Sustainability Initiatives: Insights from Stock Exchanges into Motivations and Challenges

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Executive summary

EIRIS has worked with stock exchanges over a number of years, including the Johannesburg Stock Exchange (JSE), Bolsa Mexicana de Valores (BMV) and most recently Borsa Istanbul (BIST), to assist them in the development of sustainabliity initiatives.

The findings of this paper are based upon the interviews by EIRIS of 11 stock exchanges. By giving a voice to stock exchanges themselves, this paper is unique in its approach. The stock exchanges were interviewed about their motivations for implementing sustainability initiatives, the challenges that they have faced in the course of implementation and any insights that they can share with other stock exchanges.

There were a variety of perspectives put forward by the exchanges, which are at very different stages of the implementation process. Some of these are highly-established players in the field, such as the JSE and BM&FBovespa; others are newcomers that are starting to implement sustainability initiatives, such as the BIST.

Motivations

The following key motivations were identified by the participants:

- to improve the environmental, social and corporate governance (ESG) performance of companies listed on their exchanges
- to encourage and to help investors engage with companies on sustainability issues
- to identify themselves in the marketplace as committed to sustainability
- to draw on the latest research to support the link between long-term financial performance and ESG issues

Recommendations for stock exchanges

EIRIS makes the following recommendations in response to the insights given by stock exchanges:

- engage with companies and investors around the long-term benefits of driving better company performance on ESG issues, both for the benefit of these groups and for society as a whole
- engage with investors, particularly those from the mainstream, in order to identify the sustainability-focused products and services that exchanges can offer which would be of most value to investors
- explore ways of working together to overcome the challenges stock exchanges face (for example, regional co-operation by smaller exchanges)
- work with an established data provider, such as EIRIS, to help exchanges to develop, launch and grow sustainable indices, from defining criteria and collecting data, to engaging with companies and investors
- work with national regulators to develop ESG-related listing rules, preferably on a 'comply or explain' basis
- continue to share information, best practice, research, etc. with other exchanges through forums such as the Sustainable Stock Exchanges Initiative or the World Federation of Exchanges
- encourage companies to provide audited ESG data
- draw on the latest research to support the link between long-term financial performance and ESG issues
- engage with civil society and other stakeholders in the development of sustainability index objectives and criteria

Introduction

Stock exchanges play a crucial role in capital markets which goes far beyond the environmental and social impacts of their direct operations. As the representative from the New York Stock Exchange (NYSE) said:

'You've got to get your own house in order first, to make sure that you as a company are doing things right, in terms of reporting. We're the only global exchange group that is carbon neutral, and we're very proud of that … but ultimately your larger impact is going to be within your network of companies.'

With their pivotal position in the financial ecosystem and their ability to influence huge numbers of listed companies worldwide, stock exchanges are well-placed to provide a powerful boost to sustainability. This paper addresses this 'larger impact'.

This paper presents the views of a group of stock exchanges interviewed by EIRIS. The exchanges were asked to discuss their motivations for implementing sustainability initiatives, the challenges they have faced, their relationships with stakeholders, their insights into the implementation process and any recommendations they would give to other stock exchanges.

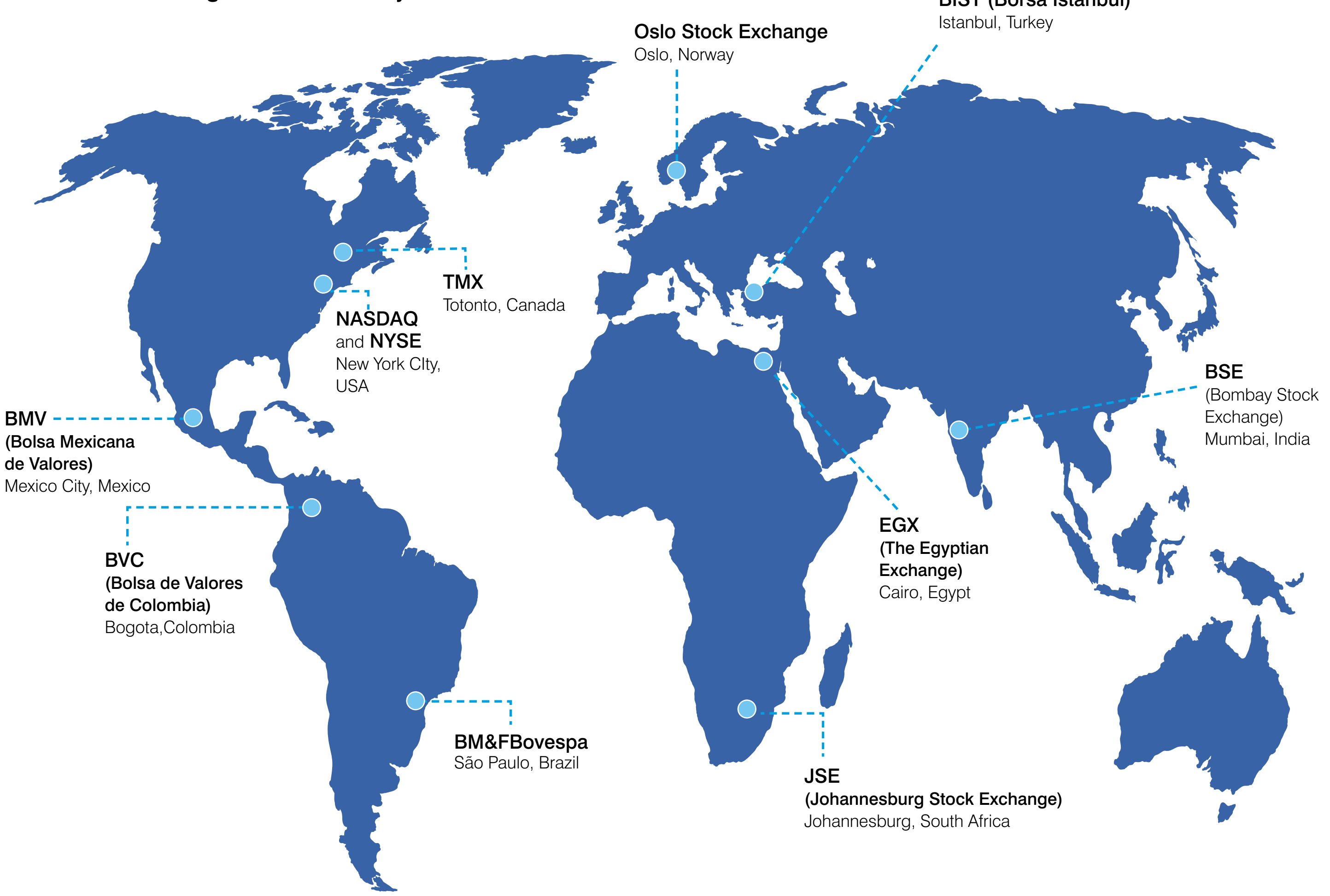
EIRIS carried out interviews with 11 stock exchanges. This paper does not aim to discuss the details of the sustainability initiatives implemented, which are amply discussed elsewhere[1], but to provide insights from the exchanges themselves on the reasons for their involvement in sustainability initiatives and their reflections from implementing such initiatives.

Exchanges interviewed

Country	City	Exchange
Brazil	São Paulo	BM&FBovespa
Canada	Toronto	TMX
Colombia	Bogota	BVC (Bolsa de Valores de Colombia)
Egypt	Cairo	EGX (The Egyptian Exchange)
India	Mumbai	BSE (Bombay Stock Exchange)
Mexico	Mexico City	BMV (Bolsa Mexicana de Valores)
Norway	Oslo	Oslo Stock Exchange
South Africa	Johannesburg	JSE (Johannesburg Stock Exchange)
Turkey	Istanbul	BIST (Borsa Istanbul)
USA	New York City	NASDAQ
USA	New York City	NYSE

[1] http://www.sseinitiative.org/

Stock Exchanges Interviewed by EIRIS



Motivations

One of the primary aims of the interviews was to identify stock exchanges' motivations for implementing sustainability initiatives. For example, the JSE shared its motivations:

'We believe that the hybrid approach that includes a strong regulatory basis, combined with other incentives, will have most impact. As a result, our focus is also on getting investors on-board, and to facilitate investors engaging with companies about how they disclose and how they look at material issues, because that is something that we believe is going to, and has demonstrated to have, a lot of effect on the way that companies think about sustainability.'

Many of the stock exchanges discussed their broader motivations for creating sustainability initiatives in terms of encouraging better corporate behaviour on country-specific challenges, such as environmental damage or labour rights.

Interviewees referred to the commitment of leadership within stock exchanges towards fostering improved company performance, with the aim of promoting the sustainable long-term viability of companies, and thereby of the market and of stock exchanges themselves.

In addition, the implementation of sustainability initiatives was commonly found to have created platforms and opportunities for engagement with companies, investors and stock exchanges on ESG issues. This proved conducive to the discussion of sustainability, which in turn motivated companies to address the ESG issues of their countries of operation, potentially also raising the profile of these issues with investors.

The representative from the Egyptian Stock Exchange (EGX) discussed the contribution that managing ESG-related risks makes to a company's overall risk management. Other exchanges similarly discussed these long-term impacts on the viability of companies, the market as a whole and therefore the exchanges themselves.

An interviewee from NASDAQ stated:

'We believe that this is a process and a managerial technique, and a data mining technique that provides more information for the management of the company, and enables the company to survive well into the future, as well as it enables the investor to make an informed decision about the company… We think it's really a win-win and the economics are easy to argue.'

With their pivotal position in financial markets, stock exchanges are able to create new markets focused around sustainability. As a BM&FBovespa representative remarked, 'the exchanges should create new markets all the time.'

Business case and challenges

Although many of the stock exchanges interviewed are deeply committed to maintaining and strengthening their sustainability initiatives, and believe in both the importance and the long-term benefit of supporting sustainability in financial markets, they may face challenges when implementing these initiatives.

One challenge has been the financial investment required and the return available from sustainability initiatives. The proportion of the global investment market investing sustainably has seen rapid growth globally year-on-year. However, it remains a relatively small percentage of global assets under management and many mainstream investors have not yet implemented responsible investment policies.

To date the revenue from the creation of indices has therefore been limited. According to some of the exchanges interviewed, one potential way to increase revenue is to explore opportunities for expansion of available sustainability products. Products could include tracking funds or value-added products around the data collected. For example, this could be sector comparisons or engagement with companies and investors on particular sustainability issues.

Stock exchanges also have options around the type of indices they design and how cost intensive they are. According to one exchange:

‘Because in a cost constrained environment we need to find a balance between a model that can maximise the impact, but will also be either financially sustainable or cost effective. I think it’s not an unreachable goal, especially since responsible investment is increasingly becoming mainstream.’

Stock exchanges are aware that indices are a long-term investment, with there being an initial period that could last several years when investors become familiar with the methodology. The importance of investors understanding the methodology, and learning to trust its reliability and relevance, was emphasised in the interviews. Once this happens the index becomes commercially viable.

The Bolsa de Valores de Columbia (BVC) interview confirmed that BVC expects there to be market opportunities for sustainability initiatives, although they acknowledged that this may not materialise during the first few years.

For one of the exchanges interviewed it was a different situation; at the time of the creation of their sustainability index, they were less focused on the commercial opportunities. This exchange stated that, ‘the idea for the index was not that it would be a revenue creator, but that it would be part of our contribution to the sustainability debate.’ However, in recent years, this exchange has further explored the business case.

It is a recommendation of this paper that exchanges explore the possibilities for developing additional products that integrate and complement their sustainability initiatives, either by themselves or in partnerships with third parties. Part of this process should include consultation with mainstream investors, in order to identify the products that would appeal most to them.

Several interviewees mentioned the reputational benefits for those stock exchanges that engage with sustainability issues. These include creating a strong, positive, international profile and positioning the exchange as engaged with the future sustainable development of their country. According to the BIST it is ‘one type of advertising’ with a sustainable index providing ‘free advertising’ for the companies listed. According to the BMV:

'Companies have shown their interest to be part of the sustainability index, they are pleased with the visibility they can get by being part of it, and the benefits of having more investors interested in their shares due to their sustainability practices.'

The exchanges interviewed were positive about the future, seeing the increasing take-up of sustainability initiatives among companies, the increasing engagement of investors and the commitment of exchanges. Debate around the business case can aid future development by tying these themes into the business strategies of the stock exchanges. The representative from the NYSE summarised this:

'Like everything else within sustainability, I think the best sustainability initiatives are those that also have a business purpose underlying them.'

Competition

Those stock exchanges that operate in competitive environments face extra challenges when it comes to sustainability initiatives. In countries with multiple national stock exchanges this was particularly marked, with companies having an easy option of moving to an alternative exchange if they found listing requirements on one exchange to be too onerous.

According to NASDAQ:

'Our market is more competitive, the fight for listings is perhaps more fierce for us than it is for [the JSE and BM&FBovespa], so we're a little more reticent to jump out in front of this by ourselves, which is why we think it's essential to have the other exchanges participate in the effort.'

Another interviewee explained that being a small exchange in a competitive environment had so far prevented them from implementing substantial sustainability initiatives. Although the exchange planned to monitor investor demand and legislative changes relating to sustainability, it stated:

'[A]s a small exchange we are focusing on being in compliance with international standards, so harmonisation within or between the financial community. We might be reluctant to implement requirements that are specific to our exchange, independent of other requirements.'

In these highly competitive situations, where the introduction of ESG-related listing rules may result in exchanges losing competitiveness, the role of the regulator is crucial.

India is a highly competitive national environment with multiple exchanges, but the regulator (the Securities and Exchange Board of India) has taken a leading role in promoting and mandating ESG disclosure, according to the Bombay Stock Exchange (BSE):

'The regulator has an important role in places like India where there are multiple exchanges because it's hard for us to impose a unilateral disclosure requirement that's new on companies… We can't do that without it being a requirement on all exchanges, otherwise it may become a regulatory arbitrage.'

This role for the regulator is led by the Indian government:

'From the government's point of view they see it as a priority. They see these issues as having real practical significance for the potential of India's economic development to continue and to prevent the environmental problems from worsening. … This clearly signals down from the central government that regulators, exchanges, companies, ministries should really be trying to focus on this.'

Other exchanges have also emphasised the role of the regulator. For example, one exchange said that, 'regulators should generate the mechanisms, regulations, norms to promote the initiatives. They can help [by] breaking barriers to investment.'

Some exchanges felt that more could be done by their regulator. The view from NASDAQ is that the US regulator has not taken a leading role in driving ESG:

'In a perfect world, it is the right role for them. I think they are the ones who should be outside of the market place, looking at the kind of pressures that good and bad ESG can have on the market place, on price movement, on company sustainability, on investor right to know a certain piece of information. I think that they are the ones who are probably best suited to make those kind of analyses, and they certainly have the guidance and expertise to do so, but for one reason or another, I'm not sure why, it hasn't happened ... you see it happening a little more in Europe and in other places. So that's why we're involved – we feel like there's been a lack of activity from that side of the spectrum.'

Some exchanges, such as the BM&FBovespa, engage closely with the regulator to share objectives and strategies on ESG issues. Other exchanges have a multi-stakeholder approach to running indices. For example, the Standard & Poor's /EGX ESG index is governed by an index committee that includes Standard & Poor's, the Egyptian Exchange (EGX) and the Egyptian Corporate Responsibility Center (ECRC).

The JSE highlighted the positive role that the government in South Africa can play in encouraging companies and investors to engage with sustainability issues rather than just relying upon legal coercion:

'The role of government in this is very important because typically government is just seen as a big stick type organisation wanting to beat companies into compliance, but they can influence companies in other ways as well. But I think our government has certainly started to understand this - their participation in things like the Group of Friends of Paragraph 47, … is certainly an indication that they want to be able to engage more with companies about how they tackle sustainability. The new South African Companies Act also reflects a broader way to think about sustainability.'

The key roles to be played by government and the regulator in driving forward sustainability initiatives came through powerfully in the interviews.

One of the recommendations of this paper is that exchanges should engage with the regulator to encourage more support for the sustainability agenda. Perhaps one potential roadmap to regulatory frameworks is through the introduction of the type of 'report or explain' rules adopted in Brazil.

Indices

As discussed in the section on motivations, sustainable indices are a key initiative for many exchanges. One of the first such indices was launched by the JSE in 2004 and indices have since been created by exchanges across the world.

Sustainable indices include quantitative and qualitative evaluations. They can cover single issues, such as carbon intensity, or a broader range of ESG criteria. This flexibility is one of the reasons for their popularity; indices are easily adaptable to the local economic and reporting environment.

The largest 100 companies by market capitalisation have been mandated by the Indian regulator to disclose their emissions. The BSE has created an index using a quantitive metric of greenhouse gas emissions to select the top 25 companies from that group.

In 2011 the BSE created a further index using more qualitative parameters on companies' policies, systems and reporting across a range of ESG criteria. In their interview the BSE mentioned their plan to shift the focus of this index over time:

'In the absence of an assurance framework today, we are using data submitted by companies on [an] as-is basis. When the assurance framework is created and found acceptable from all perspectives, we could consider enhancing the data with assurance capabilities.'

BM&FBovespa, the Brazilian exchange, also has a range of indices covering different ESG issues. These have provided a useful channel for communicating the sustainability agenda to companies, investors, the media and broader society, by providing concrete evidence of company performance.

According to various exchanges, the selection of ESG issues in indices is, in part, a reflection of the reporting that exists within their domestic markets.

Whilst the bar needs to be set at a level that companies can achieve, those ESG issues that are included are also aspirational targets and their inclusion can determine which ESG issues are given importance by companies seeking to get into the index. This ability to set the sustainability agenda is a key driver for most of the exchanges interviewed by EIRIS.

Indices can be broad-based and holistic, covering a range of issues; or multiple indices can be created focusing on specific issues, allowing the investor to select their focus by concentrating on a particular index that is relevant to the issues in which they are interested.

For exchanges, a key advantage of indices is that they reward good corporate behaviour. Indices can encourage and assist good performance among leading companies, without the enforcement of standards upon companies that are not yet engaging with ESG issues or that have fewer resources to dedicate to ESG. This fosters good relationships with companies and does not require the coercive enforcement regimes necessary when initiatives are mandatory.

The indices can also be progressive, developing requirements over time in order to cumulatively make substantial improvements in the ESG reporting of a market segment. As described by the JSE:

'The SRI index, which is deliberately a developmental initiative, so something that evolves and changes over time, has been our main tool for trying to influence companies. We've been getting stricter in terms of what we look at and how we require disclosure.'

In smaller exchanges there can be challenges around creating an index that is sufficiently differentiated from the main indices. As described by the JSE, in smaller markets:

'[T]he index doesn't currently differentiate sufficiently from the main indices, given that it applies a market capitalisation weighting. As a result of the fact that certain sectors (such as the mining sector) dominate both in terms of performance and market cap, the SRI index tends to track our all share index very closely. The JSE is therefore exploring ways of bringing more differentiation, maybe through sector comparison, as these are the kind of value-added things that our investors have indicated that they are interested in.'

The challenge of creating sustainability indices that are sufficiently differentiated has influenced some exchanges that have not yet launched sustainability indices. The BVC considers that Columbia has, as yet, an insufficiently developed local market to support a Columbian sustainability index. However, the BVC is working to overcome this challenge by collaborating with other countries to develop a regional sustainability index.

The BVC has been working in collaboration with some regional actors, such as the Inter-American Development Bank, regional issuers, pension funds, banks and stock exchanges, among others, to draw up plans for a regional sustainability index with Chile, Peru and potentially other regional exchanges. This will require strong commitment and collaboration to harmonise approaches, but would cement regional cooperation. The BVC hope that it will strengthen the position of the exchange internationally and make it more attractive to foreign investors.

Exchanges view sustainability indices as a product for investors. According to the interviewee from the BM&FBovespa:

‘We believe that indices have a great power to impact the market, because they can be a reference for investors, but more than this we try to have a product based on the index … the indices have two key roles – to be a reference and to be a product.’

The challenges of implementing sustainability indices

The design of indices and the monitoring of corporate ESG performance in order to select index constituents are two of the major challenges identified by stock exchanges.

The JSE discussed the various structural challenges faced when building their sustainable index:

’[W]e went through various iterations of applying different research methodologies trying to find what would be least of a burden for companies, whilst still getting the most relevant information out of them.’

The EGX discussed the importance of stringent monitoring systems, with their main concern stated as, 'the qualitative nature of the survey, which will lead to enormous mistakes if not monitored well during the process of establishing and the periodical review and revision.'

The BSE highlighted the lack of third party assurance and the fact that any monitoring of company reporting by the exchange has to rely on a company’s reporting. Currently they have to rely on unassured ESG data from companies and the development of an assurance framework would be desirable.

Some exchanges also identified sector–based challenges which could affect index creation. For example, the increasing development of heavy industries in Egypt, which have a high environmental cost, could impact the EGX index.

Several of the exchanges interviewed by EIRIS work with third party data providers in order to collate the ESG data used for their indices. EIRIS partners with the JSE, the BMV and the BIST to provide data and analysis services to help these stock exchanges develop, launch and grow sustainable indices. EIRIS' work with stock exchanges includes defining criteria and collecting data to develop and implement index rules, as well as engaging with companies and the investment community.

Data providers, such as EIRIS, can offer exchanges bespoke solutions to suit the local market. EIRIS can help to achieve an exchange’s goals based upon extensive experience of developing local partnerships to enhance the data analysis process.

Listing requirements

Listing requirements are the rules and standards that companies must adhere to in order to be allowed to join an index. Whilst many exchanges have listing requirements on governance issues, there are relatively few markets that have listing requirements on environmental or social issues. Responsibility for implementing listing rules can lie with the regulator or the exchange themselves.

The Indian regulator, the Securities and Exchange Board of India, requires the top 100 companies by market capitalisation to disclose carbon emissions, and is in the process of enacting further requirements on qualitative reporting.

In South Africa, the King Code III sets out guidance and requirements for ESG issues, particularly around black economic empowerment.

Although there are several examples of this type of initiative, the exchanges that EIRIS interviewed have some concerns about the onus for the implementation and enforcement of ESG listing requirements falling upon stock exchanges, particularly in situations where there is competition between exchanges.

As regulations, listing requirements are not usually flexible and include measures to compel companies to comply. This can be challenging for stock exchanges attempting implementation without a regulatory framework, particularly for those exchanges that face greater competitive pressures. With sanctions ranging from warning letters to suspension of companies (depending on the severity), there are options available to ensure compliance, but there are limitations on their use if the exchanges wish to maintain good relationships with companies.

Despite the challenge of introducing listing requirements, it is a shared belief of a number of international stakeholders, including exchanges, that listing rules play a role in promoting corporate transparency and accountability – two essential elements of a healthy market economy. On-going efforts are being made by member countries of the Group of Friends of Paragraph 47[2] at an intergovernmental level to seek action from governments and regulators to establish best practice models of regulatory frameworks on corporate transparency, and to lead by example in corporate sustainability reporting in the hope that other countries will follow suit.

'Comply or explain' systems are a means of encouraging reporting, whilst retaining the flexibility for companies to explain why they have not fulfilled a reporting requirement. As one interviewee mentioned, the variability of companies means that it is reasonable for companies to be given the opportunity to present their reasons for being unable to supply the information requested.

In Brazil a 'report or explain' initiative has been introduced and has improved performance, with up to 66% of companies now publishing sustainability-related information, or explaining why they have not done so.[3] In the interview with the BM&FBovespa it was suggested that 'report or explain' could be a preliminary stage to creating a listing rule, 'so when we have a listing rule it will not be a surprise for the Companies: it will be something they are practising.' The JSE similarly suggested that after a period of encouraging / influencing company reporting through other measures, the most material areas could evolve into listing requirements.

Many of the stock exchanges interviewed emphasised the benefits of voluntary initiatives. According to the NYSE, they are trying to 'provide a carrot and not a stick'.

Several exchanges highlighted their work to convince companies and investors of the benefits of ESG initiatives, particularly for long-term company performance, as the most effective way to change mindsets and to improve performance, rather than regulatory regimes.

The BSE carbon indices actively favour voluntary initiatives, allowing offsetting to be included in calculations (up to a maximum of 70%), but only where the offsetting was done voluntarily and not due to legal compliance. Several exchanges highlighted the pitfalls of enforcement mechanisms. The BM&FBovespa representative said of enforced compliance:

'When [the] rule is implemented before the minimum market conditions are in place, companies might meet it only in order to be in compliance, in an incomplete or somewhat unrealistic manner.'

According to the JSE:

'In South Africa a lot of sustainability elements have become part of the licence to operate. Some issues have almost been over regulated, and have become too much of a tick box compliance exercise. … So you almost need to take companies back to thinking about the principles – why it is that they are engaging in these initiatives.'

[2] http://www.unep.org/resourceefficiency/Business/SustainableandResponsibleBusiness/Reporting/FriendsofParagraph47/tabid/105011/Default.aspx

[3] http://www.bmfbovespa.com.br/novo-valor/en-us/news/2012/Fifty-more-companies-publish-sustainability-reports-or-explain-why-not-20121217.asp?titulo=Report%20or%20Explain

Relationships with stakeholders

Many of the stock exchanges interviewed were active in providing guidance and training on sustainability issues, to both companies and investors, as well as acting as a forum for discussion and the sharing of information. The development of their relationships with key stakeholders was emphasised as one of the important aspects of their sustainability initiatives.

An example of such relationship-building is the creation of guidance by stock exchanges. This includes the BM&FBovespa's '*In Good Company*' guidance documents, the NYSE's workshops and partnership with the CDP, and the EGX's sessions with companies to inform and encourage disclosure. The NASDAQ exchange offers outreach programmes, including webinars, papers and one-to-one communication. The NASDAQ interviewee said:

'We think it's something that our companies need to know, and we have this unique relationship as the exchange to interact with thousands of global companies.'

The JSE says that its index criteria, which are publicly available, can be used by any organisation. They are aware of some (particularly smaller) companies who use it as a guiding framework, which may position companies well for reporting against the Global Reporting Initiative or Integrated Reporting frameworks in the future.

Relationships with companies

Many stock exchanges interviewed emphasised the strength of their relationships with companies on sustainability issues. In South Africa, the JSE created its initial sustainability index in part in response to company requests for sustainability guidance. The reasons for these requests were described by the interviewee from the JSE:

'I think it was probably a confluence of a number of factors. I think the South African environment is a strong factor – the more recent history of our democracy, and that companies have had to deal with sustainability issues … We've certainly seen … investors are willing to pay a premium for companies that have good corporate governance standards. We've also seen in South Africa that investors or analysts now routinely include black economic empowerment figures into their valuation models and that's something that companies get engaged on quite significantly … Coupled with the fact that a lot of the sectors in South Africa are labour and environmentally high impact … Companies started noticing increased focus from an investor perspective … there was a lot of confusion about what were the right things to be doing, and how do we demonstrate to our shareholders that we are looking at the right things in the right way. And I think it was just that understanding within the particular time and within the particular environment that really made them approach the JSE with the idea.'

The JSE also commented on what happened once the initiative had begun:

'The Companies certainly bought into the initiative right off the bat. A lot of them certainly understand and leverage the great reputational benefit that comes from being on the SRI index.'

Other stock exchanges also emphasised the engagement of particular companies with ESG issues; these companies engaged with the exchange, sought information and suggested expansion of ESG indices to cover emerging issues.

The view of the exchanges is that those companies leading the field on ESG issues, and those actively seeking to enter ESG indices, are those that engage most closely with exchanges. This fosters a positive relationship. As the NYSE stated:

'The way we approach it is as a carrot rather than a stick, and we do everything we can to help. So the companies that we hear from are those that want the help, who are happy to take advantage of it, so it's all very positive.'

Although many exchanges experience enthusiastic responses from companies, there were also challenges. For example, companies may have difficulty paying the costs of regulatory compliance, or may be reluctant to add to those costs. According to the JSE, South African companies 'increasingly want to know "what's the value add?" and "why are we going to all of this effort?"' The BM&FBovespa exchange highlighted the importance of the exchange engaging with the Investor Relations department or the CFO/Financial Director within companies when trying to encourage increased ESG performance, 'because it's a business thing'.

The exchanges also see themselves as playing a role in facilitating communication between companies, and between companies and investors. The NYSE, for example, has coined the term 'collaborative responsibility' for programmes to help companies share best practice on ESG issues, including a recent veterans hiring initiative. The BVC discussed the power of opening dialogue on materiality between companies, and between companies and investors, in order to find a common language and to bring them closer together.

For those companies that engage with ESG issues in a meaningful way, sustainability indices provide a good window onto their achievements. In one of the interviews, the subject mentioned that they find companies appreciative of the engagement opportunities that result from the sustainability index; companies have described it as enhancing their investor relations, as they find it useful to engage investors in discussions about their ESG performance.

Relationships with investors

Most of the stock exchanges interviewed emphasised the importance of engagement with the responsible investment community. Groups mentioned included Principles for Responsible Investment signatories, pension funds and major institutional investors.

In South Africa, the Government Employees Pension Fund (GEPF) has played a big role in the responsible investment debate since 2006. When the King III Code was released in 2009 the GEPF worked with the South African Institute of Directors to develop the Code for Responsible Investment in South Africa. This provides a guide on engagement, how to carry out proxy voting and similar practical information.

In some countries the government has significant ownership stakes in some of the larger listed companies. As one exchange explained:

'Through their ownership they also have high expectations on the reporting and the compliance on such issues within these companies, which is also then impacting the whole financial market, I would say, with regards to the focus on such issues.'

The number of investors taking sustainability issues into account has expanded rapidly in recent years. Specialist investors, as well as some other investors who focus on long-term returns, engage with ESG issues and are key stakeholders for stock exchanges. However, responsible investment has not yet become the mainstream. In the experience of the JSE:

'At the time when we started the index there was very little investor interest, mainly from niche investors who are focused on sustainability investing particularly. That has changed quite a lot over the last few years … But it still remains quite a challenge to get the mainstream investment community to understand the purpose of such an index.'

The BVC stated that, '[c]apital markets find the issues disconnected. While they may be aware of the issue, they are unable to implement measures to understand/incorporate the information'. However, the BVC has found itself in a good position to engage financial institutions and intermediaries on the issues.

The BM&FBovespa has also been active in sharing information with investors, particularly through federations and associations, who have 'the power to talk to their associates, to talk with industry.' It has been most challenging to engage analysts:

'[W]e have good discussions with the Association of Analysts in Brazil, … they are quite open and engaged with us, but the analysts themselves are a very specific category that deals with metrics, and we do not have metrics for ESG … at this time.'

As mentioned earlier, one of the recommendations of this paper is that exchanges develop engagement with investors in order to more clearly understand the information investors want on company sustainability. Stock exchanges can then use this to inform the sustainability initiatives that they develop, as well as the products and services that they provide.

Working with other stock exchanges

A number of the exchanges had good relationships with other exchanges around sustainability issues: sharing information, guidance and technical expertise, and discussing future strategies. According to the exchanges, this sharing of information has been crucial to the development of sustainability initiatives.

One initiative that was mentioned several times by those interviewed was the Sustainable Stock Exchanges initiative (SSE) (co-organized by the United Nations Global Compact Office, the United Nations Conference on Trade and Development, the United Nations-supported Principles for Responsible Investment and the United Nations Environment Programme Finance Initiative), which this year grew to 8 exchanges, representing over 13,000 listed companies. The JSE described the SSE initiative as an 'exciting opportunity to share experiences and also to get access to research that one might not otherwise be able to do on your own.'

Responsible investment initiatives are also developing within the World Federation of Exchanges, which widens the discussion to those exchanges that are not yet active in enacting sustainability initiatives.

A key area of potential collaboration is the work taking place around a possible global ESG stock exchange standard. This presents major challenges, but is seen by some interviewees as an opportunity to collaborate, share best practice and act in concert. As a participant in this process NASDAQ is aware of the challenges:

'It's going to be very difficult to come up with a universal standard. Every stock exchange had localised rules, localised customs, localised regulatory bodies in some cases. Whatever standard we come up with that manages to span the globe is going to have to be extremely adaptable to each exchange's particular needs.'

Many of the exchanges interviewed also described important direct relationships and information sharing with other exchanges or groups of exchanges. The NYSE described this:

'One of the nice things about this issue, is it's an area where the exchanges really can, and increasingly are, collaborating around finding the right answers … It's an area where there's great *potential* for collaboration: I'm not sure it's all been realised yet.'

Relationships with civil society

Most of the stock exchanges interviewed also have close working relationships with civil society representatives. These relationships offer an opportunity to share expertise on sustainability with international and local bodies, NGOs supporting sustainability and responsible investment, and academia.

Stock exchanges globally have partnered with the UN-supported Principles for Responsible Investment, Global Reporting Initiative, CDP, the various Social Investment Forums, the UN Environment Programme, the UN Global Compact, the Sustainable Accounting Standards Board, and a host of organisations and bodies within the countries in which they operate. These relationships are in some cases closely integrated into the operating structure of the exchange, forming part of advisory boards or other institutional structures.

When the NYSE described its partnerships with non-profits, the interviewee said:

'Their goals are to increase the number of companies reporting, and we try to help with that effort by reaching out to all of our companies, and making all of these tools and services and events available to all of our companies, so I think we are reaching out broadly across the community.'

According to the BVC, NGOs 'can play an observer role but also an active role' to hold the exchange to account. The JSE said that NGOs have come to realise that investors are a 'very important lever for them to engage to influence corporate behaviour – a more effective tool perhaps than some of the tools they have used in the past.'

There are also some close relationships between exchanges and academic institutions, which can have an important role in partnering on research and developing knowledge.

Some of the stock exchanges interviewed also discussed fostering relationships with the public, through inviting feedback on exchange initiatives, inviting representatives on panels to discuss future approaches, and running financial education courses. In some ways the involvement of exchanges in sustainability issues supports their licence to operate.

The representative from the BM&FBovespa said that part of the motivation for providing financial education programmes is to 'make capital markets more popular' after the economic crises of recent decades.

One exchange that works closely with civil society stated:

'[These have] not been easy conversations, because I think civil society sometimes … have broader expectations than what the exchanges can deliver. For example, it is not our role to verify or police legal compliance, because that legislation is not something that falls within our jurisdiction, but we can facilitate engagement or incorporate non-compliance into our assessment of the companies.'

Insights and opportunities

A valuable outcome from the interviews was the insights that the exchanges provided to other exchanges that are considering developing sustainability initiatives. These included advice on the benefits of getting senior management buy-in, the improvements seen in company performance and the exciting opportunities opening up around research demonstrating a link between good ESG performance and long-term financial performance. The exchanges were also the source of a number of practical recommendations for other exchanges.

Leadership within the exchange

Most of the stock exchanges interviewed emphasised that strong leadership on sustainability issues within the stock exchange from the CEO and board is pivotal to the success of those initiatives. Undertaking a commitment to the principles of sustainability, to the establishment of a relevant team and to a budget for sustainability initiatives, has a big impact on the success of implementation.

A commitment across the exchange has also been important. For example, at the NYSE it was a deliberate decision to have a small ESG team, because they wanted to avoid the team being 'the responsibility of those people over there - we felt that it was something that should be integrated throughout the company.'

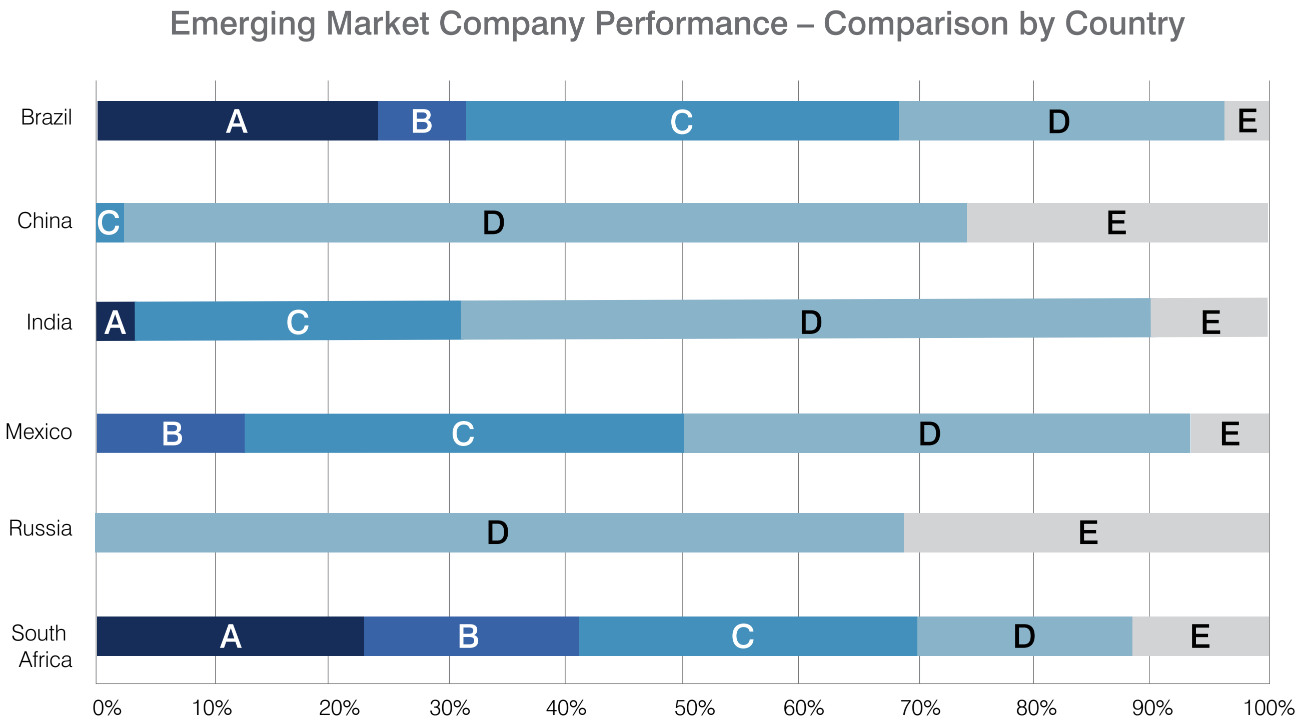
Improvements in company performance

Sustainability initiatives can not only measure the performance of companies on ESG, but also improve performance on ESG. This can be either through setting a bar that companies seek to reach, or through incremental increases in the requirements for companies.

The BM&FBovespa interviewee stated that there was no doubt that the index influenced company performance. For example, before the launch of their Carbon Efficiency index in 2010, 70% of the largest 50 companies in Brazil didn't report emissions, but by 2013 70% were reporting this information.

Measuring performance is identified by the exchanges as an important first step, for 'we do not manage what we do not measure'. One of the exchanges said that their indices have significantly impacted the ways in which companies report, stating that, 'even smaller companies have said to us that it really impacted the way they report, and it's helped them to perform their internal risk management in a more holistic and integrated manner.'

Case Study: ESG Performance of Emerging Market Companies



Percentages of companies rated with a particular grade by EIRIS' Global Sustainability Ratings

EIRIS research on emerging markets supports the view that those companies from countries with stock exchanges that have implemented significant sustainability initiatives do better when rated on their ESG performance.

In an analysis of the performance of the largest 300 emerging market companies against EIRIS' Global Sustainability Ratings there was a markedly strong performance from both South African and Brazilian companies. The EIRIS' Global Sustainability Ratings product grades companies from A to E using a range of ESG indicators, with A being the best and E being the worst.

The graph above is based on data extracted from the EIRIS database in October 2013. The graph shows that Brazil and South Africa have a good proportion of companies attaining high grades, with India and Mexico also showing some good performance, but weaker performance in China and Russia.

Using this measurement we can see a strong correlation between those markets with stock exchanges that have pioneered sustainability indices and strong corporate ESG performance. An analysis of changes over time, as more sustainability indices are created, will provide further data.

Link between corporate financial and ESG performance

One of the most interesting areas of research currently taking place is around the positive financial impacts for companies that do a good job of addressing their ESG risks. There is increasing evidence to support the view that in addition to any desire to implement sustainability for its broader benefits, there is also a long-term payoff in the future financial success of a company. For example, the work carried out by Dr Andreas Hoepner and fellow academics[4] using data from EIRIS over more than a five year period, finds a strong correlation between corporates highly rated by EIRIS on environmental criteria and a reduction in worst-case-scenario risk and volatility.

There is a hypothesis that those companies that effectively address their ESG risks will be better equipped to weather adverse events and changes in regulation; these companies should be less likely to breach major international norms and therefore should be less exposed to crises or reputational risk.

The exchanges interviewed by EIRIS were cautiously optimistic about the outcome of these research themes. The NASDAQ representative stated:

'I think that they [investors] are starting to recognise the financial argument – there have been lots of studies from Harvard, there was a Deloitte paper a couple of years ago, there's been lots of proof out there that companies that manage this well return better results in the market, so they should certainly be attractive investment targets. So I think that's starting to be commonplace, but I wish it could happen faster, and with a bit more rigour.'

One of the other exchanges similarly asserted that more evidence needs to be collected to analyse the extent to which there is a link with financial performance:

'This is not something that we have embarked on as yet. We felt that an index like this needs to be running for a number of years in order to be able to do modelling on it to be able to draw proper conclusions.'

Studies carried out by the exchanges have given a tantalising suggestion that a link to financial performance can be demonstrated. BM&FBovespa's publication '*The Value of ISE*' has compiled evidence suggesting that companies within the BM&FBovespa ISE sustainability index have a market value 10% greater than other companies and higher than other companies in the same sector. BM&FBovespa's publication also suggests that there is an abnormal return in the two-day window around the portfolio announcement, which may be due to the expectation that the company will join the portfolio and gain market valuation as a result of ISE membership. BM&FBovespa summarised this:

'Now we can say that there is a financial return, and we can prove it from the share value of the companies that are part of the portfolio.'

Over the next few years it is anticipated that more data will become available, due to the greater number of sustainability indices running for a number of years and other sources of information about long-term corporate performance on sustainability. The exchanges are keen to see increasing evidence of the strong, long-term, positive financial performance trends associated with companies adopting sustainability policies and practices.

Further evidence to support this link with financial performance would be a very powerful tool to mobilise company performance and investor commitment, thereby helping to promulgate sustainable investment and initiatives into the mainstream. The commitment of exchanges to the sustainability agenda will play an important role in generating further evidence to support such a link.

Given the significant positive impact that research linking ESG performance and long-term financial performance could have upon highlighting the value of sustainability initiatives to both investors and companies, it is important that exchanges continue to develop research in this area and that they share the results with one another and the wider investment community.

[4] http://www.eiris.org/blog/are-top-environmental-performers-better-able-to-weather-future-financial-storms/

Recommendations from stock exchanges

The stock exchanges interviewed by EIRIS were asked to make key recommendations to other stock exchanges that are attempting to implement sustainability initiatives. Below is a selection of these recommendations:

- One exchange said that they see their role as a facilitator and a supporting channel. Exchanges must generate trust and credibility in the market and support it. They also said that for decisions in this area to be credible, decisions must come from the top of an organisation.

- According to BM&FBovespa, '[s]ustainability is a reality. Our recommendation to the exchange is to see sustainability this way – this is a new model that we need to create' and also, '[t]o be very good at communication – because if you are talking about a new world, it's necessary, it's mandatory to explain very well what kind of world we are talking about … Communication is crucial to advance the agenda'.

- The BSE encouraged exchanges to '[s]tart with the best, top companies, because they have resources, they are investing, they have international presence. Once it is given to top companies then it will come to the other companies … Other companies are inspired to come to that league … Rather than forcing all companies at one stroke.'

- The NASDAQ gave this advice: 'Join the SSE, commit to the UN Global Compact, participate in GRI and CDP reporting, encourage your listed companies, vendors, and partners to do likewise. In short, leverage your platform to educate everyone you touch about the business virtues and economic returns of sustainability.'

- According to the NYSE: 'I think it's very context specific. I think it's a very different thing to implement some of these efforts in one country versus another country, so there is definitely a need to take the context into account. But I think it's understanding what is it that your companies need that could help them in their sustainability journey, and how can you be a catalyst for them and a helper to them, as they move forward in this, because that's an effective way to advance the field more broadly.' The NYSE also felt that providing a public celebration of those doing good work is important, in order that best practice is shared.

- The JSE pointed out that this project '[r]equires quite a comprehensive approach to consultation making sure that you consult very broadly amongst the people who would be interested in and affected by what you want to do.'

Conclusion

By giving a voice to stock exchanges themselves, this paper is novel in its approach. The paper provides insights from stock exchanges on their reasons for involvement in sustainability initiatives and their experiences from the implementation of such initiatives.

The exchanges interviewed by EIRIS represent a wide variety of organisations, both in their global location, size and progress to date in implementing sustainability initiatives. However, a common thread between them all is their strong commitment to sustainability, due to a belief that improved company performance on ESG issues benefits companies, investors and society as a whole.

Those stock exchanges that have managed to implement sustainability initiatives are to be highly commended. EIRIS sees great value and potential in the further development of existing initiatives and the encouragement of new initiatives in order to support long-term global sustainability.

There are a number of challenges that stock exchanges face, including securing wider investor buy-in, convincing companies that it is in their best interests to engage with ESG issues and gaining the support that exchanges need from government and regulators. However, as the exchanges in this paper have demonstrated, these are not insurmountable.

Hearing from the stock exchanges themselves empowers stakeholders with an understanding of how best to interact with, support and encourage stock exchanges' sustainability initiatives globally. Stock exchanges can reflect on the perspectives of their peers, the similarities of experience and the opportunities for innovation and collaboration in the future.

EIRIS' reponse to the insights given by stock exchanges is to recommend the following actions to help them realise effective sustainability initiatives:

- engage with companies and investors around the long-term benefits of driving better company performance on ESG issues, both for the benefit of these groups and for society as a whole
- engage with investors, particularly those from the mainstream, in order to identify the sustainability-focused products and services that exchanges can offer which would be of most value to investors
- explore ways of working together to overcome the challenges stock exchanges face (for example, regional co-operation by smaller exchanges)
- work with an established data provider, such as EIRIS, to help exchanges to develop, launch and grow sustainable indices, from defining criteria and collecting data, to engaging with companies and investors
- work with national regulators to develop ESG-related listing rules, preferably on a 'comply or explain' basis
- continue to share information, best practice, research, etc. with other exchanges through forums such as the Sustainable Stock Exchanges Initiative or the World Federation of Exchanges
- encourage companies to provide audited ESG data
- draw on the latest research to support the link between long-term financial performance and ESG issues
- engage with civil society and other stakeholders in the development of sustainability index objectives and criteria

About EIRIS

EIRIS is a leading global provider of independent research into the environmental, social and governance (ESG) and ethical performance of companies. With 30 years' experience of conducting research and promoting responsible investment strategies, EIRIS now provides services to over 200 clients globally. EIRIS is the partner of choice for a number of stock exchanges around the world, including the Johannesburg Stock Exchange, the Bolsa Mexicana de Valores and the Borsa Istanbul. We provide data and analysis services to help stock exchanges develop, launch and grow sustainable indices, from defining criteria and collecting data, to developing and implementing index rules, and engaging with companies and the investment community. EIRIS offers bespoke solutions to suit the local market and to help achieve an exchange's goals, and has extensive experience of developing local partnerships to enhance the data analysis process. EIRIS has a multinational team around 60 staff in London, together with teams in Boston, Washington, D.C., Paris and Gothenburg. Additionally EIRIS has a global platform of research partners which includes research organisations in Australia, Germany, Israel, Mexico, South Africa, Spain and South Korea.

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