



**SOCIAL INVESTMENT ORGANIZATION**

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4700 Keele Street  
Toronto, Ontario, Canada  
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Attn: Archana Sridhar

Dear Ms. Sridhar:

**Re: SOCIAL DISCLOSURE CONSULTATION**

Thank you for the opportunity to comment on the consultation paper. I would like to comment on three aspects of the paper in particular: the need for a comprehensive ESG disclosure framework, the need for regulatory reform of ESG disclosure, and the definition of materiality. My comments will also touch on the recent Report to the Minister from the OSC. SIO will be preparing a fuller brief on the report to be sent to the OSC and the Minister in early January.

### **Comprehensive disclosure**

As SIO stated to the Ontario Securities Commission, SIO believes that the decision by the Commission to re-frame the consultation into a consultation on governance and environmental matters (ignoring social disclosure) was short-sighted.

The resolution of the Legislature stated quite clearly that the OSC was to consult broadly on ESG issues "to develop and adopt an enhanced standardized reporting framework for both quantitative and qualitative social and environmental information, to ensure corporate disclosures are understandable, comparable and outcome focused." As the OSC has noted, the resolution was non-binding. Nevertheless, while we believe there was no obligation to act on the consultation (since this ultimately is a matter for the government to decide), we believe the OSC had an obligation to conduct the consultation in a manner pursuant to the will of the Legislature. By dividing up the issue into three distinct parts, and arbitrarily ignoring one, the OSC did not conduct the consultation in a manner consistent with the Legislative resolution.

Therefore, I believe this consultation was a missed opportunity to examine this issue in its fullest context.

## The need for regulatory reform

As I stated in the discussion paper reviewing regulatory reform proposals in Europe and the US, the starting point for this discussion should be an examination of the need for ESG disclosure.

Your consultation paper quite clearly documents the growth of sustainable and responsible investment, and the growing consensus that the integration of ESG information into investment analysis and portfolio construction can enhance long-term investment returns and mitigate risk. I won't review this information here.

However, in spite of significant legal and financial drivers encouraging the spread of responsible investment and large numbers of investors and collaborations improving RI research and practice, the development of responsible investment is hobbled by a lack of widespread, easily accessible, comparable and systematic information on the ESG performance of companies. The current situation is marked by low rates of voluntary corporate reporting on ESG issues and inconsistent reporting and presentation of data. With a low number of voluntary filers the current voluntary<sup>1</sup> reporting regime captures just a small amount of the total potential ESG information in the market.

Further, these reports are idiosyncratic, prepared on a company-by-company basis that makes it difficult for analysts to draw systematic comparisons. Such comparisons are essential in the preparation of "best-in-sector" or "best-in-class" analyses that permit investors to create portfolios based on corporate ESG leaders.

As a result of this lack of meaningful, systematic reporting on ESG issues, asset managers, fund companies and other investors are unable to obtain the information they need to conduct thorough, comprehensive analyses of companies. This failure is slowing the development of analysis and practice on responsible investment, and represents a significant barrier to the integration of ESG issues into mainstream investing.

The second key concern that makes regulatory reform in this area necessary is related to the growing consensus that ESG transparency can be useful in helping to prevent unforeseen calamities, the type of event that has become known as "black swan events." According to author Nassim Taleb, who introduced the concept in his 2007 book *The Black Swan*, black swan events lie outside the realm of regular expectations, carry extreme impact and are explainable and predictable only after they have occurred.

In the financial industry, black swan events challenge traditional assumptions of the efficient markets hypothesis and modern portfolio theory.

In the case of the credit markets of 2008, it is now quite clear that the collateralized debt obligations (CDOs) and other structured finance products so prevalent in the mid-2000s contained significant undisclosed ESG risk. This included social risk represented by the very real ethical concerns of masses of homeowners, who felt unfairly treated by sub-prime mortgage lenders. This perception eventually resulted in large numbers of defaults, which cascaded into huge losses for the holders of the CDOs. Similarly, the CDOs contained significant governance risks in the compensation plans that encouraged executives of merchant banks and other CDO distributors to take excessive risks in packaging the CDOs and offering them for sale to clients.

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<sup>1</sup> By saying that the current system is marked by "voluntary" reporting, I recognize that there are disclosure obligations related to materiality, management's discussion & analysis, and specific regulatory disclosure requirements. However, as I will explain later there is debate over the definition of materiality, which effectively makes the current disclosure regime a "voluntary" framework.

It now seems obvious in hindsight, but mandatory disclosure of these risk factors would have provided better understanding of these underlying risks, with the result that they would have been priced into the securities, and their widespread use would have been curtailed. This point is explored in detail in a recent report commissioned by the Social Investment Organization, *The Financial Crisis: an environmental, social and governance perspective*.<sup>2</sup>

Not only were ESG risks poorly understood, it is arguable that sellers of structured finance products failed to consider them at all because ESG analysis lays outside of the normal analysis applied to such investments. The result was a “black swan event” of enormous consequence.

In the case of the unregulated structured finance market, the lack of mandatory ESG transparency was exacerbated by the absence of even minimal financial reporting requirements. This speaks strongly to the fact that the market for structured finance products needs to be regulated, and, together with public equities, they need to be subject to a mandatory ESG reporting framework.

For sustainable investing to realize this ambitious vision, ESG information must be widely disseminated and easily accessible in the market. Therefore, mandatory ESG reporting is essential from both a long-term perspective of enhancing returns and reducing risk and a short-term perspective of identifying unusual but potentially-calamitous possibilities. The costs to issuers of such reporting must be kept as low as possible, of course, but it is clear that the benefits of mandatory ESG reporting to investors and society as a whole far outweigh the costs to issuers.

### **The definition of materiality**

On the question of the definition of materiality, I refer you to the OSC Report to the Minister,<sup>3</sup> which defines a test for “materiality” as:

*...a “reasonable investor” test. Information is likely material if a reasonable investor’s decision whether or not to buy, sell or hold securities in an issuer would likely be influenced or changed if the information in question was omitted or misstated. Stakeholders generally believe that the type of information that may affect a reasonable investor’s investment decision has shifted in recent years to include a greater scope of corporate governance and environmental matters. This shift is expected to continue as we move towards a carbon-constrained economy.*

This test is a sensible definition of materiality. It permits dialogue on specific issues between companies, investors and other stakeholders, and does not hold the test of materiality to a strict investment threshold based on market capitalization. It is somewhat ambiguous, but does recognize that there can be differing views on materiality. In fact, differing views on materiality have been the subject of scores of shareholder resolutions brought forward to corporate management.

Some attendees at the social disclosure roundtable argued that an issue is only material to a company if it can be argued that it affects a certain established percentage of the market capitalization of the company. There are two problems with this view.

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<sup>2</sup> See <http://www.socialinvestment.ca/documents/FinancialCrisis-AnESGPerspective-CRStrategies-June2009.pdf>.

<sup>3</sup> See <http://www.osc.gov.on.ca/en/26531.htm>.

First, some issues that are important to investors cannot be clearly reduced to a market capitalization analysis. Either there is insufficient information to conduct a cash flow analysis or the issue deals with the cultural practices of the company, such as governance issues, that are unrelated to the company's operations. In either case, investors should be able to raise these issues with the company, and the company has an obligation to make reasonable disclosures on these issues.

Second, a definition of materiality based on a percentage of market capitalization provides corporate management with unilateral authority to decide whether an issue is material. This negates the purpose of material disclosure, namely; to enable a reasonable investor to decide whether to buy, sell or hold a security. The definition of material cannot be so narrowly defined that management has the sole right to determine what is material.

I look forward to your final report, and I would be pleased to discuss these issues in further detail.

Sincerely,

A handwritten signature in blue ink, appearing to read "E. Ellmen".

Eugene Ellmen  
Executive Director