CSR and CSR Reporting: Reporting as a way to Create Socially Responsible Business. ♦[1]

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Abstract

Admitting the theory of a company being a set of multiple interests, the first part of this article intends to give an overview of the Shareholder and Stockholders models in the Corporate Social Responsibility debate. The prevailing view in western Company Law (the cases of the UK and US are considered) is that of the Shareholder Wealth Maximization model. For the author of the article, events such as the financial crisis showed that the financial conditions of companies giving its' extended effects should give way to calls for public accountability in company management. However there seems to be a deadlock given that the prevailing model favours shareholders.

In this scenario the Reporting of Non-Financial Information is studied as a way to create socially responsible businesses. In addressing the reporting of non-financial information, the article provides a state of affairs regarding reporting and considers specific examples of disclosure of corporate information. The CSR battle has been transferred to the reporting of non-financial information but in this field there are many difficulties unresolved and challenges ahead.

Key words: Corporate Social Responsibility, Non-Financial Reporting, Stockholders, Reporting.

Resumen

Partiendo del punto de vista de la Sociedad Mercantil como un conjunto de intereses, la primera parte del artículo ofrece un resumen de los modelos de los Accionistas y Stockholders en materia de Responsabilidad Social Empresarial. El punto de vista mayoritario en el Derecho Societario occidental (los casos del Reino Unido y Estados Unidos son mencionados) es el de la Maximización de las Utilidades para los Accionistas. No obstante, eventos como la crisis financiera de 2007 ponen en

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evidencia que el manejo de las empresas tiene efectos extendidos sobre otros grupos de interés. Esta situación en opinión del autor hace que exista una legitimación en pedir un sentido de responsabilidad en favor de los grupos de interés afectados lo cual no resulta sencillo si se tiene en cuenta que el modelo prevaleciente es el de los accionistas.

En este escenario, el reporte de Información No Financiera se analiza como una forma de crear empresas socialmente responsables. Al revisar el tema el artículo cubre el estado del arte en material de reporte de información no financiera de sociedades e incluye ejemplos específicos sobre regímenes de revelación de información societaria. La batalla de la RSE ha sido trasladada al campo del reporte de información no financiera de sociedades pero en este campo hay muchas dificultades sin resolver y desafíos al acecho.

Palabras Claves: Responsabilidad Social Empresarial, Reporte, Información No Financiera, Stockholders.

SUMMARY

Introduction

The way in which a company is managed has been a particular concern of Corporate Law and Corporate Governance academic literature for some time in the past. At a present age, where governments and institutions must come up with solutions to the stagnating economic development in the world these issues are again relevant. The social interest involved in the management of companies is one of these issues.

This document will merely reflect upon a specific point already known by practitioners and academics: the social responsibilities of companies. Arguably the debate is not new and has been settled in favour of sustaining that Corporate Law should and does in fact give prevalence to the interest of the shareholders and that other interest involved in a Company are better dealt with by other areas of law or business management. However, there seems to be an *impression* (it might be a personal one) that the goal of responsible business should be pursued, encouraged and perhaps even required. A particular way for this to happen might well be the reporting of information by companies regarding their social performance.

Thus, I intend to cover the premises of the Shareholder Wealth Maximization and the Stakeholder Theory. The US and the UK will be used as terms of reference in their regulatory attempts to include stakeholders' interests as part of Corporate Law. Specifically, the US "constituency statutes" and the UK's Enlightened Shareholder Value would be considered. In doing this reference it will be stated that in fact Shareholders are the preferred constituency yet as a matter of fact the impact of companies on larger constituents cannot be ignored and its consideration as part of their management cannot be entirely suppressed. The 2007-2008 financial crisis gave yet another example in modern history of the unintended effect of companies on extended constituencies. This justifies a call for public accountability of companies. However, from a Shareholder Primacy perspective, the regulatory responses for this are limited. Self-regulation is an alternative and you might say that so it is government regulation. Both already have a "handicap": shareholder primacy should not be put into question.

From this perspective is that I intend to analyse Corporate Reporting as regulatory tool used by governments to show some political commitment without imposing a particular substantive duty to companies. Yet many challenges surround the reporting of non-financial information. Whether reporting should be mandatory, the lack of standardisation of the reported information and the utility of reports should be considered. Furthermore, there are regulatory challenges as to the political context for regulating certain interest groups: I will use as example the regulation on the reporting of bank's executive remuneration in the UK.

All of these premises and challenges lead to the question of whether or not Mandatory Reporting of non-financial information is the solution for engaging companies in social responsible practices.

1. A preliminary issue: What does Corporate Social Responsibility mean?

What is understood as CSR? Is it a legal term? Is it a business concept? It is precisely this lack of certainty one of the characteristics of this topic. Yet in law the lack of a clear definition might be intentional and due to the existence of innovative legal concepts likely to be in permanent evolution, thus by not defining them there is room left for their development.[3] However, a starting point definition adopted and adapted from existing academic literature[4] (without intending it to be flawless) would be useful and thus it would be possible to say that CSR recognises the existence that in a company there are interests other than those of shareholders that can be affected by the way in which a company is managed. Accordingly, CSR constitutes a set of corporate practices that take into account all the interests involved in the operation of a company.

With this general definition at hand it is possible to move on to establish in whose interest companies should be managed.

2. In whose interest should companies be managed?

The core of the definition previously set out rests in the existence of multiple interests around a company all of which should be taken into consideration by those managing it. Thus, the title of this part of the paper shows a question commonly addressed by Corporate Governance commentators. This question would naturally lead us to briefly

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[3] M. Kerr et al. *Corporate Social Responsibility. A legal analysis*. (Ontario, 2009), P. 5.
[4] Particularly interesting are the definitions contained in M. Kerr et all, n.1 above, pp. 6-8.

refer to a *classic* debate as to whether or not companies should have any social responsibility at all.

a. The traditional and (so far?) prevailing perspective: The Shareholder Primacy or Shareholder Wealth Maximization Theory

The date or origins of this tendency are not that important for this paper,[5] the relevant fact is the recognition that in Company Law the shareholders are the preferred and prevailing constituency.

There are different authors and references to understand an approach to this theory[6], one of the most commonly cited due to its importance but also mordacity is Milton Friedman who argues that managers of companies should only have one *social* responsibility: to pursue profits for the shareholders.[7] Friedman sees social responsibilities as an individual moral duty that falls outside legal entities such as companies (he uses the economic term of firms). Thus it is up to individuals to pursue any kind of social responsible goals. In a private sphere, any individual may pursue whatever interests he desires and in doing so he would be acting as principal of his own interests. In the case of companies, corporate executives are the executors of the companies will however when they are acting as managers they do so as agents of the *owners,* thus if they pursue an interest in their capacity as executives of the company they would be acting as agents of someone else's interests. As such, there can be entities structured to pursue social goals but the difficulty comes about when business executives intend to implement social behaviour on the company without the authority of the *owners*. On the one hand, this situation represents for Friedman a clear undermining "of the basis of a free society"[8] being nothing more than "pure and mere

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[5] Professor A. Keay in one of his several articles briefly discusses them on the topic: A. Keay, *Moving Towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value and all that: Much Ado about little?* (2010). <http://ssrn.com/abstract=1530990> Accessed on 18 July 2011.

[6] S. Bainbridge. 'In Defense of the Shareholder Maximisation Norm: A Reply to Professor Green'. (1993) 50 *Washington and Lee Law Review* 1423. H. Hansmann and R. Kraakman. The End Of History For Corporate Law (January 2000). <http://ssrn.com/abstract=204528> Accesed on 9 July 2011. Friedman. 'A Friedman doctrine. The Social Responsibility of Companies is to increase profits'. (*New York Times*, September 13, 1970).

[7] M. Friedman. n. 4 above. P.4

[8] M. Friedman. n. 4 above. P.1.

unadulterated socialism".[9] On the other hand it represents the functioning of business executives as public representatives by deciding how someone else's money should be used towards socially desirable purposes. This implies the existence of CSR as an anti-democratic scheme.[10] In addition, a director seeking social goals sacrificing profits is most likely to be fired by the existing or future shareholders (since the share price is likely to be reduced and the business exposed to a takeover bid) being replaced for directors with a different attitude towards those social responsibilities.[11] Furthermore, as to the use of socially responsible practices as a mechanism to obtain good reputation, Friedman recognises that the market may reward a business that engages in these trends and thus it would be in the best interest of the firm to do so however this would be not only hypocritical but also fraudulent.

From Friedman's view, the Shareholder Theory has evolved accepting that shareholders are not owners of the company but merely owners of a share, which gives them an entitlement to some rights.[12] This concept creates a difference in the logical structure of the argument as he proposed it. Bainbridge for instance accepts the existence of flaws in Friedman's reasoning since an updated theory of the firm has a different rationale and sees the firm, as a nexus of contracts and by definition is not possible to own the nexus itself. However, according to Bainbridge this logic although appropriate does not have a substantial effect on Shareholder Primacy. From the claim that managers are not *stealing* from the shareholders since it is not *their* money (it is the company's) one cannot jump to the conclusion that Shareholder Wealth Maximization should be abandoned.[13] Theoretically Bainbridge differentiates between the objective of a company and the ultimate control over its management,[14] claiming that Shareholder Primacy argues for the increase of profits for shareholders and the control given to directors.[15] Accordingly there might be situations where in order to achieve a higher value for the shareholders; a company's management should have

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[9] M. Friedman. n. 4 above. P. 1.
[10] M. Friedman. n. 4 above. P. 3.
[11] M. Friedman. n. 4 above. P. 3.
[12] R. Grantham, 'The Doctrinal Basis of the Rights of Company Shareholders', (1998) 57 *Cambridge Law Journal* 554.
[13] S. Bainbridge. n.4 above. P. 1428.
[14] That is the difference between ownership and control presented by Bearle and Means.
[15] In theory it is given to the shareholders who in turn choose the directors, in practice however it is a power of the directors.

regard of the interest of other constituencies.[16] Yet, he openly defends shareholder maximization as the ideal model at least in the US and shows some scepticism as to a normative move towards a primacy of other stakeholders. In the same line of reasoning, Professors H. Hansmann and R. Kraakman argued over a decade ago defending the prevalence of the interest of shareholders in the management of companies. They stated that such should be the focus of corporate law and claimed that with time this would be a worldwide tendency without disregarding that companies should consider social goals, engage in non-commercial activities and act considering the benefit of other constituencies, yet it is not efficient for Company Law to achieve that result. The best use of the resources involved in the management of a company are better left to managers for the interest of their shareholders. This dogmatic view of Company Law is *pure* in a Kelsen sense, leaving it to other areas of law to take care of those other constituencies. The social responsibility of a company according to them is to perform its activities in accordance with the law in all its regulatory regimes.[17]

b. The recognition of other interest: The Stakeholder Theory

The argument cannot be completed without mentioning those who claim rightly that companies tend naturally to have an effect over other constituencies with whom they interact and do not restrict exclusively to the interest of those who provide the company's capital.[18] In that sense interest groups such as the consumers of the goods and services provided by the company, its' employees, its' creditors, the community where it operates and even the environment are somewhat affected by a company and that is why the objective of a company[19] should focus not only on making profits for the capital providers but also for all existing stakeholders and furthermore they should be managed and be accountable to those extended constituencies.[20]

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[16] This view has been found in case law. For instance see: *People's Department Stores v. Wise* [2004] 3 S.C.R. 461. Where it was especifically said that: "…in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, inter alia, the interests of the shareholders, employees, suppliers, creditors, consumers, governments and the environment."
[17] H. Hansmann and R. Kraakman. n. 4 above. P. 9.
[18] Perhaps the main defender of this tendency is R. Freeman. *Strategic Management: a stakeholder perspective*, (New Jersey, 1984).
[19] In the sense used by Bainbridge. n. 4 above.
[20] A. Keay. n. 3 above. P. 6.

While accepting that the Shareholder Wealth Maximization is the prevailing perspective, it seems that it is no longer an entirely satisfactory explanation and justification in a global economy. There are sets of events in which this paper does not intend to dwell showing demands for a sense of accountability of private entities in reason of the impact they have on extended interest groups.[21] However, what constituencies should be given preference? Do all constituencies affect all companies in the same manner? The reform of Company Law embodied in the Companies Act 2006 saw some of these questions at the core of the restatement of Directors' Duties where while acknowledging the traditional acceptance of the shareholders' as the preferred interest group within Company Law, the Act tried to fit the interests of a broader stakeholder approach. The English government proposed the so-called "Enlightened Shareholder Value" as the objective managers should have in discharging their duties. This Enlightened Shareholder Value gave rise to the idea that at last there was a substantial shift in the focus of attention of Director's Duties and thus the Stakeholder Theory would have gained way into legislation. Yet all the excitement came to an end when a proper assessment of the provision was undertaken. Currently, the "enlightenment" is contained in S. 172 of the Act where it is stated that managers should exercise their duties as directors in the best interests of the company aligning the interests of the company with that of it's current shareholders. Nonetheless in such discharge directors could take into consideration the interest of a list of other extended constituencies different from shareholders included in Companies Act S.172 (1) (a)-(f).[22]

[21] C. Williams. 'Corporate Social Responsibility in an Era of Economic Globalization'. 35. *U.C. Davis. L. Review*. 706. 2001-2002. P. 4.
[22] For the aid of readers I cite an unusually long footnote:
UK Companies Act 2006. S. 172. Duty to promote the success of the company
(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
(a) the likely consequences of any decision in the long term,
(b) the interests of the company's employees,
(c) the need to foster the company's business relationships with suppliers, customers and others,
(d) the impact of the company's operations on the community and the environment,
(e) the desirability of the company maintaining a reputation for high standards of business conduct, and
(f)the need to act fairly as between members of the company.

Is this provision particularly innovative? Not really. At a comparative level, it is possible to find that for instance the US had previously attempted a similar approach although not by way of legislation. The *Constituencies Statutes* adopted by the majority of states in the US allowed managers to consider the interests of groups other than the shareholders of the company. Some commentators on these statutes mention that the extent and practical effect of their wording sometimes allowed not only to consider extended constituencies but even to treat them all (including the shareholders) as entirely equal.[23] Yet, even if some of these statutes took such a radical approach to the debate, their practical effect was not substantial. The area in which they were mainly considered was in takeover situations where managers could take into account the interest of those constituencies in order to accept or reject a takeover bid. Their use was sometimes seen as a hindrance, and given the regulatory competitive environment in the US[24] and that states as Delaware did not include such statutes in their legislation, they would end up becoming ineffective.[25] Notwithstanding, it can be argued as Keay does[26] that there is an underlying theoretical value for the legislation regarding these statutes: the pervasive thought that companies should not only be managed with regard to the interests of the shareholders of the company. Thus its importance is not entirely lost.

At an English level, the 1985 Companies Act already contained a provision[27] that could be seen to allow for an inclusion of the Stakeholder Theory, and even case law was developed before 2006 admitting that directors while discharging their duties could have regard of the interest of employees.[28] Some commentators even argue that the

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(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.
(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

[23] The following comments are based on the analysis brought forward by A. Keay. n. 3 above. Pp. 8-19.

[24] F. Reyes Villamizar. *Derecho Societario de los Estados Unidos. Introducción Comparada*. (Bogotá, 2006). P. 51.

[25] A. Keay. n. 3 above. Pp. 8-19.

[26] A. Keay. n. 3 above. P. 12.

[27] Companies Act 1985 S. 309. Directors to have regard to interests of employees.

[28] *Re Welfab Engineers Ltd* [1990] BCC 600.

previous UK provisions had more practical consequences,[29] thus the existing regime seems not only to lack innovation, but also useless for the constituencies themselves. It is perhaps the first case where mandatory legislation of director's duties tries to balance those conflicting interests. The approach doesn't accept the Stakeholder Theory in full and specifically supports the shareholders as the prevailing interest group in company management. The idea as the former UK Minister of State for the Industry would admit is to modernise English Company Law and align the interest of all those who have a stake in the company: "The law is now based on a new approach. Pursuing the interests of shareholders and embracing wider responsibilities are complementary purposes, not contradictory ones."[30]

The acceptance of the extended constituencies under S.172 of the UK Companies Act 2006 can be critically seen as timid and made with the intent to give the impression of change but with no substantial underlying effect for the reason that the constituencies do not have a direct tool to enforce the rights conferred to them by the section. English Company Law still operates under the rules in *Percival v Wright*, *Foss v Harbottle* and *Hickman* which restrict the ability of the constituencies contained in S.172 (1) (a)-(f) to initiate a claim in their own right. S.172 is included as part of Directors Duties, and so according to *Percival v Wright*[31] directors owe their duties to the company and not to other individuals such as shareholders or stakeholders.[32] Thus, if for instance directors fail to execute their duties adequately by not considering the interests of employees in a company decision, the employees could not start an action since S.172 contains a duty of the directors owed to the company and thus the proper claimant would be the

[29] The fact that the interest of constituencies such as consumers, employees and the environment are included although remarkable for a Company Law statute, should be critically assessed by the fact that those constituencies cannot enforce on their own benefit such provisions given that directors duties are owed to the company and the assessment of those further interests is made as part of such exercise. J. Lowry. 'The Duty of Loyalty of Company Directors: Bridging the Accountability Gap through Efficient Disclosure'. (2009) 68 *Cambridge Law Journal* (3). Also see: A. Keay. n.3 above. P. 56.
[30] DTI. Ministerial Statements. 'Duties of Company Directors'. Companies Act 2006. June 2007. <http://www.bis.gov.uk/files/file40139.pdf> Accessed on 23 February 2011.
[31] [1902] 2 Ch 421.
[32] In *Dodge v. Ford Motor Co*. 204 Mich. 459, 170 N.W. 668 (1919) it was especifically said that Management of the company should focus on the profits for the stockholders.

company.[33] It could happen that by means of a derivative claim the cause of action that originally was created in favour of the company would fall upon the shareholders. However, for this to work under the stakeholder perspective there would either need to be a hypothetical case where a shareholder decides to start an action for the benefit of the constituencies (which even though is not impossible it reflects some doubts as to the practical effects of the section) or one of the stakeholders would also need to be a shareholder of the company,[34] yet the exercise of the action might be restricted either by the terms of issue of the shares (no action clauses) or generally by the *Hickman Principle* according to which a shareholder can only claim a right given in his condition as shareholder and not in his condition as consumer or employee.[35] Thus, as the constituencies included in the provision are not able to enforce it on their own right, the provision is for directors to use it as a defence in discharging their duties. The provision can be used as a shield not as a spear.[36] That is, they can defend their *business judgement* by saying that they took a specific business decision taking into account the interests of those extended constituencies.

These practical flaws however were not entirely ignored by the government when adopting the existing wording. The Company Law Review Steering Group (CLRSG) identified a tendency to accept that directors should consider the interest of other groups without necessarily giving primacy to members of the company. However it didn't find a practical response as to how this could be enforced. Thus it recommended the government to reject such an absolutely pluralist approach on the basis of it's being unworkable or inconvenient.[37] Furthermore, the government rejected the idea of extending directors duties to other constituencies by means of mandatory rules, yet the political lobby during the enactment of the Companies Act managed to repeal the inclusion of an Operating Financial Review (OFR) required from all listed companies

[33] Companies Act 2006. S. 260. According to the rationale of one of the prongs of the rule established in *Foss v Harbottle* [1958] CLJ 93.
[34] This could happen if for instance there is an employee share scheme, or the stakeholders go into the securities market.
[35] *Hickman v Kent*. [1915] 1 Ch. 881. However this principle does include exceptions but mainly addressed at directors rights under the constitution.
[36] L. Sealy and S. *Worthington. Sealy's Cases and Materials in Company Law.* (Oxford. 2010), P. 322.
[37] CLRSG report. Completing the Structure. November 2000. § 3.5. <http://www.berr.gov.uk/bbf/co-act-2006/> Accessed on March 7 2011. This argument of inconvenience would also be used by other countries while considering adopting the UK approach and consequently rejected altogether. See A. Keay. n. 3. P. 41.

where social and environmental information would have to be included and thus in the final version only S.417 of the Companies Act survived requiring directors to provide shareholders with a much simpler Financial Review (not as part of listing requirements) that would help them assess the performance of director's duties under S. 172. This report is meant to be a narrative and forward-looking statement included in the company's annual report. Therefore, without sacrificing the "new scope" of duties, the rationale would be to eliminate the risk of an increase in litigation for company directors, and thus the enforcement of S.172 would be achieved by way of reporting and consequentially by encouraging public accountability of companies rather than by fear of litigation.[38]

From this perspective, where the recognition of other interest involved in the management of a company and the failure to find a scheme under Company Law to reconcile them and protect them in an efficient manner, a regulatory alternative has been the reporting of non-financial information of companies as we shall later continue to explore.

c. Did S.172 of the UK Companies Act 2006 solve the Shareholder vs Stakeholder debate?

An assessment on the effectiveness of S.172 allowed us to see that its' value should be considered carefully and even though it is contained in a statute, and made its way into legislation its practical effect is reduced to the voluntary practice of companies. At paragraph 2.21 the CLRSG document on *Modernizing Company Law: Developing the Framework*, it is recognized that Chapter 10 of the Companies Act 2006 aims at a balance between the pluralist approach and shareholder primacy. This balance however is not easy to find, and thus regulation did not attempt to try one by way of mandatory regulation. It was acknowledged that the reputational risk of not adopting sustainable business practices could serve as the missing link between the interest of the shareholders and other interest groups. This observation summarizes the state of affairs in the UK. There is an awareness of the voices that claim companies must consider larger interests, but the government lacks a clear regulatory response on the way to achieve this within a free market framework thus it is still a primary object to manage companies in the interest of shareholders. The matter is more conveniently

[38] DTI. Ministerial Statements. n. 28 above. P. 6.

seen as a management issue made on a voluntary basis. Therefore managers could engage in corporate practices that include other constituencies without being liable to the board or the shareholders for doing so. On the other hand there is no direct form of enforcing S. 172 by the remaining stakeholders.

Notwithstanding the recognition of the prevalence of shareholders as an interest group the theoretical debate continues[39]. Haansman and Kraakman argued that there is a social responsibility of companies: functioning according to the law. Thus in this view CSR would need to be part of the existing legal framework to be part of a company's social responsibilities, yet achieving CSR regulation is a difficult process. However, from a business management perspective, engagement in CSR is a sound practice[40]. Companies engage in sustainable practices that involve extended constituencies. This is a reality, even though it is not mandatory. This explains the existence of indexes showing engagement in accepted socially responsible practices,[41] or the existence of an ethical investment market with Socially Responsible Investment (SRI) criteria. Companies get involved in CSR practices for many different reasons i.e. improvement of internal processes, reputational risks, benchmarking, financial market pressure,

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[39] A.K. Sundaram and A.C. Inkpen. 'Stakeholder Theory and "The Corporate Objective revisited": A reply.' Vol. 15, No. 3 *Organization Science*. May-June 2004. Pp. 370-371.

[40] The debate can also be brought in terms of weather or not CSR has a financial return. In this regard, it is helpful the analysis and the figures studied in J. Allouche (ed). Corporate Social Responsibility: Performance and stakeholders. Part One: Corporate Social Responsibility and Economic/Financial Performance. On a more up to date reference as to whether or not the market is in need of non-financial information, reference should be made to two working papers from the Business Faculty of Harvard University showing that focus on long term growth and sustainability is rewarded with higher share prices and that there is indeed a growing interest on non-financial information on the market. In this last regard the papers establish a difference between different types of consumers of this information (i.e. equity providers, buy-out users or creditors), different kinds of information (social issues, environmental issues, management and governance issues) and the possible reasons that make some of them more required by consumers than others (i.e. easy to measure or include in models, greater impact on governance of a company, effect on share price, etc.). Eccles, Krzus and Serafeim. 'Markets interest in Nonfinancial Information'. Harvard Business School. Working Paper 12-018. September 22, 2011. http://hbswk.hbs.edu/item/6841.html Accessed on October 2011. Eccles, Ioannou and Serafeim. 'The Impact of a Corporate Culture of Sustainability on Corporate Behavior (sic) and Performance'. Harvard Business School. Working Paper 12-035. November 04, 2011. http://hbswk.hbs.edu/item/6865.html?wknews=11092011 Accessed on November 2011.

[41] <http://www.ftse.com/Indices/FTSE4Good_Index_Series/index.jsp>. Accessed on July 18th 2011.

moral acceptance, etc.[42] Yet these practices and evidences are still left to private initiatives and self-regulation since government regulation would hamper evolution. Notwithstanding, evolution is still possible once a regulatory framework exists but given that Shareholder Wealth Maximization is the prevailing view, substantive regulation imposing social responsibilities does not appear to be justified. This is the context in which regulation as to CSR reporting emerged. Still there have been some changes and evolutions that deserve to be reviewed.

3. The reporting of non-financial information

Companies produce more than just financial statements that can help in the assessment of their financial and social performance. Thus, in the spectrum of corporate reporting there is both financial and non-financial information and some commentators go even further arguing the existence of a separate kind: CSR information. Given the focus of this paper the last two should be considered and the latter in particular. According to Chiu, non-financial information provides elements for shareholders to review the proper functioning of the board of directors and complement the assessment of the company's financial performance.[43] On the other hand, CSR information possesses different ethical needs and motivations thus allowing for a separate legal and regulatory treatment.[44] Beyond the doctrinal favouring of the Shareholder Primacy Theory, I have argued here for the acceptance of calls for public accountability of companies and therefore the public reporting of information regarding social responsibilities is thought to have become necessary. The purpose of this information would be to bring about accountability for extended constituencies and not

[42] N. Finch. 'The Motivations for adopting Sustainability Disclosure'. Macquaire Graduate School of Management. Working Paper 2005-17. **<**http://ssrn.com/abstract=798724**>** Accessed on 11 July 2011. Futerra Sustainability Communications, et al. *Trends in non-financial Reporting*. *Reporting Change. Readers and Reporters Survey 2010*. <http://www.futerra.co.uk/downloads/Reporting_Change.pdf> Accessed on 16 August 2011.

[43] I. H-Y. Chiu. 'The paradigms of mandatory non-financial disclosure: a conceptual analysis: Part 1.' 2006. *Company Lawyer*. 259. P. 7-12.

[44] Chiu does not agree with this and that is one of the reasons why it is possible to differentiate between non-financial disclosure and corporate social disclosure. See: I. H-Y. Chiu. N. 40 above. P. 1-3; I. H-Y. Chiu. 'The paradigms of mandatory non-financial disclosure: a conceptual analysis: Part 2.' 2006. *Company Lawyer*. 291. P. 7. The differentiation of different types of non-financial information is also used as a matter of fact by Eccles, Krzus and Serafeim. n. 38 above.

to create mechanisms for shareholder discipline (by evaluating the short-term value and financial performance of the company).[45] Nonetheless there are many challenges for the reporting of this kind of information.

a. Corporate Reporting as a regulatory tool and its Challenges

In the absence of a dogmatic agreement as to whether or not companies should have social responsibilities regulators do not seem to find a legitimate foundation to require companies to display socially responsible behaviour. Yet there are interest groups such as unions, NGOs and recently newspapers and consumers that, by being critical of the social implications of companies, are pressing for public accountability of them. In this setting the reporting of information is an ideal regulatory tool because it allows governments to show engagement with these social needs without in fact imposing a substantive mandate on private enterprises.[46] Furthermore, the reporting of company information responds to the need to promote transparency and public accountability by making information publicly available for interested parties to access and assess it. Regardless of the critics of this hypothesis, the reasoning appears to be similar to that of the Efficient Capital Market Hypothesis (ECMH) where, by making the largest amount of information publicly available, the market will incorporate it within the share price of a company.[47] However, Corporate Reporting in general faces many challenges and criticisms. Some commentators see the fact that reporting is the *ideal* regulatory tool as a downside because governments fail to engage with the underlying issues being reported in order not to risk their political capital.[48] Reporting is deceptive as a regulatory tool because it attempts to show a political will but without assuming any clear position.[49] Governments would be willing to require reporting but not to impose substantive regulation, letting the users of the information deal with it unsystematically. This political behaviour avoids the displacement of responsibility so that regulators cannot be blamed for lack of action since there is in fact some regulation, although not

[45] I. H-Y. Chiu. n. 40 above. P. 2.
[46] M. Pallenberg at all. *Trends in non-financial reporting*. Global Public Policy Institute. Berlin. 2006. P. 27. <http://www.gppi.net/publications/research_paper_series/> Accessed on 16 August 2011.
[47] J. Coffee Jr. 'Market Failure and the Case for a Mandatory Disclosure System'. 70 *Va. L. Rev.* 717 1984.
[48] O.S. Simmons. 'Taking the Blue Pill: The imponderable impact of executive remuneration reform'. 62 *S.M.U.L. Rev.* 299 2009. P. 321.
[49] P. Cioppa. 'Executive compensation. The Fallacy of Disclosure'. Vol. 6. Issue 3. *Global Jurist Topics*. 2003.

enough as to be seen as the cause of the problem. By avoiding this risk, not only would political capital be spared but also regulators would be seen as credible and effective agents.

Our focus on corporate reporting comes at a time when the tide for regulatory action is rising; new regulation may be around the corner or is already being implemented. Several fronts of battle are taking place:

- At an International level, last year the International Integrated Reported Council (IIRC) was launched as an initiative to achieve in the foreseeable future an integrated model of reporting that modernizes reporting practices and is suitable for sustainable practices.[50]

- At a European level, at the end of last year a consultation was launched on non-financial reporting, and following the receipt of the responses, the European Commission appointed an Expert Group in charge of assessing the regulatory alternatives.[51] Furthermore, the Single Market Act (SMA) has the aim of increasing transparency and thus confidence in the European market and in a similar direction the Capital Requirements Directive (CDR3) on disclosure of remuneration. This last Directive is being implemented in the UK through SYRC.

- In the UK, the consultation process made by the BIS and Section 417 of the Companies Act 2006 sets a general framework for Corporate Reporting. Moreover, the Financial Services Authority and the Financial Reporting Council have set out complementary disclosure requirements for companies contained in the FSA Disclosure and Transparency Rules, the FSA Listing Rules, the FSA Handbook, and the UK Corporate Governance Code.

The aftermath of the 2007 crisis seems to have identified some fundamental Corporate Governance flaws that although were not the cause of the crisis, may have contributed to the results that were seen and suffered throughout the world. In all these cases the approach chosen by regulators seems to be the disclosure of information. By providing

[50] <www.theiirc.org> Accessed on 15 August 2011.

[51] European Comission. Directorate General Internal Market and Services. Capital and Companies. Accounting and financial reporting. *Expert Group on Disclosure of Non-Financial information by EU Companies First Meetin*g. Brussels, 11 July 2011. <http://ec.europa.eu/internal_market/consultations/2010/non-financial_reporting_en.htm> Accessed on 19 August 2011.

the information to the market all the market participants are better informed (at least in theory) with a transparent veil surrounding market transactions ergo creating a feeling of trust. These battlefronts however do not make the difference between non-financial information and CSR reporting mentioned above. This lack of differentiation could be a dangerous path for the future of CSR[52] since its future may be linked to that of non-financial information for better or worse, however, it must not be forgotten that it is already hard enough to justify the need for disclosure of certain types of non-financial information. Therefore, in this paper, even though accepting the difference between those types of information and agreeing with its rationale, reference will be made to non-financial information as a category comprising CSR information and other indicators that are more related to the financial performance of the company.

b. Should the reports be mandatory?

Given that there is no agreement on the role Company Law should play in CSR then regulation has admittedly left to private initiative the establishment of trends regarding non-financial (and CSR) reporting. Thus far CSR has been seen predominantly as a voluntary practice and the same has occurred regarding the reports on social responsibility, sustainability or non-financial information.[53] This room for self-regulation has allowed for evolution in this area of Corporate Governance and Business Management yet problems concerning the lack of comparability of the information, and even more the lack of its utility, cast doubts as to allowing reporting to continue being voluntary. While some believe that this should be left to private initiatives others believe it is a matter of prescriptive regulation. In favour of allowing it to continue to be voluntary are those who claim that private initiative would be more efficient than the government in determining the best practices in the market. Moreover,[54] it has been argued that CSR reporting is a new practice requiring room for adapting to the changing needs of enterprises. In addition, that by introducing regulation the political lobbying could become an obstacle for efficient practices. Furthermore, regulation by different countries would create multiple national regimes that are costly to comply and

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[52] I. H-Y. Chiu. 'Standardisation in Corporate Social Responsibility Reporting and a Universalist Concept of CSR. A path paved with good intentions'. 22 *Florida Journal of International Law* 361. 2010. P. 372.

[53] The ICC in particular endorses the view of CSR and non-financial reporting as a voluntary practice. See: ICC. *The Role of the UN in promoting CSR.* Available at <www.iccwbo.org/policy/society/id14802/index.html> Accessed on 19 July 2011.

[54] M. Pallenberg. n. 43 above. P. 25.

make comparison more difficult. In contrast, supporting mandatory reporting commentators find that there is a resolve to end the stagnation on the number of reporting companies. In addition, enforcement based on market mechanisms such as benchmarking is seen as ineffective; and countries such as France and Denmark where non-financial reporting is mandatory have shown a substantial increase as to the number of reporting companies.

On supporting either argument I have found conflicting statistics. A survey made by consultancy firms shows that fear of regulation is not a substantial drive for companies in their reporting process[55] and neither is reputation. The main drive according to this survey is the improvement of internal processes. This result would support the view that regulation is not needed to increase the number of reports and that private initiatives better serve this purpose. Yet the previous argument doesn't seem to be so *straightforward* according to another study[56] showing that while 50% of the interviewees believed that non-financial reporting would remain a niche practice unless regulation would step in, 48% believed it would develop into a mainstream practice even without regulation. Thus, these numbers do not give a clear sign in the market as to whether regulation for reporting should be implemented.

The UK Government launched a consultation during 2010 on The Future of Narrative Reporting and published a summary of the responses[57] once the consultation period was over. The document collects the opinion of companies, lawyers, unions and NGOs on specific questions being asked referring to corporate narrative reporting and some of them referring in particular to Environmental, Societal and Governance (ESG) issues. There is no consensus in all the consulted topics and in particular on whether the reporting regime should be reduced or simplified or reporting should be made mandatory. In this last regard a question was made on the usefulness of mandatory reporting and encountered divided views. While there was a need to assure comparability by unifying the framework through a regulatory scheme the concern was

[55] The survey report establishes differences between the point of view of Reporters and Readers. In this specific matter their views differ and while Reporters don't see regulation as a main drive, Readers (in the US) do. Futerra Sustainability Communications et al. n. 39 above.
[56] M. Pallenberg. n. 43 above. P. 20.
[57] BIS. *The Future of Narrative Reporting. A Consultation. Summary of Responses*. December 2010. <http://bis.gov.uk/assets/biscore/business-law/docs/s/10-1318-summary-of-responses-future-narrative-reporting-consultation.pdf> Accessed on 11 August 2011.

mentioned as to the need for flexibility for companies to be able to tell their unique story.[58] Others stated that comply or explain standards could improve the reporting and the existing non-statutory guidance could be improved. Overall, the view was that a market approach would be accepted if accompanied by the strengthening of the FRRP (Financial Reporting Review Panel) as an entity in charge of complaints for inadequateness or failures in reports. Thus the government seems to have gathered proposals and views and is expected to propose a reform. In my opinion, as it will be argued, mandatory regulation would be helpful in setting a minimum mandatory framework as to what should be reported, yet this is far from being a satisfactory response to create socially responsible businesses. Mandatory reporting is only an indicator that helps the assessment of a reality and that should not be forgotten when discussing these issues. Thus, even though mandatory regulation as to what to report is necessary the other phases of the company interaction with stakeholders should be considered. That is, regulation should also consider the way the information is being produced (interaction with stakeholders), disclosed and used.[59]

c. What should be reported? The issue of Standardisation

What to report? That is the question to answer once it is accepted that there should be a report on non-financial matters of a company. In this regard, the lack of regulatory consensus alongside with the need to provide that information[60] has caused the emergence of a broad number of non-regulatory options as to what and how companies should report. Initially companies would disclose to the public whatever they thought proper (environmental issues were the first topics), and due to the lack of coordination or guidance the information became ignored by the market (being self-laudatory) or difficult to assess. Later the *Corporate Social Reports* of companies included within auditing reports a mention of Triple Bottom Line issues i.e. (ESG).

[58] BIS. n. 53 above. P. 21.

[59] D. Hess. 'The Three Pillars of Corporate Social Reporting as New Governance Regulation: Disclosure, Dialogue and Development'. *Michigan Ross School of Business Working Paper. No. 01112*. July 2008. P. 23. <http://ssrn.com/abstract=1176882> Accesses on 12 August 2011.

[60] Even though accentuating the voluntary nature of CSR and the reporting of it, the ICC acknowledges that financial information is not enough for the stakeholders of a company and that by reporting non-financial information a company can find certain benefits as employee's and commercial partners' commitment as well as an improved capacity to raise capital. ICC. *ICC views on economic, environmental and social reporting.* <http://www.iccwbo.org/policy/society/id599/index.html> Accessed on 19 July 2011.

Following this tendency, many standards for the way the information should be reported would be developed[61] thus giving a degree of comparability to the assessment of the reports. Moreover, other mechanisms are found in best practices and investments selection criteria. For instance, in the financial markets indexes as the *Dow Jones Sustainability Group Index* and the *FTSE4Good* were established as incentives for disclosure of social information. Investment funds with ethical goals were created choosing investment decisions based on the social impact or sustainability of the project, giving rise to *Social Responsible Investment* (SRI).[62] The market created and developed standards to measure the sustainable activities of companies. Thus far, the critics of mandatory regulation were right to keep it as a field for self-regulation since the flexibility of the voluntary approach allowed experimentation on the reporting and in order to avoid mandatory regulation considerable progress had been achieved.[63]

The G3.1 Guidelines[64] as a privately developed standard for the reporting of non-financial information create parameters that allow companies to choose whether or not they want to report as well as the level of the reporting they want to make. The guidelines however do not contain an assessment or imply an audit on the content of the information. Other standards (not necessarily exclusive with each other) such as the UN Global Compact, the ISO2600 or OECD Guidelines for Multinational Enterprises serve as a way to present the information and do not assess its' content either. For auditing purposes other instruments have been developed. The purpose is to provide the market with standardised and comparable data.

However, as expected within a market dynamic, the first initiatives gave rise to several standards with different criteria. In addition SRI funds developed their own sets of standards in order to choose investment opportunities. This spree of standards turned

[61] N. Finch. n. 39 above. P. 9 and D. Hess. n. 55 above. P.17

[62] In this new market for socially responsible investments there is a framework set by the UN: The United Nations Principles on Responsible Investment (PRI). <http://www.unpri.org/principles/> Accessed on 28 July 2011.

[63] I. H-Y. Chiu. n. 49 above. P. 366.

[64] It is the latest version of the guidelines developed by the Global Reporting Initiative (GRI). <http://www.globalreporting.org/ReportingFramework/G3Guidelines/> Accessed on 23 August 2011.

the goal of harmonization into difficult to achieve[65] and could now be taken as an obstacle for non-financial reporting or if achieved done in very general terms as Chiu comments it.[66] There are some attempts to standardise corporate reporting. The Business Review mandated by S. 417 of the Companies Act 2006 is a general example. This statutory reporting requirement intends for directors of companies to include in their annual reports the way in which they have engaged with the environment, employees and the community to the extent that their business requires it. Yet there is no guidance as to how exactly companies should provide for this requirement and as a result, there is still no satisfactory regulation for a standardised non-financial reporting. The existence of multiple standards could make the reporting of information lose its value. However governments should not attempt to develop an entirely new approach on their own but instead should rely on the developments achieved at an international level in order to facilitate harmonization.[67]

d. The utility of non-financial reports for stakeholders

Given that companies can decide on what to report and even if they report at all alongside with the lack of a harmonised set of guidelines to be used in the reports there is a consequential lack of comparability of the information reported by companies.[68] In addition, interest groups (stakeholders) have realised that there are other challenges that go beyond reporting itself: companies will only see reporting useful in a voluntary context if the cost of incurring in the report is compensated by the benefits obtained from it; moreover due to the fact that constituencies can't do much with the little (or much) information reported then the appeal of reporting as a tool for achieving accountability towards stakeholders could be fading turning interest groups into alternatives (political activism, public awareness campaigns, etc.) where their scarce resources might be put to a better use. Even though there are improvements,

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[65] At a EU level there are attempts to harmonise the reporting of non-financial information. See the Public consultation on disclosure of non-financial information by companies available at: <http://ec.europa.eu/internal_market/consultations/2010/non-financial_reporting_en.htm> Accessed on 11 August 2011.
[66] I. H-Y. Chiu. n. 49 above. P. 366.
[67] An interesting view on standardisation is proposed by Chiu who argues that it has unintended effects of convergence in thin issues and causing lack of critical reports thus the individualization of a company's CSR profile should be encouraged assisted by the international efforts as to reporting guidelines and assurance. See, I. H-Y. Chiu. n. 49. Above. P. 387.
[68] This was one of the most common complaints about CSR reporting and reporting in general. See BIS. n. 53 above.

the lack of a single set of guidelines makes the assessment of the information if not difficult at least costly, making stakeholders wonder on the effectiveness of the resources employed in doing so if there are no material results in sustainability.[69] The case for mandatory regulation I believe is becoming stronger.

e. The challenges from a Regulator Perspective: The Remuneration Code and Project Merlin as examples of regulation

In a market economy a company can decide independently how much and on what to spend its financial resources. However, there might be circumstances in which the private nature of the practice may vanish. This could happen when remuneration policies become a factor for encouraging financial risks with macroeconomic effects or when there is a substantial disparity between the payments of executives and ordinary employees. Executive's remuneration,[70] in particular in the banking industry, can be a good example of the political struggle behind the ability of regulators to alter established practices regarding closed interest groups. But the relevance of it for the purpose of this paper is not due to this fact but to two factors: On the one hand it is an issue that has raised public discontent and on the other hand the regulatory solution has been the reporting of information.

The topic has been subject to academic comments for some years due to the agency costs involved and also due to its economic significance. In certain occasions, this topic raises sensationalist reactions[71] yet there is an apparent substantial increase in the level of executive remuneration that is not entirely possible to explain due to size, performance or industry reasons.[72] Since they are seen as excessive, then remuneration policies are subject to public scrutiny and demands for public accountability when institution involved in the excess have a public nature or a public interest is involved. UK Banks are in this particular situation not only due to the middle

[69] D. Hess. n. 55 above. Pp. 38-49.
[70] This includes salary but also the bonus payments, the stock options and long-term investment plans.
[71] J. W. Lorsch. 'The Compensation Silly Season'. *Harvard Business Review Blog Network*. <http://blogs.hbr.org/hbsfaculty/2011/04/the-compensation-silly-season.html> Accessed on 22 August 2011.
[72] For an analysis of the period between 1993 and 2003: L. Bebchuck and Y. Grinstein. 'The Growth of Executive Pay'. *The Harvard John M. Olin Center for Law, Economics and Business Discussion Paper Series*. <http://www.law.harvard.edu/programs/olin_center/> Accessed on 23 August 2011.

ground in which the banking industry is located between being part of a private profit industry and having an embedded social function, but also due to the fact that the government chose to inject public funding into some of them with the intention of containing the potential collateral effects of their collapse (with the fiscal effect that this has caused). Thus, public funding legitimised the calls for public accountability with regards to the activities of the bailed out banks, although it appears to have focused the spotlight on the entire industry.

Executive remuneration is thus seen as an issue for regulatory action for several reasons. From a Corporate Governance perspective, there are agency costs and the potential for conflicts of interest for directors influencing or establishing their own remuneration packages at the company's expense.[73] The UK Corporate Governance Code calls on companies to consider this and correspondingly the Section D Main Principle states that a company should avoid paying more than what is necessary for the role, and should link a *significant proportion* of the remuneration to corporate and individual performance.[74] Moreover, after the 2007 crisis, there has been a substantial amount of regulation attempting to correct all of the problems that were seen as causes of the crisis. Excessive risk-taking, encouraged by inappropriate remuneration policies, is one of those factors thus also served to justify regulation.[75] In the UK, the Corporate Governance Code includes provisions on this and even though they create awareness on a sensible topic, its principles-based approach seems to be inadequate for solving the problem. The BIS acknowledged that after the crisis, executive remuneration was still based on firm size and not in performance and the average remuneration package was still increasing.[76] Thus, more regulation on executive remuneration was issued. In particular it is possible to find two different *sets* of regulation both using reporting of information as part of the solution and thus could be used as reference as to the role regulators should play in the reporting of non-financial information.

On the one hand, the UK Remuneration Code implemented in 2009 and modified in 2011 is a regulation based on the EU Capital Requirements Directive (CDR3), the

[73] BIS. Long Term Focus for Corporate Britain. A Call for Evidence. October 2010. P. 5. http://www.bis.gov.uk/assets/biscore/business-law/docs/l/10-1225-long-term-focus-corporate-britain Accessed on 11 August 2011.
[74] UK Corporate Governance Code 2010. Section D.
[75] O.S. Simmons. n. 45. P.335.
[76] BIS. n. 5 Directors Remuneration. P. 25.

guidelines of the Committee of European Bank Supervisors (CESB) and the Walker Report. On the other hand the so-called *Project Merlin* agreement between the largest UK banks and the government. The former uses disclosure of information as part of the regulatory response but only as part of a comprehensive set of regulations. It is also based on well-developed international standards and its provisions are prescriptive in nature. The latter, even though also uses disclosure as part of the regulatory scheme is substantially different due to the fact that is an agreement and also because it is rather vague and general.

I intend to draw remarks of each of these and assess their usefulness as standards for the reporting of information as a regulatory tool.

(i) <u>Remuneration Code</u>

Scope of Application: In its initial version it was only applicable to a restricted number of financial entities. However, after the modification made on January 2011 it will have a substantial change in its scope of application including large banks but also all banks and building societies and a substantial number of investment firms.[77] As to its territorial application it does not limit to institutions located on the EEA (European Economic Area) but also subsidiaries of EEA located parents that function in non-EEA states.[78] In addition, the remuneration to which it is applicable is not restricted to senior executives but includes provisions applicable on a firm-wide basis. Even though it restricts some provisions to Code Staff, this concept is rather extensive including any employee capable of taking risks in the name of the company and whose remuneration is in the same bracket as that of senior management.[79]

Content of the provisions: The Code follows a principles-based approach set by the CDR3 and the Corporate Governance Code but goes beyond the latter given that it is much more prescriptive and does not limits to simply impose a cap on payments. For instance, even though in some cases it only gives an indication without categorical statement i.e. while firms should consider an

[77] FSA Handbook. SYSC 19A.3.1 R.
[78] FSA Handbook. SYSC 19A.3.1 R.
[79] FSA Handbook. SYSC 19A.3.4 R and 19A.3.6. G.

appropriate ratio between fixed and variable remuneration,[80] in other provisions it states that at least 40% of the payment should be deferred in three to five years (this percentage is increased to 60% if the amount is higher than GBP 500.000 or for some other reasons is considered particularly high).[81] The use of prescriptive language can also be found in other provisions such as in the case of the use of *guaranteed bonuses* restricting its use only for the first year of employment[82] or in the restriction for *retention bonuses* to exceptional circumstances (such as the stay during a takeover or a merger)[83]. The Code goes further and establishes a percentage of the variable component of the remuneration that should be paid in shares, share-linked instruments or equivalent[84] (which should be subject to retention clauses as to align the interest of the staff with the long-term performance of the company),[85] and states that in any case the variable or deferred remuneration should be subject to readjustment according to individual performance.[86]

Disclosure provisions: In regards to disclosure, particular provisions require companies to make reports to the FSA with specific information in conformity with the CDR3 European requirements.[87] Thus, companies acquire a responsibility for public disclosure as to: the institutions' remuneration policy; who is in charge of establishing it; under what criteria; what employees are affected by it and why; an explanation of how performance and pay are linked and the indicators used to measure it; and the different types of variable remuneration used by the company and the rationale for doing so.[88] The reporting is not made in a *one-size-fits-all* manner but rather different disclosure requirements are created according to the firm's characteristics.[89] Lastly, and in reference to enforcement powers, the FSA is given ample powers to forbid

[80] FSA Handbook. SYSC 19A.3.44 R.
[81] I.e. considering the firm's size and business. FSA Handbook SYSC 19A.3.49 R
[82] FSA Handbook. SYSC 19A.3.40 R.
[83] FSA Handbook. SYSC 19A.3.43 G.
[84] FSA Handbook. SYSC 19A.3.47 R.
[85] FSA Handbook. SYSC 19A.3.8 R.
[86] FSA Handbook. SYSC 19ª.3.36 R and 19A.3.51 R.
[87] FSA. PS10/21: Implementing CRD requirements on the disclosure of remuneration. Annex 1. <http://www.fsa.gov.uk/pages/Library/Policy/Policy/2010/10_21.shtml> Accessed on 23 August 2011.
[88] FSA Handbook. BIPRU 11.5.18 R.
[89] FSA Handbook. BIPRU 11.5.20 R (2).

practices, render void agreements, and claw back payments according to the substantive provisions.[90]

The intention in assessing the content of the Remuneration Code is not to make critical and substantial comments as to its provisions. The intention is to highlight its regulatory *architecture*, recognizing a process where the substantial issue to be regulated was controversial but also garnered strong support for political intervention in the form of regulation. This in turn made for the development of substantive requirements, part of which included disclosure[91] of information for assessing the effectiveness of the rules provided and to achieve public accountability (and transparency). There is no doubt that some of the provisions of the Code are subject to critical assessment as to their practical effects such as the restriction of retention bonuses, the territorial application of the code, and the compliance costs associated with it. In any case, this statute is identifying substantial ways to address the core problem. It is perhaps too early to assess the effects of this specific type of regulation, nonetheless and for our purposes it can be said that the instrument is comprehensive and ambitious in attempting to properly confront the underlying issue.

(ii) Project Merlin:

The other example is the agreement announced in February of 2011 and that since then has been subject to many press commentaries and exposure, involving the UK government and the four largest UK banks called *Project Merlin*.

Scope of application: The agreement involves Lloyds, RBS, HSBS, Barclays and partially Santander (only regarding lending). It covers four topics: lending, taxation, executive pay, and further economical and societal contributions. In return for the commitments included in the agreement, banks are then able to expect regulatory passivity on the governmental portion. This is already an interesting document that raises questions as to its necessity and its nature.

[90] Financial Markets Act 2010 S. 139A. (9) and FSA Handbook SYSC 19A.3.54 and Annex 1.
[91] Using disclosure as the only regulatory response is deceptive and fails to deal with substantive issues. On the matter see: P. Cioppa. n. 46 above.

Content of the provisions: The document itself acknowledges, "the banks explicitly recognize their responsibility to support economic recovery"[92] which supports the idea that even though they are private entities they still have larger responsibilities.[93] Briefly mentioned, its content covers the following main points: on lending, the commitments are generally aimed to increase the amount of available funds for companies without meaning a sacrifice in credit risk as an attempt to increase national economic growth. Of particular interest is the fact that the Banks' CEOs agreed to link their pay on lending targets.[94] On taxes, the agreement includes the increase in the bank levy tax (already implemented) as a compensation for not imposing taxes on bonus payments over a specific amount.[95] On remuneration, the agreement includes a commitment to have the overall bonus payments for 2010 lower than those of 2009. The remuneration committees are to check the ten highest salaries according to corporate governance provisions (as it is already required) and further encourage institutional shareholders engagement in this regard. A specific disclosure commitment is reached where banks will publish the remuneration for their CEOs, and on basis of anonymity that of its five highest paid executives. Special considerations were given to RBS and Lloyds (the bailed out banks) establishing a cap on bonus payments for 2011 to be paid in shares that should be retained until 2013.

The necessity of the agreement would need to be assessed according to the different topics that it covers yet in general is said to be a threat from the government that shows that if banks fail to act then government regulation would be underway.[96] Regarding executive remuneration it is difficult to see it as necessary since European and national initiatives already exist as hard law in the UK. Thus, it could be interpreted as a sign of mistrust in the efficiency of existing regulation, as a regulation threat or

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92 Project Merlin. Banks' Statement. 9 February 2011. <www.hm-treasury.gov.uk/d/**bank**_agreement_090211.pdf> Accessed on 25 August 2011.

93 One might argue that due to the social impact of banking activity then social responsibilities are more feasible. I am not prepared to accept that proposition but is not the intention of this paper to answer it.

94 Project Merlin. S.1.6.

95 GBP 25.000. Allegedly it is compensated by the increase in the levy and justified for competitive reasons for the banking industry in hiring adequate and capable executives.

96 P. Iglesias Rodriguez. 'Project Merlin and Regulatory Threat over the UK's Banks'. Vol. 32, Issue 7. *Business Law Review*. July 2011. P 172.

merely as a sign of over-regulation after the financial crisis. The nature of the document also leaves some space for inquiry. The fact that it is a voluntary agreement in return of regulatory easing evidences an underlying political concern for regulators.[97] Given that governments are political entities subject to political risks, they take into consideration the exposure of their political capital with a regulatory intervention. Moreover, a regulatory intervention may pass-on the responsibility for the underlying issues to regulators who failed to fix the problem and while the political capital increases if the intervention is successful, the opposite occurs if it fails.[98] The motivation for regulatory intervention is even more constrained when it refers to issues affecting established interest groups due to the lobbying achieved by them. Project Merlin and his *provisions* on banks' remuneration seem to expose this reality. While the UK government faces public discontent with payment of banks' bonuses, particularly acute in the after-crisis, a strong intervention may affect its political capital due to the threat of relocation (whether real or not) made by some banks in case of excessive regulation.[99] This agreement can be an attempt to achieve a feeling of public accountability but with no substantive effect. In the end is simply a press act directed to the electorate. The agreement itself is not comprehensive since it covers only a small number of institutions with an arguably restricted overall effect on the UK economy. Its provisions are rather general and in some cases repeat existing regulation. There are no clear consequences as to what would happen in case of a breach by the Banks and the regulatory threat is not credible due to the strong position of the banks and their potential relocation, which would be critical for the City of London and the UK's economy.[100] As to the provisions regarding pay, it limits only to bonuses which are just one of the components of executive remuneration. The provisions fail to establish a parameter for future behaviour stating only that 2010 payments are not to exceed the previous year. The disclosure component of the regulation is not clear and once the information is published there is no guideline as to what to do with that information. Disclosure seems to be used as a way to calm public demands. The entire document provides an appearance of action with no substantive effect. Again, this instrument is yet to show its effectiveness but I believe it shows deficiencies of public policy in facing the regulatory challenge.

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[97] O.S. Simmons. n. 45 above. P. 363.
[98] O.S. Simmons. N. 45 above. P. 365.
[99] P. Iglesias Rodriguez. n. 93 above. P. 174.
[100] P. Iglesias Rodriguez. n. 93 above. P. 175.

The bias is apparent in the two approaches as to the use of disclosure as a regulatory tool. The latter shows a lack of a coherent policy as to the use of disclosure, and at most attempts to rely on achieving public accountability through the reporting of information on remuneration, increasing public awareness and supporting the eventuality of a regulatory response if ever one is to be needed. Even though it could be said that it follows the corporate governance goals of reducing excessive risk taking, aligning remuneration with long-term performance, and using performance as the indicator for payment, by and large its effect is counterproductive. This would add reason for dismissing disclosure and reporting as a useful technique, serving only as a way of allowing window dressing.

4. A corollary: Can governments create socially responsible business by requiring the reporting of non-financial information?

From a regulatory perspective, disclosure of information is sought as the best solution because does not impose substantive socially responsible roles to companies (since there is no dogmatic justification for them) but gives the appearance of political engagement (when there are calls for action). However, looked at carefully it might be a negative response since it postpones the implementation of substantial regulatory measures and brings about a reputation for disclosure as a neutral and ineffective instrument. The future may pose a different landscape if the increased public awareness caused by the disclosure creates the democratic legitimacy that would allow the existence of substantive regulation. Currently there is no consensus as to the role that regulation should play as regards non-financial information in general.

Additionally, the existing economic outlook does not seem to create a friendly setting for imposing the disclosure of non-financial information, since it is likely to create compliance costs in a time where expenses should be thought through carefully. The 2007 crisis caused a substantial loss of investors' confidence in the market and the way companies do business. Therefore if one of the desirable effects of increasing corporate reporting were the consequential improvement of market transparency, then mandatory reporting should be a desirable regulatory response. Yet merely requiring new or different reports from companies would not be sufficient.[101] The absence of a

[101] Referring to the effectiveness of disclosure regarding executive remuneration: "… if past history is any indication of future performance, disclosure rules cannot fully curb

unified reporting standard and the lack of rationale as to a company's social responsibilities has created mistrust in the information disclosed by companies. Would this change automatically with the introduction of a statutory requirement mandating report of non-financial information? Hardly. All things being equal, a mandatory report would create a compliance exercise with no substantial effect for CSR practices. Therefore the problem of requiring the report of non-financial information to create social responsibilities should not only address whether or not should companies report, but also address the process of how the information reported is produced and how it is later assessed by its consumers.[102] Moreover, mandatory regulation would eventually cause an increase on the number of reports but this would not mean that companies are improving their CSR practices. The materiality of a company's responsible behaviour is not represented by a report but by actual practices. Further efforts need to be made to change the way companies operate. If reporting cannot achieve substantial results then interest groups will focus on alternatives for changing the way companies do business, yet regulation could still allow for reporting to be used accordingly.

Providing relevant information to the market is still a useful tool. A regulatory intervention should therefore consider that the issue is more complex than just simply requiring a report and letting the market see what it does with that information. Self-regulation has shown some advances but regulators can't afford to continue being bystanders. The Remuneration Code is a regulatory model that should be considered as reference. A strong justification for substantive regulation was needed for the code. In the case of the reporting of non-financial information a global economy in need of sustainable business practices would meet this requirement and justify in general the existence of regulation regarding CSR. As to whether or not there is a justification for mandatory reporting, based on the recent studies referred to above, non-financial information does in fact create social responsible business focused on long term growth and create an increase in share price, thus regulation could be justified in the need to encourage this results. Even though self-regulation would probably be the best way to achieve the desired results, an adequate regime can allow the debate to continue and not stiffen it.

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abuses or pay levels. In certain in- stances, enhanced disclosure may actually lead to higher pay levels, and it can give rise to more opaque forms of compensation." O.S. Simmons. n. 45 above. P. 343.

[102] D. Hess. N. 55 above. P. 30.

Substantive regulation and the use of disclosure can achieve public accountability for companies by attempting to solve the underlying problem. In the case of CSR, achieving this requires a regulatory response that should be comprehensive and include disclosure as one of its multiple elements, taking as a model internationally accepted CSR reporting standards.[103] Although the focus should be substantial provisions regarding CSR practices, the reporting of non-financial information remains a useful tool thus some comments can be made as to the path in which prospective regulation could be directed.

As a starting point, reporting of non-financial information should be compulsory based on a -comply or explain- approach. This would allow a balance between the flexibility for this emerging type of corporate reporting while at the same time providing useful information to the market. Likewise, understanding that not all companies face the same stakeholders and/or their interest may differ substantially then a -one size fits all- regulation should be avoided. For harmonization purposes the European Union is the ideal (although politically perhaps the most unlikely) actor to create an international regime and thus its current consultation processes will be decisive. A principles based Directive from the European Commission would support the creation of this international regime and allow EU Member States to have a degree of flexibility as to their national regimes, yet in order to avoid lack of comparability in the information produced European regulation should include provisions stating Key Performance Indicators (KPIs). A mix of principles and specific provisions would give content to the disclosed information. Indicators should vary depending on the industry and size of company. Hence a default regime of KPIs for large companies[104] could be established at EU levels according to issues applicable to companies regardless of their industry.

[103] The EU launched a consultation on non-financial information reporting and the prevailing view from participants was that even though the reporting regime needed changes those changes should use the development of existing international standards instead of creating new European standards. The consultation period ended and the responses were published and an Expert Group was appointed to discuss the underlying issues. An initial meeting was held in July and the second one is to be held during September. <http://ec.europa.eu/internal_market/consultations/2010/non-financial_reporting_en.htm> Accessed on 23 August 2011.

[104] Whether or not this should be extended to SMEs is likely to be a debatable issue. Ideally it should cover all companies but compliances costs might be a stronger argument against it. Therefore the application should at least focus on large companies either expecting a benchmarking process that would lead these practices into the entire market or leaving room for further regulation to extend it.

Issues such as employee-employer relationship and environmental policies could be appropriate, still allowing member states to extend them as long as they are within the supporting principles. KPIs for specific industries should be treated separately. European regulation should set the principles leaving prescriptive regulation for member states. In any case, even if European regulation is not achieved the UK should still commit to a regulatory framework that could be at the forefront of the non-financial reporting regime.

It is foreseeable that this approach awakes scepticism due to the increase in compliance costs[105] and in merely turning reporting into boilerplate regulation. These arguments should be contested by including the possibility of making this information available through different means[106] and by an active regulator aiding the enforcement of the reporting regime. In this regard the FRRP (Financial Reporting Review Panel) in the UK, who is in charge of ensuring that companies audit reports are kept according to regulatory standards, could have the same function regarding non-financial reporting. Furthermore, regulation should also serve the purpose of encouraging companies to engage in a dialogue with particular stakeholders according to specific needs (the way in which they do should not be mandatory and room for experimenting allowed) giving them the opportunity to use the reported information. The Corporate Governance Code already includes some issues regarding shareholder engagement[107] yet other constituencies should be included in accordance with the Stakeholder theory. However, since the rationale for including other constituencies is far from being clear and the prevailing criteria is the Shareholder Wealth Maximization or Shareholder Primacy, then disclosure of non-financial information should not create direct liability for companies or its' directors so that fear of litigation does not function as a deterrent for efficient reporting. In spite of this, there should be an effective use of the information by stakeholders by allowing them to initiate claims before regulation authorities that would

[105] A substantial increase in the cost might defeat the whole purpose of regulation especially if companies don't see clearly and added value for incurring in them. With regards to the costs in carbon reporting: 'Green group disputes carbon reporting costs'. *Financial Times*. <http://www.ft.com/cms/s/0/7179cf4e-b93d-11e0-b6bb-00144f> Accessed on 23 June 2011.

[106] Reference to websites and the consistency or layout of the reports could help the assessment of the information included in them. In this regard some views were encountered in the BIS consultation document cited in n. 53 above.

[107] UK Corporate Governance Code 2010. Section E. This is consistent with the prevailing view in the UK of the Shareholder Wealth Maximization theory.

be in charge of making an investigation.[108] Taken as a whole this general framework supports the existing developments on non-Financial Reporting at UK and European levels while at the same time could respond to the concerns regarding flexibility and compliance costs. The bottom-line is that regulation needs to take a substantial approach leaning the balance towards social responsible business helping the discussion progress and using reporting as a highly useful complementary regulatory tool.[109]

The regulatory challenges for CSR are considerable. The Shareholder Wealth Maximization perspective still prevails. However, this is not an insurmountable problem for CSR. On the one hand, managers and executives no longer accept the fact that companies should only consider the interest of shareholders. Even if not required by law, they see an interest in doing so. The long-term success of a company depends on an adequate engagement with larger constituencies. This is simply a business reality apart from any Company Law dogma. The need for non-financial information in the market is also increasing. On top of all the figures that can be shown to support this increase,[110] the publication by the United Nations Principles for Responsible Investment Stock Exchanges of a letter from a coalition of investors to the CEO's of 30 stock exchanges demanding the inclusion of sustainability criteria as part of listing rules is very significant.[111] On the other hand, under the prevailing view a regulatory solution will have greater challenges. There are currently some attempts of reaching a

108 A sanction regime should be implemented so that fear of enforcement helps the application of the regime. Again, the FRRP could serve as a model.

109 The Institute of Directors does not support mandatory regulation for narrative reporting. Compliance costs, self-regulation and lack of added value are strong reasons for this, thus preferring other measures such as executive training. IOD. 'DTI Invitation for Comment son the Business Review' and 'DTI Consultation on Narrative Reporting Requirements for Companies'. 24th march 2006. <http://www.iod.com/MainWebSite/Resources/Document/policy_consultation_business_review.pdf> Accessed on July 2011.

110 Although numbers don't reflect content, it can be an indicator that last year around 8.220 companies published almost 5,400 reports of non-financial information across 168 countries. This numbers are provided by an U.S. private database CorporateRegister.com cited by Eccles, Krzus and Serafeim. n. 38 above. P. 4. Also, according to the G3 guidelines, the most widely available standard for the report of non-financial information by 2005 the number of companies using their guidelines increased in more than 600% since its launch on 2000 and on an additional 400% by 2010. www.globalreporting.org/ReportingServices/GRIReportsList/, Accessed on November 2011.

111 The letter can be found in http://www.unpri.org/files. Accessed on November 2011.

regulatory response but in the meantime private initiatives will continue setting the pace. These initiatives could help in the continuing definition of CSR disclosure and eventually achieve a future separate from that of non-financial reporting. The IRRC could be a successful attempt to bring a uniform reporting standard although apparently does not treat separately CSR information. At a point where sovereign power fails to achieve the behavioural change that is needed, private practices emerge as an alternative and self-regulation is and would continue to move forward either by honest beliefs that CSR should form part of a business culture, or at least in order to avoid inefficient government-imposed regulation. This in itself is a difficult and costly process, and the main question remains whether or not a timely solution will be achieved in a world with scarce resources and lack of sustainable business practices.

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