Committee's recommendation for a statutory civil liability regime for continuous disclosure.

However, in terms of corporate disclosure and governance, we believe that the Committee's Report focuses almost exclusively on the financial aspects of corporate governance. In this brief we argue for a broader definition of appropriate disclosure and governance.

The SIO maintains that social and environmental analysis is an integral part of a well-managed portfolio. There is a growing body of evidence showing that corporations with positive social and environmental records have superior stock performance. By requiring Boards to consider social and environmental risks and policies, governance reforms will enhance shareholder returns over time. Also, by requiring corporations to disclose their social and environmental risks and policies, securities rules can help to shape an investment community that is increasingly sensitive to non-financial opportunities and risks. This can only help to enhance long-term shareholder returns.

The recent National Corporate Social Responsibility Report published by the Conference Board of Canada (*Managing Risks, Leveraging Opportunities*) found that corporate social responsibility is being formally integrated into business conduct and will continue to be a key business issue.

> *Global pressures are challenging corporations to think differently about the scope of their societal impact. Stakeholders have new standards of business conduct. Corporations need to ensure that all dimensions of their performance reflect the values, interests and expectations of society. Corporate social responsibility (CSR) has become a vital part of a long-term, comprehensive approach to business success.*
>
> Managing Risks, Leveraging Opportunities
> The National Corporate Social Responsibility Report
> Conference Board of Canada, June 2004

The SIO agrees with this perspective. By linking transparency, responsibility and sustainability to corporate governance and disclosure, we believe that corporations will be able to enhance returns through non-financial factors contributing to bottom-line performance. As well, by taking account of social and environmental risks, corporations will be able to apply a greater level of care and due diligence to the management of their businesses.

National Securities Regulator

The SIO agrees with the Committee Report in calling for a single Canadian securities regulator. This is both for cost-reduction reasons and for effective securities administration to enhance disclosure, transparency and accountability.

As noted in the Committee's Final Report, issuers who deal with investors across Canada are required to assume additional cost burdens through the services of registrants and counsel, registration fees and the costs of employees or advisers to comply with continuous disclosure requirements in each jurisdiction.

Many of the companies in the socially responsible investment industry are relatively small fund companies or asset managers. As such, the regulatory cost they must bear proportionate to their assets is much higher than for larger fund companies or national financial institutions. We believe that the cost savings from a national regulator would be substantial, and would help to place large and small companies on a more equal competitive footing.

More important, however, is our view that a national securities regulator would dramatically improve the administration of securities rules in Canada, particularly those in regard to disclosure, transparency and accountability.

As we will explain below, the SIO is calling for enhanced national requirements for corporate governance and disclosure. We have made similar arguments before the Canadian Securities Administrators in their requests for comment to harmonize disclosure and governance rules. While it is theoretically possible to harmonize these rules across Canada through individual securities commissions, the CSA harmonization model will invariably lead to some inconsistencies in the rules between provinces, and enforcement of these rules.

Furthermore, corporations are now facing a growing global consensus that socially responsible disclosure and governance is a fact of life in Europe and other jurisdictions such as South Africa. Multinational corporations increasingly want to issue their securities in a harmonized global investment market in which there are common rules involving disclosure and governance. As Europe moves increasingly toward a regime of socially responsible disclosure and governance, Canada risks falling behind important international standards on these issues without a national securities regulator to keep abreast of developments. It is important for Canada to implement a national socially responsible disclosure and governance framework to stay current with developments in Europe and elsewhere. In our view, a national regulator is the best way to accomplish this objective.

The Weakness of Corporate Disclosure in Canada

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

The response by many policy-makers has concentrated on issues of Board and auditor independence, shareholder rights and Board financial accountability to the exclusion of corporate accountability on social and environmental issues. We believe that this single-minded focus on balance sheet issues will simply reinforce management's mindset on short-term financial matters, to the detriment of enduring societal and sustainability factors.

Environmental problems, human rights controversies, product liability issues, employee concerns and other reputational issues all hold the potential to create share price discounts over the short-term and into the future. Likewise, companies that implement sustainability policies, codes of conduct, employee benefits programs and other corporate citizenship practices are more likely to identify market and production opportunities in the future.

By ignoring the needs of a host of corporate stakeholders, some companies not only put themselves under undue social and environmental risk, but they also undermine their share price over time. Our view of corporate governance is that social and environmental risk is a significant, yet largely unrecognized, factor in determining share value. Because of this, new regulations are needed to require corporations to disclose their social and environmental policies and risks.

Current Canadian social and environmental disclosure rules are less stringent and specific than they are in the US. As well, disclosure regulations in both jurisdictions fall far short of investor needs.

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

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

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

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

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

The link between social responsibility, environmental sustainability and corporate disclosure is being recognized by other jurisdictions. The United Kingdom is in the final stages of modernizing its Company Law. One of the proposed reforms under this initiative is a requirement that publicly-listed companies prepare an Operating and Financial Review (OFR, similar to the Management's Discussion and Analysis in Canada) as part of their annual financial reports. The draft law recognizes that corporate social responsibility issues influence company performance. Proposed regulations issued with the OFR specify that Reviews must include information and key performance indicators on "(a) the employees of the company and its subsidiary undertakings, (b) environmental matters, and (c) social and community issues" to the extent necessary for shareholders to understand how these matters affect the company. If Directors conclude that such CSR issues would not affect the company, they must explicitly say so. Finally, it requires companies in their OFRs to identify their key stakeholders, and to provide additional explanations of annual accounts if appropriate.

An OFR Preparation Guide, released in conjunction with the draft regulations, emphasizes that Directors must take a broad view of report users (as not only shareholders, but also consumers, employes and the general public who will also rely on the Report), and that Boards should have expertise and competence in the broad range of issues potentially affecting the company.

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

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

The importance of social and environmental policy disclosure has been recognized by the Canadian Securities Administrators in its recent Continuous Disclosure Guideline. The Guideline stipulates that, as part of the information required in the Annual Information Form (AIF), companies will describe their "social and environmental policies and the steps your company is taking to implement them." In the explanatory notes to the guidelines, CSA states: "Reporting issuers will now be required to disclose their social and environmental policies when they describe their business."

However, while we welcome these rules from the CSA, we recommend that the principle of social and environmental disclosure be incorporated into the Ontario Securities Act to ensure that companies are aware of their obligations to report on these matters to investors.

Furthermore, we recommend that the Act stipulate that publicly-listed companies be required to report on their social and environmental risks – a requirement now missing from the CSA Guideline. We recommend that the Ontario Securities Act be amended to specifically call for disclosures on social and environmental risk factors, which should discuss financial and non-financial events, actions or circumstances that will adversely affect a corporation's ability to achieve its business objectives. These would include stakeholder issues such as employees (union disputes, data on fatalities and lost time incidence, discrimination and harassment complaints), customers (product quality or safety issues), community involvement (human rights complaints or operational problems in developing countries and aboriginal communities in Canada) and environment (emissions problems or other sustainability risks).

Our intention is not to be inordinately prescriptive in detailing the need for social and environmental risk disclosure. We take a principles-based approach to securities regulation, rather than a rules-based approach. That is why we have prescribed the content by way of example, rather than laying out specific data to be disclosed. We feel this permits management and Boards to focus on the issues of most significance. As well, we also recognize that new issues can arise that are unforeseen at present. This recommendation includes enough flexibility to provide for these contingencies.

Enhancing Corporate Governance

We support the recommendation in the Committee Report that "the Act be amended to give the Commission rulemaking authority over corporate governance matters more generally. For example, we would support giving the Commission rulemaking authority to make rules relating to the composition, functioning and responsibility of boards of directors and nominating and compensation committees."

However, we believe that this rule-making authority should stipulate a mandatory *Code of Business Conduct and Ethics*.

Business Codes are a long-established vehicle for corporations to declare their fundamental values and beliefs, and communicate those to their employees, customers, shareholders and other stakeholders. As such, they represent a critical tool in effective management of the corporation's social and environmental issues.

Because of this, SIO believes that Business Codes should not be voluntary, as is currently proposed in CSA Policy 58-201 on corporate governance. Since Business Codes represent a key tool for communicating basic values and beliefs, all publicly-listed companies should be expected to create a Business Code. Otherwise, the basic operating ethics of the company will go unstated, leaving a major gap in corporate communications with stakeholders and the public. The best way to ensure compliance is to make the existence of such a Code a requirement under the Act.

While issuers would be required to create and disclose their Business Codes, some guidance is required to help them in drafting their Codes.

SIO recommends that the Ontario Securities Act stipulate that companies are required to have a mandatory Business Code, and that the following items be included as items of required Business Code content. If corporations do not address any or all of these items of required content, we recommend that they be required to explain why they do not. The items we recommend to be included as required content are:

- Conflicts of interest
- Protection and proper use of corporate assets and opportunities
- Confidentiality of corporate information
- Compliance with laws, rules and regulations; and
- Reporting of any illegal or unethical behaviour.
- Reporting of and compliance with social responsibility guidelines with regard to the issuer's key stakeholders (employees, customers, suppliers, competitors and security holders)
- Reporting of and compliance with sustainability guidelines on the issuer's impacts on the environment.

By requiring issuers to have a mandatory Business Code, and encouraging companies to examine their social and environmental impacts through these Codes, the Ontario Securities Act can help to expand the practice of good governance to include important human and sustainability issues that have long been ignored by the corporate sector.

Without being unnecessarily prescriptive, our recommendations would go a long way toward encouraging Boards to take a holistic view of their impacts on the environment and the wider society. Such a view would help to enhance shareholder return over the long-term and to improve corporate social responsibility.

Conclusion

Traditional financial analysis looks at companies without regard to social or environmental impacts. This skewed perspective is resulting in missed opportunity, unidentified risk and untold harm to our social welfare and degradation to our environment.

Governments and public policy makers can help to change this situation by putting in place some far-reaching but simple policies to encourage companies and capital markets to respond to social and environmental realities. The recommendations in this report would not place an onerous burden on companies. Neither would they entail new expenditures by government. But they would encourage a greater degree of social and environmental responsibility as well as more stable and transparent capital markets into the future.

Sincerely,

Eugene Ellmen
Executive Director