Taking stock: how leading stock exchanges are addressing ESG issues and the role they can play in enhancing ESG disclosure

Summary

- Stock exchanges play a key role in fostering market confidence and promoting good governance and disclosure.
- Good quality ESG disclosure is crucial for holistic investment decision-making, however is currently lacking across the market.
- Even leading stock exchanges are average only at managing their own direct ESG impacts.
- However, stock exchanges have already started playing a role in promoting better ESG disclosure through IPO and listing requirements in some countries.
- Key business drivers for stock exchanges to enhance their ESG disclosure requirements include reputation protection and increasing competition.
- The Sustainable Stock Exchanges Event hosted by the UN Global Compact, UN Conference on Trade and Development and the UN Principles of Responsible Investment in November presents an excellent opportunity to achieve meaningful and lasting improvements to ESG disclosure throughout the market.

- **Recommendations for stock exchanges:**
  - Incorporate ESG disclosure requirements into listing rules and corporate governance standards
  - Implement disclosure requirements on a 'comply or explain' basis
  - Support the requirement for a resolution on a CSR or sustainability report
  - Explore measures to encourage best practice amongst companies e.g. through sustainable indices

Introduction

This briefing explores the evolving role of stock exchanges, giving an insight into both their current and future role in responsible investment. In addition, this briefing analyses the current positioning of exchanges and the business drivers for promoting greater ESG disclosure in the market.

The turbulence of the global financial crisis has brought into sharp relief the potential pitfalls of our financial system's infrastructure. Stock exchanges already play a crucial role in financial markets by providing the market with liquidity and an efficient means of disseminating price information for stocks traded. At the 2008 TBLI Conference, Alain Dromer, chief executive officer of Aviva Investors, called for global stock markets to increase the pressure on listed companies to adhere to common governance and corporate responsibility standards by asking them to comply or explain under their listing rules.[1] Following this, an event hosted by the United Nations Global Compact (UNGC), United Nations Conference on Trade and Development (UNCTAD) and the United Nations Principles of Responsible Investment (UNPRI) this November will be examining the question of how exchanges can address environmental, social and governance (ESG) issues in a way that fosters responsible investment and supports sustainable development[2].

The evolving role of stock exchanges

Listing requirements, both at the Initial Public Offering (IPO) stage and through on-going reporting requirements, ensure basic information such as regular financial reports and audited earnings reports are available to investors. While stock exchanges differ in their requirements, a drive towards better risk management, governance and transparency is a consideration for all exchanges.

As the long-term sustainability of our current financial models are brought into question, stock exchanges are well positioned to restore confidence in the market in the short-term and could, through improved ESG disclosure, drive market efficiency as better managed companies are rewarded.

Furthermore, the growing sustainable investment market presents new opportunities for stock exchanges in the form of new products and services for responsible investors. These include specialized indices such as the Johannesburg Stock Exchange Socially Responsible Investment Index or the Deutsche Börse DAXglobal Alternative Energy Index. As the popularity of companies addressing specific environmental challenges, such as climate change, rises[3] stock exchanges can also provide access to investment in cleantech companies through their listing.

While regulation and company law play an important role in establishing and improving standards, it is increasingly apparent that stock exchanges are well placed to play a key role in the responsible investment debate and in particular in improving ESG disclosure through a principles-based market mechanism.

Drivers for better ESG disclosure

Investor perspective

Signatories to the Principles for Responsible Investment (PRI) recognize that they have a duty to act in the best long-term interests of their beneficiaries and in this fiduciary role, believe that ESG issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). The third principle of the PRI is “we will seek appropriate disclosure on ESG issues by the entities in which we invest”[4]. Good quality disclosure of the material ESG risks and opportunities faced by a company and its strategies for addressing these is a crucial component of good investment decision-making, enabling the investor to understand the governance and risk management of the companies in which they invest. This enables capital flows to be directed towards better managed companies and provides investors with the necessary information to challenge the company should these issues not be adequately addressed.

Indeed calls from investors for increased ESG disclosure have been growing louder. In April 2009 Eurosif, the European Sustainable Investment Forum, issued a public policy position paper to recommend the European Commission encourage greater corporate transparency on ESG issues including a call for European institutions to mandate disclosure of ESG data by publicly traded, large corporations[5]. Such reporting would be principles-based and use a limited number of standardised Key Performance Indicators (KPIs), some of which would be sector specific. In July 2009 more than 50 major investment firms and professionals joined the Social Investment Forum (SIF) in calling on the US Securities and Exchange Commission (SEC) to help strengthen financial markets and foster sustainable business practices by requiring publicly traded companies to report annually on a range of ESG matters[6].

All of this takes place in the context of a number of countries mandating, or taking steps towards mandating, disclosure on ESG performance. We have highlighted three examples – the UK, Denmark and China.

In the UK, requirements for a Business Review are laid out in the Companies Act 2006[7] and are also required under the EU Accounts Modernization Directive. In the case of a quoted company the business review of that company must include information on a range of ESG issues to the extent necessary for an understanding of the development, performance or position of the company’s business. This includes information about the impact of the company’s business on the environment, the company’s employees, and social and community issues as well as information about any policies adopted by the company in relation to these issues and information on the effectiveness of those policies.

In December 2008 Denmark adopted a law requiring the 1,100 largest companies in the country to report on their corporate responsibility efforts[8]. This new bill makes it mandatory for publicly listed companies, state-owned companies and institutional investors to include information on corporate social responsibility (CSR) in their annual financial reports. The reports must include information on the company's policies on CSR or socially responsible investment (SRI), how such policies are implemented in practice, and the results obtained as well as managements' expectations for the future with regard to CSR/SRI.

China's State-Owned Assets Supervision and Administration Commission (SASAC) released a directive in 2008 strongly encouraging state-owned enterprises to report on their sustainability activities[9]. While this is not yet a requirement, the SASAC has considerable influence within the Chinese business community.

There are a number of other countries both in developed economies (such as France and Sweden) and emerging markets (such as Malaysia) who have introduced mandatory ESG or corporate responsibility (CR) reporting and many more countries with voluntary reporting guidelines.

An EIRIS report conducted in 2008 into the State of Responsible Business found that global disclosure levels were poor even where the issue was identified as highly business relevant for the company. An analysis of the FTSE All World Developed index found the following disclosure rates for companies identified as high risk for the particular issues highlighted. In human rights over 60% of high risk companies had no evidence of reporting. For supply chain labour standards the levels for no disclosure ranged from almost 20% in Europe to 80% in Japan, Hong Kong and Singapore. In environment and bribery over 40% of companies were found to have inadequate reporting[10].

Against a backdrop of increasing investor and wider stakeholder demand for enhanced ESG disclosure and a shift to governments addressing ESG disclosure with regulatory instruments, there is a growing business case for stock exchanges to play a greater role in the drive towards greater ESG disclosure.

Stock exchange perspective

Stock exchanges are facing an increasingly challenging operating landscape as competitive and market pressures challenge their traditional business model. An increasing commitment to ESG disclosure may present important business opportunities:

Reputation - The primary reasons companies list are to access capital, profile and liquidity. Stock exchanges already compete on standards, for example the London Stock Exchanges (LSE) advertises that "the highest standards of corporate governance ….. give participants greater confidence [which] improves market efficiency and drives down costs". Some exchanges, including the London Stock Exchange, already cite strong reputation and brand name as a key competitive strength (Annual report, 2009). As a company's profile is linked to the reputation of the exchange and the integrity of the requirements for companies listing, there is a business case for exchanges to lead by example on ESG disclosure and performance.

Increasing competition – The introduction of the Markets in Financial Instruments Directive (MiFID) in 2007 provided harmonized regulation for investment services across the European Economic Area, thereby increasing competition. For stock exchanges, this increased competition manifested itself as the proliferation of electronic trading platforms, such as ChiX, providing cheaper and often faster trading opportunities and thereby eroding the margins from trading revenues. These often represented a significant proportion of revenues of traditional stock exchanges. Listing services present an opportunity for stock exchanges to differentiate themselves from these trading platforms as these platforms do not offer these services. They are also important to maintain the pricing information necessary for data sales (another important revenue stream for stock exchanges). However, additional competition from new stock exchanges such as PLUS Markets is emerging. While stock exchanges seek to protect their position, rigorous listing requirements may present an important differentiator.

Pressure from investors and protecting liquidity - While the global financial crisis has resulted in a significant drop in the number of IPOs, the number of IPOs in 2008 was down 41% on the number of IPOs in 2007[11], the numbers are likely to rebound in 2010. In addition as economic stimulus packages focus on 'green growth' there is likely to be an increase in cleantech companies, e.g. in alternative energy technology, seeking capital via the markets. Emerging markets, in particular India, have also seen an increase in IPOs. As the number of IPOs recovers, the best positioned companies will maintain and gain market share. Stock exchanges have an interest in providing these companies with access to capital and providing investors with liquidity which in turn helps to maintain stock exchange revenues. ESG credentials and an ability to attract cleantech companies will be important in order to benefit from this upturn.

How are exchanges currently positioned?

As this paper highlights, stock exchanges have significant influence through their listing requirements. However, it is also interesting to understand how stock exchanges are managing ESG issues in their own operations. This is because corporate management of direct ESG impacts may be considered as a proxy for the general level of awareness and strategic importance given to ESG issues by the stock exchange. In particular, it can be an indication of how engaged the exchange is and whether there are key personnel with the necessary expertise in ESG issues to help them steer through the challenges of incorporating ESG disclosure requirements into their listing rules. It should be noted, however, that stock exchanges may perform well but not disclose their performance.

We have seen that stock exchanges with their own sustainability index are keen to meet their own index requirements so we expect to see performance on ESG disclosure to improve if listing requirements are introduced.

EIRIS has assessed a cross-section of listed stock exchanges on their own ESG performance. The total ESG score is based on an assessment of a selection of business-relevant ESG issues. The criteria are deliberately weighted towards social and governance matters as this is where their direct impacts are most significant.

Environment: environmental policy

Social: equal opportunities policy, equal opportunities systems, employee training, customer policy, customer systems

Governance: responsibility for stakeholders, ESG risk management, bribery policy, systems and reporting, code of ethics, code of ethics systems

Each of these areas are assessed against multiple indicators to produce a four or five point scale which is then converted to a score. The total ESG score is presented as a percentage of the total possible maximum score. An additional score is awarded where exchanges have established a sustainability index(s). This score differentiates between a single issue index e.g. on alternative energy and a sustainability index covering a broader range of ESG issues.

Key findings

- Most exchanges perform poorly on ESG performance with most achieving below 50% of the maximum score
- The Australian Stock Exchange (ASX) performs best with 70.2%
- Exchanges perform better on social issues (average 50.9%) than environmental (35%) and governance issues (48.3%)
- Each region performs in line with the overall average with the emerging markets lagging slightly behind. (Although this is only based on three companies in each region.)

Table 1: How well do exchanges manage ESG issues?

Company	Country	Region	ESG score	Examples of sustainable indices
ASX	Australia	Asia Pacific	70.2%	
BM&F Bovespa	Brazil	Emerging market	41.7%	Corporate Sustainability Index (ISE)
Bolsas y Mercados Espanoles (BME)	Spain	Europe	53.9%	FTSE4Good IBEX index
Deutsche Boerse	Germany	Europe	62.9%	Range of indices including DAXglobal Alternative Energy Index
Hong Kong Exchange & Clearing	Hong Kong	Asia Pacific	59.6%	
JSE	South Africa	Emerging market	53.9%	JSE SRI index
Korea Exchange (KRX)	South Korea	Emerging market	22.8%	Korea SRI index (in development)
London Stock Exchange (LSE)	UK	Europe	53.9%	Range of FTSE4Good indices
NASDAQ Stock Market	USA	North America	52.1%	Range of indices including NASDAQ Clean Edge US index and OMX GES Sustainability Nordic Index
NYSE Euronext	USA	North America	59.4%	Range of indices including NYSE ArcaCleantech Index
Singapore Exchange	Singapore	Asia Pacific	22.8%	
TMX Group	Canada	North America	49.1%	

The path ahead

Stock exchanges have already contributed meaningfully to the arena of responsible investment and in particular to promoting ESG disclosure. A report published in March 2009 by the Sustainable Investment Research Analyst Network (SIRAN), a working group of the Social Investment Forum (SIF) in partnership with EIRIS, assessed 40 leading companies in ten emerging markets against key ESG criteria[12]. The report found that the selected South African and Brazilian companies stood out overall as consistently having the highest assessments among the companies sampled. These countries also developed some of the first responsible investment indices in emerging markets (the JSE SRI index in South Africa and the Bovespa Corporate Sustainability Index in Brazil).

This acknowledges investor interest with ESG performance here. A major emerging market investor survey from the Emerging Markets Disclosure (EMD) Project published in June 2009, analysed by EIRIS and sponsored by the International Working Group of the Social Investment Forum, highlighted the lack of ESG disclosure as the biggest challenge to investing in emerging markets. However, survey respondents commended two emerging market countries, Brazil and South Africa, for having made the most progress towards greater ESG disclosure[13]. Both countries have developed a sustainability index to which their listed companies can aspire through improved disclosure. While responsible or sustainable indices can provide a powerful driver for improved disclosure, specific requirements are not mandated for all companies.

Incorporating ESG disclosure requirements into listing rules and corporate governance standards, as some exchanges are already doing, would have a far-reaching impact on improving ESG disclosure across all significant proportions of the market.

IPO disclosure requirements- Public listing is a key source of capital for many companies. The IPO stage is therefore an important junction at which greater ESG disclosure can make a key impact on investment decision-making and access to capital. In 2008 the Ministry of Environmental Protection (MEP) in China launched the 'Green Securities' policy later supported by the 'Green Initial Public Offering (Green IPO)' policy in the same year in partnership with the China Securities Regulatory Commission (CSRC)[14]. The aim was to raise the bar for the country's 13 most polluting industries (the so-called 'Liang Gao') for listing on the Shanghai and Shenzen Stock Exchanges. Greenpeace China reports that last year the MEP insisted that 27 companies should invest a total of RMB 359 million in pollution-control measures before it would give its seal of approval to their listings on mainland stock markets. Moreover, applications for loans totaling RMB 474 billion for 157 projects associated with the 'Liang Gao' were either rejected or deferred for further assessment. NGOs in China are also playing an increasing role in highlighting the environmental impact of companies and using the 'Green IPO' policy to hinder IPO applications from damaging companies.

On-going listing requirements – Reporting requirements, mostly financial requirements, are already incorporated in the listing rules of most stock exchanges. Embedding more specific ESG disclosure requirements could have a significant impact on the quality of disclosure. A number of countries have started taking steps in this direction. In Malaysia, the Bursa Malaysia has incorporated mandatory CSR reporting requirements into their listing requirements.

Corporate governance codes – Corporate governance codes represent an important standard for well governed companies. National corporate governance codes are increasingly including CSR or sustainability related issues in these codes. King II is one such example in South Africa. In Australia the Corporate Governance Council of Australian Securities Exchange (ASX) has incorporate an ESG disclosure requirement in its Corporate Governance Principles. The principle that 'companies should establish policies for the oversight and management of material business risks and disclose a summary of those policies' specifically includes a note that those risks may include environmental and sustainability risks. Companies are required to disclose on a 'comply or explain' or 'if not, why' basis. This principle-based approach seems most appropriate within a market framework.

Going further, stock exchange support for a separate resolution on a CSR or sustainability report, in the same way that in countries such as the UK there is an advisory vote on the remuneration report, would raise disclosure further up the agenda. To date, we are not aware of a stock exchange taking such a step. However, it is clear that such a vote would give a greater voice to shareholders on this issue.

Conclusion

There is no doubt that stock exchanges currently play a key role in capital markets through setting a benchmark for disclosure through their listing requirements, ensuring liquidity and maintaining confidence and integrity in the market. In the aftermath of the global financial crisis, confidence in capital markets is understandably low among investors, regulators and wider stakeholders.

However, under the auspices of the UNGC, UNCTAD and the UNPRI there is now an opportunity to address this to the benefit of stock exchanges themselves as well as the wider market. Enhancing ESG disclosure gives greater transparency to investors and facilitates the flow of capital to companies appropriately managing the business risks and opportunities associated with ESG issues.

The responsible investment industry will follow with great interest the progress made at the November event in New York, however the ramifications, if successful, will be felt throughout the capital markets.

Recommendations for stock exchanges

- Consider adoption of the Principles of Responsible Investment – www.unpri.org
- Participate fully in the discussions and initiatives to take forward:
  - Incorporating ESG disclosure requirements into listing rules and corporate governance standards on a 'comply or explain' basis
  - Support for the requirement for a resolution on a CSR or sustainability report
  - Exploring measures to encourage best practice amongst companies e.g. through sustainable indices
- Consult with relevant stakeholders including responsible investors and ESG research providers to understand the ESG information requirements

Notes

[1] Aviva Investors chief ups ante on CSR and responsible investment , Responsible Investor, www.responsible-investor.com/home/article/aviva/
[2] UN PRI www.unpri.org/sustainablestockexchanges09/index.php
[3] Stock Exchanges & Sustainable Investment www.world-exchanges.org/files/file/article%201_Executive%20Summary%20WFE%20study%20on%20exchanges%20and%20sustaible%20investment%20by%20dan%20Siddy.pdf
[4] United Nations Principles for Responsible Investment www.unpri.org/principles
[5] Eurosif Public Policy Position Paper www.eurosif.org/content/download/1361/7711/version/1/file/Eurosif+Public+Policy+Position+Paper+2009.pdf
[6] Social Investment Forum www.socialinvest.org/news/releases/pressrelease.cfm?id=143
[7] UK Companies Act 2006 www.opsi.gov.uk/acts/acts2006/pdf/ukpga_20060046_en.pdf
[8] Denmark introduces mandatory CSR reporting for big companieswww.unglobalcompact.org/newsandevents/news_archives/2008_12_17.html
[9] CSR Asia www.csr-asia.com/index.php?id=11096
[10] The State of Responsible Business (2008), EIRIS www.eiris.org/files/research%20publications/stateofrespbusinesssep08.pdf
[11] World Federation of Exchanges www.world-exchanges.org/statistics
[12] A review of ESG practices in large emerging market companies, EIRIS www.eiris.org/files/research%20publications/emergingmarketsmar09.pdf
[13] Emerging market investor survey report, EIRIS www.eiris.org/files/research%20publications/emdpinvestorsurveyjune09.pdf
[14] Greenpeace www.greenpeace.org/raw/content/china/en/campaigns/green-investment/issue-3/ignoring-the-environment-is-no.pdf

How we can help

EIRIS has developed a comprehensive suite of products to help investors and stock exchanges

- **EIRIS UNPRI toolkit** - consists of three products specifically designed to assist signatories with several aspects of the Principles of Responsible Investment including integration, engagement, and improving corporate ESG reporting practices (UNPRI toolkit)
- **Sustainable indices** – EIRIS has many years experience advising and helping to establish a robust index methodology, facilitating engagement with companies to improve ESG performance and encouraging the uptake of the index amongst asset owners and asset managers
- **Advising on ESG voting** – EIRIS advises on the establishing of voting policies and provides voting recommendations to use existing voting opportunities to encourage corporate disclosure and other investment objectives

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About EIRIS (www.eiris.org)
EIRIS is a leading global provider of independent research into the environmental, social, and governance, (ESG), and ethical performance of companies. With over 25 years experience of conducting research and promoting responsible investment strategies, EIRIS now provides services to more than 100 asset owners and asset managers globally. In the last ten years new EIRIS research has focussed on the risks and exposure of companies in key ESG areas, and how companies are responding. EIRIS works with clients to create their own ESG ratings and rankings, to engage with companies and to create specific funds for their clients. EIRIS has a multinational team of over 50 staff in London, together with offices in Boston and Paris. The EIRIS network includes research organisations in Australia, France, Israel, Germany, Spain and South Korea, and now covers around 3,000 companies globally.

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