To: IFRS Foundation Trustees

From: Rick Alexander, CEO, The Shareholder Commons (TSC)

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Response to the Consultation Paper on Sustainability Reporting

The Shareholder Commons (TSC) is an independent, not-for-profit organization focused on ensuring that companies act in a manner that promotes the best interests of their investors and that asset owners and managers act in the best interests of their beneficiaries. In order to achieve this goal, TSC seeks to ensure that companies and investors look beyond the effect that an individual company's activities have upon its financial return to shareholders. Instead, corporate managers and investors must also understand and manage the effect that a company's activities have upon the social, economic and environmental systems in which human ecosystems (including the investing ecosystem) are embedded.

It is an unpopular truth that the corporate decision that is best for society and the environment is not always the decision that will optimize an individual company's financial returns, even over the long run. Moreover, most investors are broadly diversified, so that the success of their investments relies more upon the performance of the overall market than upon any single company. Such diversified shareholders lose when companies harm the economy in order to turn a profit, because the value of diversified portfolios rises and falls with GDP.[1]

TSC believes that an adequate disclosure regime must reflect this fundamental reality and provide shareholders with not only "outside in" information, which describes how companies are affected by social and environmental issues, but also "inside out" information, which tells shareholders how a company's activities will affect critical social and environmental systems, and thus the overall economy and the performance of their diversified portfolios. Such information will enable shareholders to use their collective power to curb corporate activities that harm social and environmental systems in pursuit of individual company profit.

To put it in financial terms, beta—the overall market return to investors holding a fully diversified and indexed portfolio—is far more important than alpha—the financial return to investors generated by a company or portfolio above or below returns on comparable companies or portfolios. Indeed, alpha, which is the sole focus of most disclosure regimes, accounts for only 9 percent of the variance in the return of diversified portfolios. Beta (and environmental systems and social institutions) suffers from an alpha-centric investment approach that encourages companies to externalize costs on the overall market in pursuit of short-term profits. Current reporting regimes exacerbate this threat by conceiving of financial materiality as a concept that only addresses alpha. To be effective, disclosure must include inside-out information, and that information must not only describe the effect that corporate activity has on civil society, but also on diversified investors.

[1] See *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors,* Appendix IV (demonstrating linear relationship between GDP and a diversified portfolio) available at https://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf; cf. https://www.advisorperspectives.com/dshort/updates/2020/11/05/market-cap-to-gdp-an-updated-look-at-the-buffett-valuation-indicator (total market capitalization to GDP "is probably the best single measure of where valuations stand at any given moment") (quoting Warren Buffet).

Question 1. Is there a need for a global set of internationally recognised sustainability reporting standards? (a) If yes, should the IFRS Foundation play a role in setting these standards and expand its standard-setting activities into this area? (b) If not, what approach should be adopted?

In order to provide investors with sufficient information to address global issues including climate change, antimicrobial resistance and inequality, an inside-out reporting scheme must involve some level of international standardization. Inside out reporting will empower shareholders to engage with companies to reduce behavior that creates negative social and environmental externalities that threaten the values of diversified portfolios. However, such activism will be effective only if the behavior in question can be addressed at all companies, allowing for competition on an even and sustainable playing field. Global capital markets will be able to engage in such leveling activism only if there is uniform reporting across all markets.

Question 2. Is the development of a sustainability standards board (SSB) to operate under the governance structure of the IFRS Foundation an appropriate approach to achieving further consistency and global comparability in sustainability reporting?

The IFRS Foundation is certainly well placed to fulfill such a role, but a uniform approach that did not include inside-out, beta-based disclosure could do more harm than good by reinforcing the company-first model of corporate governance.

Question 3. Do you have any comment or suggested additions on the requirements for success as listed in paragraph 31 (including on the requirements for achieving a sufficient level of funding and achieving the appropriate level of technical expertise)?

Success would require a recognition of three essential elements of disclosure:

1. *Traditional financial materiality:* information specifically reflective of how a company will perform financially over the long term.
2. *Inside-out, beta materiality:* how a company's actions will affect society and the environment and consequently affect the return of a diversified portfolio.
3. *Inside-out, civil society materiality:* information to assist other stakeholders, including regulators, employees and customers, to understand how a company affects critical social and environmental systems.

Question 4. Could the IFRS Foundation use its relationships with stakeholders to aid the adoption and consistent application of SSB standards globally? If so, under what conditions?

TSC concurs with the World Benchmarking Alliance's (WBA) view that the IFRS Foundation could play a useful role in aiding the adoption and consistent application of global sustainability reporting standards among companies of all sizes, including those that are privately held and state-owned, which often escape public scrutiny and investor pressure. Such broad-based disclosure is necessary to create a level playing field in a market-based economy, where non-reporting companies could otherwise follow unsustainable practices to increase profits, putting more reporting companies at a disadvantage in the competition for margin, talent and capital.

Question 5. How could the IFRS Foundation best build upon and work with the existing initiatives in sustainability reporting to achieve further global consistency?

Other commenters have noted the movement among the primary existing standard setters to work increasingly together and to push for some degree of convergence, and the need for any new entrant to the space to work with those entities to build upon their work. The IFRS Foundation has the opportunity to lead the way in consistently implementing inside out disclosure principles that encompass the effect that companies have on both diversified investors and on civil society more generally.

Question 6. How could the IFRS Foundation best build upon and work with the existing jurisdictional initiatives to find a global solution for consistent sustainability reporting?

TSC defers to other commenters on this question.

Question 7. If the IFRS Foundation were to establish an SSB, should it initially develop climate-related financial disclosures before potentially broadening its remit into other areas of sustainability reporting?

Question 8. Should an SSB have a focused definition of climate-related risks or consider broader environmental factors?

TSC believes that the most important task the Foundation could accomplish would be to establish the principle of the need for the tripartite system of reporting suggested in the answer to Question 3.

With that principle established, it may be that the most effective second step would be the design of principles or rules for estimating costs to diversified portfolios, before moving to specific areas. Some asset managers have developed proprietary systems of estimating social costs, and public reports on the economic costs of climate change, inequality, racial injustice and antimicrobial resistance are available. Methodologies for explaining an individual company's contribution to these costs will be important in an effective inside-out reporting regime.

With those principles established, moving to specific issues is an obvious next step. While climate change is certainly one of the top threats to society, it is important to keep in mind that the most severe threats are interrelated and cannot be solved in isolation.

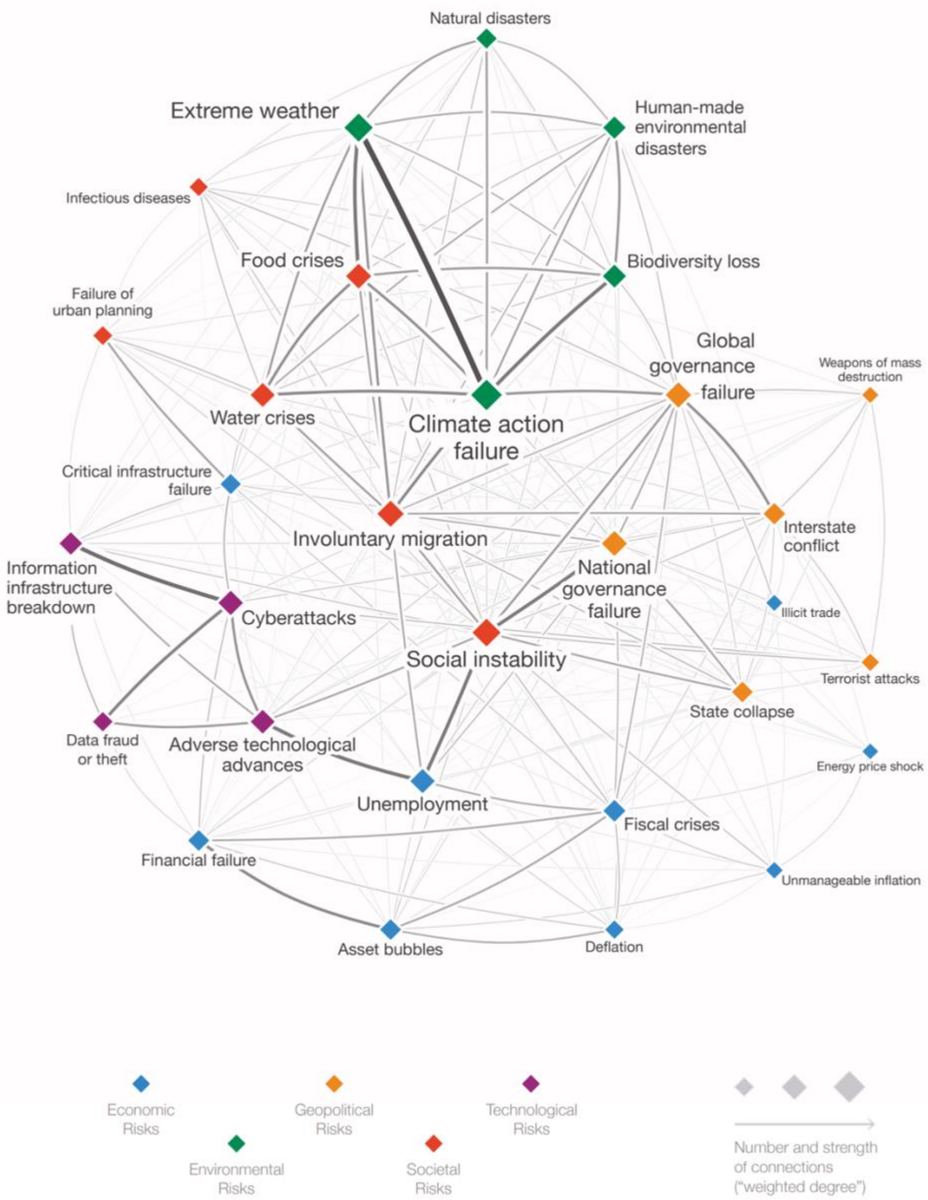
Dr. Elley Quigley of the University of Cambridge proposes a theoretical and practical framework for investing[2] that "matches the scale of the existential risk posed by climate change and other challenges of our time." Quigley notes:

> The Universal Owner is acutely aware that the world's current ills are collective action problems to be dealt with via large-scale cooperation across borders. Mass migration, food system collapse, biodiversity loss, and inequality-fuelled populism and violence are a few of the issues slated to worsen if action is not taken to prevent them, yet they are all technically solvable by well-coordinated Universal Owners.

The issues Quigley cites are interdependent. The World Economic Forum illustrates this concept graphically in its annual Global Risks Report[3]:

[2] Quigley, Ellen, Universal Ownership in the Anthropocene (May 13, 2019). Available at SSRN: https://ssrn.com/abstract=3457205

[3] World Economic Forum. *The Global Risks Report 2020.* http://www3.weforum.org/docs/WEF_Global_Risk_Report_2020.pdf



Source: World Economic Forum

We believe that it is critical to keep these interrelationships in mind when designing any framework.

Question 9. Do you agree with the proposed approach to materiality in paragraph 50 that could be taken by the SSB?

The statement appears to mistakenly conflate inside-out information with information not relevant to investors, even though that information may be critical to diversified investors. As we have noted in our previous answers, one cannot purport to be acting in the interests of diversified shareholders without explicitly attending to the vitality of the social and economic systems on which a thriving economy, and thus diversified portfolio returns, depend. A systems-first, beta-focused approached is the only one that truly maximizes diversified shareholders' prosperity. Thus, we believe that an approach to sustainability reporting should simultaneously incorporate all three elements described in our answer to Question 3.

Importantly, we do not believe there is strict separation between these. Corporate decisions that threaten civil society are likely to threaten beta, and corporate decisions that threaten civil society and/or beta are likely to engender reputational difficulties and increased regulation, and to compromise social licenses to operate, all of which can threaten alpha at an individual company.

Thus, rather than “moving gradually,” we would suggest recognizing the interconnectedness of these issues and focusing on size of impact in any particular area, rather than in which category it is most felt.

Question 10. Should the sustainability information to be disclosed be auditable or subject to external assurance? If not, what different types of assurance would be acceptable for the information disclosed to be reliable and decision-useful?

TSC concurs with ShareAction’s view that while assurance may be desirable where possible, disclosure requirements should not be limited to what assurance providers are prepared to audit. Disclosure of information including governance, strategy and management approach is important for a variety of stakeholder audiences, including investors. The absence of assurance does not prevent information from being useful.