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Corporate Citizenship and Sustainability Arrive:

Are Capital Markets Addressing New Business and Investment Risk Factors?

By Steven Godeke, Senior Research Advisor for financial markets and corporate citizenship to The Conference Board

Perhaps the only thing that is certain today in global capital markets is that traditional performance measures are not capturing important investment risk factors.

There is genuine unease among players in the world's capital markets. More knowledgeable capital providers are asking capital consumers sophisticated questions about financial controls and how business risk is defined and managed. Investors now recognize the need to understand the fundamentals and "look under the hood." Financial intermediaries need a more complex business model than "if we can place it, we should sell it." Meanwhile asset managers can no longer assume a steady inflow of new funds as they had during the boom that has since faded. As a result, investors and other stakeholders are demanding a better understanding of how new investment risk factors including intangibles, such as reputation and brand, affect the market value of companies. They are also seeking new and innovative performance measures to supplement traditional accounting systems.

Many of the new investment risk factors traditional accounting does not address adequately revolve around these intangibles. In addition, surging interest among governments, consumers, civil society organizations, and values-centered investment funds are adding momentum to non-traditional factors such as corporate performance in citizenship and community engagement, supplier conduct, human rights, and sustainable development.

This is occurring amid a generally accepted understanding that in order for capital to effectively flow from investors through financial intermediaries to the corporate issuers, checks and balances must remain intact despite cyclical shifts in power between issuers and investors. The dynamics of this process produce tensions that become clearer upon review of a stakeholder analysis of the capital raising process. (Editors Note: Table 1 at the conclusion of this report provides a visual display of the stakeholder analysis of the capital raising process.)

Significant New Investment Risk Factors Are Not Being Addressed

In the current climate of falling investor confidence and egregious lapses in corporate responsibility and conduct, it has become clear that:

1. Investors need a better understanding of the intangible elements that affect corporate value and behavior; and
2. They seek a more accurate model of business behavior that will address new investor demands on issues such as the following:
   - What qualitative performance measures beyond traditional quarterly earnings should companies provide?
   - What new and standardized measures need to be in place to assess sustainability, environmental and ethical performance, and corporate citizenship implementation and practice?
   - What are the management best practices which go beyond mere legal compliance?
   - What is the most appropriate level of more objective, more transparent and, therefore, more accurate disclosure of company information?
   - How will all of this contribute toward a better understanding of a wider array of investment risk factors?

What Is Driving Investor Behavior These Days?

For managers and executives involved along the capital raising chain, these developments suggest a need to understand three key forces that will increasingly drive investor behavior:

- An explosion in transparency of information of all types driven by easy access to technology and leading to more scrutiny of information;
- A shift away from intermediaries and toward consumers as the key investment decision-makers; and
- The increased importance of non-traditional financial measures, irrespective of the absence of specific and comparable measurement criteria to "prove" their significance.

Heightened Transparency

Investors and other stakeholders can now use technology to obtain the information that gives them the power to punish corporations that do not deliver on expectations. As Wall Street analysts recently discovered, all communication is public. The ability to distinguish between internal and customer-focused information has decreased dramatically. Many corporations recognize the need to maintain dialogues simultaneously with people who are shareholders, customers, and social activists. Focusing solely on the analyst community is no longer an effective communications strategy.

Financial intermediaries face increased scrutiny as they balance the conflicting interests of securities issuers with the need to remain credible providers of viable investments to investors. Underwriting and advisory mandates are awarded to banks for providing research support to issuers as well as for demonstrating an ability to place newly-issued securities and provide ongoing liquidity in a existing security. Financial intermediaries must now rebuild trust with investors after a period when issuers appeared to have had the upper hand. Calls for a clear separation of investment banking (origination) and analytical departments (research) have been the result of this conflict.

In the United States, Regulation Full Disclosure (Reg FD) has also changed the ground rules of access to information. Research analysts may lose their central role as information intermediaries. Companies are discovering that in some instances they can now deliver more value through a business web or a partnership than through a traditional vertically-integrated structure. However, organizations need to manage this additional transparency. Commenting on the emerging demand for company transparency, Don Tapscott of Digital 4Sight Corporation described as "blue companies" those organizations, which successfully manage relationships with all stakeholders in a transparent world.

The Dynamics Along the Capital Raising Chain

In testimony before the U.S. Senate early in 2002, Thomas Bowman, the President of the Association for Investment Management and Research, outlined the dynamics along the capital raising chain:

"Collaboration between research and investment banking is by no means the only conflict that must be addressed if we are to provide an environment that neither coerces nor entices analysts to bias their reports and recommendations."

Turning his attention to corporations,

"Issuers complain to Wall Street firms' management about "negative" or uncooperative analysts. They are also known to bring lawsuits against firms and analysts personally for negative coverage. But the more insidious retaliation is to "blackball" analysts by not taking their questions on conference calls or not returning their individual calls to investor relations or other company management."

Mr. Bowman dispels the image of investors as innocent bystanders:

"In addition, institutional clients on the "buy-side" may have their own vested interests in maintaining or inflating stock prices. They do not want to be blindsided by a change in recommendation that might adversely affect their portfolio performance, and hence their compensation. The "buy-side" has been known to "turn in" a negative analyst to the subject company."

Regulation Full Disclosure (Reg FD):

The U.S. Securities & Exchange Commission adopted Regulation Fair Disclosure (Reg FD) in August 2000 to "address the problem of selective disclosure by issuers of material nonpublic information. Selective disclosure occurs when issuers release material nonpublic information about a company to selected persons, such as securities analysts or institutional investors, before disclosing the information to the general public."

Reg FD does not define "material," but relies on the securities law definition: information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision and if it would "significantly alter the 'total mix' of information made available."

A December 2001 SEC Roundtable Report on Reg FD called for the SEC to:

- Provide a clearer definition of "material information";
- Allow issuers to use technology to satisfy Reg FD; and
- Assess the impact of Reg FD on the quality and amount of information provided to investors.
- New techniques of information dissemination have dramatically increased:
- Some issuers use real-time continuous disclosure through website postings of current earnings estimates
- Webcasts have increased 4X since the adoption of Reg FD

The Consumer as Investment Decision-Maker

The increasing responsibility of individuals for the management of their own pension and savings plans is a worldwide trend. It will grow as public sector and corporate defined benefit plans are replaced with defined contribution plans such as 401(k)s and IRAs. Despite this risk transfer, the investment decision process has remained concentrated between financial institutions and portfolio managers. Discrepancies between the long time horizons of retirement savers and the short-term performance hurdles of portfolio mangers may have led to inappropriate investment allocations. Investors are increasingly aware of the risks which they bear through self-managed plans and are exercising their rights as shareowners.

The risk shifted to consumers before the infrastructure was available for them to manage it. An individual employee's options are usually limited to mutual funds that are chosen by the employer, and may include a large undiversified risk from company stock. However, technology is now providing individuals with more efficient means for making their own decisions. This "democratization" of investing should lead to increased demand for better disclosure and standardized industry reporting.

Increased Shareholder Activism

Shareholder activism is experiencing a merger of interests between traditional corporate governance and social resolutions. Socially responsible funds and Non Governmental Organizations (NGOs) may have initiated shareholder resolutions, but mainstream investors now understand that they can be severely affected if they invest in companies that mismanage their "license to operate."

A March 2002 report of the Investor Responsibility Research Center and the Shareholder Action Network of the Social Investment Forum Foundation outlined recent trends in shareholder resolutions: Of the 712 shareholder resolutions filed so far in 2002:

- Two-thirds are traditional corporate governance resolutions
- One-third address corporate responsibility concerns
- Global warming and global labor practices are high profile

The 2001 season was the busiest since 1992 when South Africa was still an issue:

- 262 social policy and crossover resolutions were proposed to 177 companies during the year
- 159 social policy proposals came to votes, the highest number since 1992.

Growth of Social Reporting and Social Investing Strategies

The investment strategy known as socially responsible investing (SRI) has evolved from the negative screening of specific industries such as tobacco and arms manufacturing to include positive screening, which seeks to further good corporate citizenship. SRI is more than a passing fad. Some examples:

- Social Investment Forum reported that total assets under management in portfolios screened for socially concerned investors climbed from $1.49 trillion in 1999 to $2.03 trillion in 2001. SIF states that socially screened assets grew 1.5 times faster than all U.S. managed portfolio assets since 1999, and that one out of every eight dollars under professional management is involved in socially responsible investing.
- A recent survey of UK investment managers by Deloitte & Touche, found that in the previous 12 months, more than 50 percent of fund managers perceived an increase in interest in SRI from their pension fund and other institutional clients.

As positive screening increases, so has the demand for "social" reporting through which companies communicate their sustainability, environmental, and community engagement programs. Companies are also producing these reports in an attempt to maintain a voluntary reporting framework in the face of calls for legally required "social" reports. The European Union, for example, is currently considering whether a requirement for corporate "social" reporting should be made obligatory.

Social reporting and SRI should be rich sources of knowledge for investors trying to inoculate their holdings against intangible risks such as reputation and aggressive accounting practices. However, information is difficult to apply to investment decisions because a clear reporting consensus has not emerged. When companies attempt to communicate their "good" works to the investor world, they face a bewildering array of surveys, questionnaires, and standards that are often not comparable to each other. SRI investors need to incorporate their selection criteria into more traditional investment models in order to make them useful to more investors.

Increasing Importance of Non-Traditional Financial Measures and Standards

- As the importance of intangible assets such as reputation and brand value increase relative to traditional measures such as book value and earnings per share, companies must address the primary operational challenge of meeting additional non-traditional financial reporting requirements and standards.
- Successful investing will require more knowledge of corporate activities and disclosure than is currently available.
- As demands for additional information increase, the call for objective standards and measures will also increase. For example, the Global Reporting Initiative was launched as a permanent institution in April 2002 to "lead a worldwide, multi-stakeholder effort to establish standards for how corporations report their economic, environmental and social performance."
- Investment advisors will need to provide new risk assessment tools that incorporate elements of the current SRI tools and social reporting as well as additional traditional investment criteria. Until now, companies have not emphasized softer factors in favor of more "objective" measures. In order to attract investors back into the arena, these traditional measurements are no longer sufficient.

Changing SRI Disclosure Requirements in Europe:

Since July 2000, U.K. Pension trustees must consider social, ethical and environmental issues in their investment decisions. Trustees are required to include in their annual policy statement a comment on: "the extent, if at all, to which social, environmental or ethical considerations are taken into account in the election, retention and realization of investments." Most of them have delegated responsibility for implementing this to fund managers, which has added significantly to the growing socially responsible investment movement. Similar disclosure requirements exist or are pending in several European countries.

(See the Commission of the European Communities Greenpaper on "Promoting a European Framework for Corporate Social Responsibility," Brussels, 2001.)

Table 1

Stakeholders Analysis of the Capital Raising Process:

	Securities Issuers	***Financial Intermediaries***	***Asset Managers***	***Investors***	***Professional Service Providers***	***Public Sector and Non-Governmental Organizations (NGOs)***
Stakeholders:	• Corporations	• Investment Banks • Commercial Banks • Securities Exchanges	• Portfolio Managers • Public & Corporate Pension Funds • Mutual Funds • Insurance Cos.	• Individuals • Corporations • Foundations • Institutions • NGOs	• Accounting Firms • Consultants • Rating Agencies • Index Cos.	• Bank Regulators • U.S. S.E.C. • U.S. Treasury • European Community • Associations • Activist Groups • International Development Organizations
Goals:	• Maximize Share Price within appropriate time frame • Meet Earnings Expectations • Retain Access to Capital Markets • Manage Reputation • Maintain License to Operate in all jurisdictions • Manage Shareholder Resolutions • Increase Liquidity of Stock • Be Employer of Choice • Avoid Additional Disclosure Requirements	• Maximize Revenue & Fees within appropriate time frame • Win underwriting & advisory mandates from issuers • Enhance Credibility with Asset Managers and Investors • Don't exclude any industry as potential client • Avoid expansion of current regulations	• Increase Mandates by outperforming benchmarks • Respond to Investor Demands within Fiduciary Duty	• High Returns • Low Fees • Control & Influence over Investments • Trust, Transparency & Choice • Education & Knowledge • Impact on Corporate Governance • Integrate Financial & Social Goals	• Provide Services • Develop New Knowledge • Retain Objectivity • Maintain Client Confidentiality • Brand Products as Standards	Public Sector: • Macroeconomic Growth • Competitiveness • Disclosure • Public Confidence • Pension Security • Efficient / Fair Capital Markets NGOs: • Enhance NGO Brand • Change Behavior of Corporations to support NGO mission

About the Author

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New Networking and Knowledge Opportunity from The Conference Board

The Conference Board is launching a new network to study Corporate Citizenship and Sustainability in the Capital Markets: Capturing New Risk Factors, focusing on the measurement of intangibles, social and sustainability reporting, socially responsible investing, and shareholder resolutions. For information on membership, please contact steve.godeke@conference-board.org.

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