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Materiality in Corporate Governance: The Statement of Significant Audiences and Materiality

by Robert G. Eccles and Tim Youmans, Harvard Business School*

Many if not most directors view their primary fiduciary duty as serving the interest of shareholders, a view that is widely believed to be required by law. Given the prevalence of this “shareholder primacy” doctrine, directors often find it difficult to propose or support significant investment of corporate capital or other resources in their non-investor stakeholders, such as their employees, their local communities, or “the planet.” As we will argue in this paper, law does not prevent the directors of value-maximizing companies from recognizing the significance of stakeholders beyond shareholders and their contributions to long-run corporate competitiveness and value.

Corporate stakeholder initiatives and investments are an important focus of a growing set of corporate disclosure practices known as “integrated reporting.” In the recent book, The Integrated Reporting Movement: Meaning, Momentum, Motives and Materiality, we define an integrated report as one that combines information from traditional, financially-oriented annual reports with the “material” parts of the corporate sustainability reports that the largest companies in most developed nations have been producing for at least the past decade. By “material,” we mean information about those stakeholder issues that, when managed effectively, represent a significant contribution to company value or that, if mismanaged, could lead to a significant loss of value and opportunities to create or preserve future value. Given the potential effects of such stakeholder considerations on value, we believe strongly that the arguments about materiality and significant audiences presented in this paper are as relevant for “Form 10-K” and “Form 20-F” reporting as for integrated reporting.

This paper’s main points about director fiduciary duty and materiality in corporate governance apply to all forms of corporate reporting, traditional as well as integrated, in all countries. However, for many boards, this is likely a new way of thinking. With the aim of helping boards in this new realm of accounting for the value created (or lost) through the consideration of stakeholder issues, we have structured this paper in four parts. We begin by reviewing the concept of director fiduciary duty, as it is understood not only in the U.S. but in a global context. In the second part, we review the relevance of materiality in corporate governance. In the third section, we present our “audience-focused” approach for determining the materiality of issues relevant to the company’s many different stakeholders. In part four, we propose the new idea of an annual “Statement of Significant Audiences and Materiality” to be issued by corporate boards. As we envision it, such a statement would provide a clear identification of the investor and non-investor audiences whose issues will affect the ability of the company to create value and the time frames the board uses to evaluate the impact of its decisions on these audiences. We believe that this can be done in a single page.

Director Fiduciary Duty

The objective of the “going concern” corporation, as a separate and potentially immortal legal entity, is simply to survive and, if possible, to thrive.

A prevailing ideology across the globe is that the fiduciary duty of directors requires that they place primacy on shareholders’ interests. But what about the law? What obligations and constraints does it put on corporate managers and boards to put shareholders first?

The answer, it turns out, is almost none. According to the law of virtually all nations with publicly listed corporations that have been examined to date, shareholders are construed as the owners not of companies nor of corporate assets, but rather of a set of freely tradable rights—rights that entitle them to vote, receive dividends or other distributions, and to claim the “residual value” of corporate assets. And this means, contrary to the popular view, that shareholders are not in fact “the owners” of public companies. The responsibility of ownership—that is, with common import for traditional, integrated, and sustainability reporting.

1. By U.S. Securities and Exchange Commission Rules, U.S. listed domestic companies must submit annual reports on Form 10-K, and foreign companies listed on U.S. exchanges must submit annual reports on Form 20-F.

2. It is this general sense that describes the difference between Chapter 5 of The Integrated Reporting Movement: Meaning, Momentum, Motives and Materiality and this paper. While Chapter 5 looked at materiality and governance in the context of integrated reporting, this paper is focused on materiality in the context of corporate governance.

* Much of the material presented in this paper has been adapted and updated from Chapter 5 of Robert Eccles’ recent book, The Integrated Reporting Movement: Meaning, Momentum, Motives and Materiality. Tim Youmans, the co-author of this paper, was a significant contributor to Chapters 5 and 6, as well as other chapters.

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overseeing and ensuring the efficient management of the corporation’s assets—is entrusted to the board of directors, a trust that is commonly referred to as “fiduciary duty.” Shareholder value is in large part the outcome of directors’ decision-making and the execution of their commitment to making investments in developing and maintaining all of their corporation’s critical capabilities (which are often referred to as “capitals”) and investments in the corporate stakeholders who are essential to enabling companies to make commercial use of those capitals.

In sum, shareholders and other providers of financial capital are but one important audience among several that companies need to invest in and engage with. As the corporation mobilizes financial, manufactured, intellectual, human, social and relationship, and natural capital, each form of capital has one or more audience.

Moreover, the potential immortality of the corporation implies, both in a legal and an economic sense, that future generations are also stakeholders. Considering all possible combinations of issues and stakeholders, in terms of both nonfinancial (e.g., environmental, social, and governance, or “ESG”) and financial performance over the future as well as near-term time frames, would appear to make directors’ fiduciary task nearly impossible, given limited corporate resources and competencies. Recognizing these limitations, directors must make choices about which audiences are significant, and which are not. This choice of “significant audiences,” which will in turn determine which issues are “material,” is critical to the ability of the corporation to sustain itself over a self-defined period of time.

With the aim of building resistance to the natural tendency toward excessive focus on short-term financial performance, we suggest that directors, when determining which of their audiences are significant (and whose concerns are therefore “material”), devote more of their time to prioritizing the companies’ relationships with their most important stakeholders—with the implication that a broader range of issues will be considered over a longer time horizon. To the extent that a commitment to shareholder primacy has been widely perceived as a legal requirement, directors have by and large failed to give adequate consideration to the full array of potentially significant audiences in their oversight of strategy, investments, and reporting.

Research is now being conducted with the goal of establishing a composite global legal framework that allows directors to consider the universe of stakeholders in their materiality determination process. Over the past 21 months, we have gathered legal memos provided by leading law firms in 32 countries, including all of the G20 countries, about the fiduciary duty of board directors in their respective jurisdictions. The template for these memos was developed in collaboration with Linklaters, a renowned global law firm. (See Appendix I for more detail on this research.)

The main finding of this research to date is that, in every jurisdiction across the world without exception, the board of director’s primary duty is to the corporation itself as a separate legal entity. The concept of “corporate personhood,” separate and apart from shareholders as well as other providers of capital and other stakeholders, appears to be universal and underlies both the limited liability of shareholders of public corporations and the liquidity of freely tradable shareholder rights (i.e., “shares”). In some jurisdictions, most notably the United States, there is “dual primacy” in the sense that directors’ duty to the separate corporate entity has equal co-primary legal standing with directors’ duty to shareholders. In no jurisdiction, however, is a director’s duty to shareholders construed as a higher duty than the duty to the corporate entity. What’s more, in some jurisdictions such as Brazil, the current legal duty of directors to the corporate entity requires consideration of a full range of potential stakeholders, including employees, customers, and NGOs representing various interests of civil society.

**The Relevance of Materiality in Corporate Governance**

Materiality, in its essence, is entity-specific. Whether the interests and issues of a certain stakeholder audience are material will vary from company to company, depending on sector, strategy, business model, and the time frame under consideration. As a consequence, materiality determination must ultimately reflect the judgment of the board of directors. The board’s guiding principle in determining whether a given stakeholder group is “significant” should be economy of director focus and information. Boards that have the courage to, for example, limit reporting to only material information are sending their investors and other key stakeholders the

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5. “In other words, once again beyond legal requirements, the interests of others, including human rights, derive from those of the corporations’ shareholders. So the argument for shareholder value has been profoundly influential in shaping the laws and conventions that govern the conduct of our corporations. So elegant is the argument that I will employ it in coming to the exact opposite conclusion (pp. 31-32).” Shareholder value is an outcome not an objective. It should not drive corporate policy but be treated as a product of it. (p.261)” See Colin Mayer, “Firm Commitment: Why the Corporation is Failing Us and How to Restore Trust in It,” 2013. See also Lynn Stout, “The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public,” 2012.


7. “The Brazilian Corporate Law also provides for a requirement to satisfy the “public at large” and the “social role” of the company. Our view is that such concepts could be construed as to encompass not only a duty to the company itself (and its shareholders) but also to non-shareholders that could be impacted by the company’s activities, such as, for example, the company’s employees, third parties with business relationship with the company, the community in which the company’s activities are carried out, the environment and the society in general. See Mattos Filho Advogados, “Legal Perspective on an Annual Board Statement of Significant Audiences and Materiality,” October 2014, p.2, on the American Bar Association Sustainable Development Task Force: Duty of Board Directors web site, http://www.americanbar.org/content/dam/aba/administrative/environment_energy_resources/brasil_legal_memo.authcheckdam.pdf.
message that the board has the ability to exercise this judgment—in other words, to govern.

Indeed, determining materiality could well be described as the essence of directors’ fiduciary duty as overseers of the management of the corporation. A recent statement by the International Integrated Reporting Council (IIRC) makes this point when it says that the act of defining materiality “emphasizes the involvement of senior management and those charged with governance in the materiality determination process in order for the organization to determine how best to disclose its unique value creation story in a meaningful and transparent way.” We go farther than the IIRC and argue that the responsibility for making this determination ultimately lies with the board and that, in order to fulfill its primary fiduciary responsibility to the sustainability of the corporation, it must make this determination. But before prescribing a more specific role for the board and proposing new board tasks in the annual reporting cycle, we think it’s useful to recall the basic role of boards as actors in the social construction of materiality.

In one of the most important business books of all time, The Modern Corporation and Private Property, Adolf Berle and Gardiner Means identified three broad privileges granted to corporations by the State:

1. The ability to limit liability, or socialize losses, while privatizing profits, thus attracting risk capital.
2. The ability of corporations to own other corporations, allowing for concentration of control that is disproportionate to share of risk capital.
3. The separation of ownership rights from control rights, enabling freely tradable shares.

Berle and Means went on to say that “The property owner who invests in a modern corporation so far surrenders his wealth to those in control of the corporation that he has exchanged the position of independent owner for one in which he may become merely a recipient of the wages of capital... [Such owners] have surrendered the right that the corporation should be operated in their sole interest.” Because society has granted corporations these special privileges, corporations can and should be thought of as having a civic, if not a moral, duty to think not only of profits, but also of the good of society. This underpins the duty of corporations not only to “perform,” but also to “report” to society, including reporting on all short-, medium-, and long-term value creation initiatives related to their significant non-investor stakeholders.

The duty of a corporation to take society’s interest into account in exchange for these special privileges is held in trust by the board of directors. Through a privilege granted by majority of its stock, various legal devices have been developed. Of these, the most important among the very large companies is the device of “pyramiding.” This involves the owning of a majority of the stock of one corporation which in turn holds a majority of the stock of another—a process which can be repeated a number of times. An interest equal to slightly more than a quarter or an eighth or a sixteenth or an even smaller proportion of the ultimate property to be controlled is by this method legally entrenched.” Berle and Means, The Modern Corporation, p. 69.

14. “The separation of ownership from management and control in the corporate system has performed this essential step in securing liquidity. It is the management and “control” which is now wedded to the physical property. The owner has no direct personal relation to it and no responsibility toward it. The management is more or less permanent, directing the physical property which remains intact while the participation privileges of ownership are split into innumerable parts—shares of stock—which glide from hand to hand as a “token”, irresponsible and impersonal... Most striking of all, a liquid token acquires a value purely and simply because of its liquidity.” Berle and Means, The Modern Corporation, pp. 250-251.

15. Lynn Stout (The Shareholder Value Myth, 2012) describes that the foundation of the “profit maximizing,” thus stakeholder minimizing, corporate governance is the self-disproving view of social interaction symbolized by “Homo economicus”: “Let us see how our friend Homo economicus stacks up against the list (of clinical sociopathic behaviors). Lack of remorse (item 7)? Obviously: why would Homo economicus feel bad just because he hurt or misled another, if he advanced his own material welfare? Irresponsibility and reckless disregard for the safety of others (items 5 and 6)? Homo economicus feels responsible only when he cares about, no one else but himself. Irresponsibility (item 8)? Homo economicus is happy to lie at any time to serve his interests. Failure to conform to social norms with respect to lawful behaviors (item 1)? Whenever and wherever the police aren’t around describes Homo economicus. Although Homo economicus is neither cranky nor impulsive—items 3 and 4—he has five of the seven characteristics on the list. Unburdened by ploy or remorse, he will lie, cheat, steal, neglect duties, break promises—even murder—if a cold calculation of the likely consequences leads him to conclude that he will be better off. Like any sociopath, Homo economicus lacks a conscience.” It is clear that most modern corporate board members are not Homo economicus, and it is within the norms of the modern corporate social construct to recoup back to society, beyond pure profit making. See Lynn A. Stout, “Taking conscience seriously.” Moral Markets: The Critical Role of Values in the Economy, Princeton University Press, Princeton, 2007: 157-172.
society, a corporation arrives at its own legal identity separate from its shareholders, directors, managers, employees, and other stakeholders. Along with this legal standing, to the extent that it succeeds in satisfying the legal “claims” of all these stakeholders, public corporations have the capacity to survive many generations.

In his book *Firm Commitment*, Professor Colin Mayer of Oxford University notes that the corporation’s current decisions could have an impact long after the tenure of its current management has expired and that, as a consequence, the board is the appropriate trustee of the firm’s intergenerational commitment. This implies that director judgment must be informed by a keen sense of the social context within which the corporation is operating, further informing the board’s oversight of the management team’s formulation and implementation of the company’s strategy. It also implies that the board is responsible for taking a long-term view and for ensuring that management reflects that view in its decision-making.

As part of executing board approved strategy, management may undertake an involved stakeholder engagement process that attempts to strengthen its ties to all corporate constituencies. However, it is the board’s responsibility—and indeed an important part of carrying out its fiduciary duty—to make the ultimate decision about what issues are material to corporate strategy.

**Audience-Focused Materiality Determination**

Although materiality forms the conceptual bedrock of corporate reporting, there is no authoritative definition of it. In “Securities Regulation,” Louis Loss points out that the legal field offers no specific definition of the word. Court opinions on materiality have done little more than sketch its conceptual contours. As in cases involving fraud, for all U.S. legal cases in which the concept of materiality has played a relevant role, the courts have opined that materiality must be decided on a case-by-case basis. The U.S. Supreme Court has also asserted that this determination must be based on both qualitative and quantitative factors based on the “total mix” of information made available.

Further complicating the “total mix” standard set by the Supreme Court for evaluating potentially material omissions or misstatements, the Court has left open the issue of “circularity” in its definition of materiality. Finally, adding to the difficulty of the work of corporate decision makers, the courts have also made clear that materiality must be determined with complete clarity. That is to say, these opinions do not allow for “degrees” of materiality. A fact is either material, in which case it must be reported, or is not material, in which case it need not be reported.

Such materiality assessments must be made by the board and senior management of the corporation itself. Since investors have no voice in a company’s materiality determination process other than through lawsuits (the rulings of which produce only more “guidance” instead of specific thresholds), it is management’s, and ultimately the board’s, responsibility to ascertain what information “reasonable investors” would want to know. In the end, materiality is determined by the corporation, and it is entity-specific.

Since there is no easy rule to follow in determining materiality, companies making the ultimate decision on
which issues are material for reporting purposes should use a clearly defined process with solid lines of responsibility. Because materiality is a firm-specific social construct, it poses certain challenges for corporate reporting. As every board and management team protects a unique brand, what the corporation symbolizes for society is unique to each company. This means that each firm can define its own materiality threshold within the boundaries of accepted and evolving standards. In “Westphalian” terms, materiality for the firm becomes materiality for its significant audiences.

The role of non-investor stakeholder “audiences” in long-run corporate value creation begs the question: To whom is the firm reporting? And in the context of materiality for corporate reporting, one must ask, “Who does the board address when it determines which issues are material, and which issues are not?” Although providers of financial capital are clearly a significant audience, other audiences also exert influence on the firm’s identification of material issues. Various stakeholders wield varying degrees of influence on the providers of capital and the firm itself, and the implications of that influence are often too great to ignore. Consequently, when the firm decides what information is material, it must, for its own good, take into account the perspectives of stakeholders beyond those who provide financial capital.

The Integrated Reporting (<IR>) Framework presents in its section on “Materiality” the following four-step process for determining what information is material:

1. Identifying relevant matters based on their ability to affect value creation;
2. Evaluating the importance of relevant matters in terms of their known or potential effect on value creation;
3. Prioritizing the matters based on their relative importance;
4. Determining the information to disclose about material matters.

We suggest a modification of the above process that includes the following preliminary step: “Identify audiences relevant to the corporation, their interests (including where they conflict), and the relative weight attached to each.” Our recommended preliminary step is rarely carried out with any degree of rigor for two reasons. The first is the prevailing ideology that the fiduciary duty of directors requires them to place primacy on shareholders’ interests. Second, many companies address broad stakeholder interests through general statements like “We are committed to delivering excellent returns for our shareholders and we firmly believe that addressing stakeholders’ interests further enables us to do so.” If this sounds “nice” or is consistent with emerging rhetoric in support of the “business case for sustainability reporting,” it also ignores the difficult trade-offs that must often be made between shareholders and other stakeholders, particularly in the short term. Moreover, there are not only trade-offs—and thus potential conflicts—between providers of financial capital and other audiences, but also conflicts between the providers of different kinds of capital (debt vs. equity), and even between different sustainability advocates (for example, those focused on environmental protection vs. those focused on a social issue like income inequality).

The Statement of Significant Audiences and Materiality
Determining the relative importance of different providers of financial capital and of other audiences is ultimately a responsibility of the board. What does this mean in practice?

We have proposed that the board issue each year a one-page forward-looking “Statement of Significant Audiences and Materiality (The Statement).” Such a statement would aim to inform management, providers of financial capital, and all other stakeholders the board believes to be critical to the long-run profitability and survival of the corporation. More specifically, such a statement would communicate the board’s intent to invest resources and management attention in all significant audiences along with the time frames over which they are expected to materialize. In so doing, the board is communicating both its view of the role of that corporation in society, and the financial and nonfinancial (e.g., environmental, social, and governance) foundation for the company’s corporate reporting.

Although management can play a significant role in preparing The Statement, it is ultimately a statement by the board, much like the annual financial audit. While management is deeply involved in the audit—in U.S. companies, for example, the CEO and CFO must personally sign off on the adequacy of a company’s internal control systems—it is the Audit Committee of the board that chooses and engages the audit firm and signs off on the scope of the audit. The Statement, like the audited financial statement, is ultimately a responsibility of the board—not management.
When issuing The Statement, the board must make judgments—tough judgments, since it cannot claim that all audiences are significant. Just saying “We will create value for our shareholders by meeting the needs of all of our stakeholders” is not a credible statement; it is puffery and greenwashing. A corporation, no matter how large, has limited resources and has to set priorities in terms of how resources are allocated. Take, for example, a company that chooses to cut its R&D expenses just to meet its quarterly earnings target. In making such a decision, management could implicitly be making one of its stakeholders—likely short-term shareholders—a more significant audience than either employees or long-term shareholders, who may well benefit from this research. Or the same company might take a very different approach, such as cutting dividends to avoid shortsighted R&D cutbacks or “downsizing.” Short-term shareholders may not like this decision, but long-term investors (such as pension funds or bondholders) might applaud it.

The Statement should also be clear about the time frames in which the corporation evaluates the impact of its decisions on its significant audiences. This could be as specific as saying that The Statement covers a three-year time horizon. Or it can be as general as the board simply stating that they are focused on the long term.

In its March 2015 Annual Report, the Swedish industrial products company Atlas Copco published the first “Statement of Materiality and Significant Audiences” issued by a board of directors. Atlas Copco’s Statement begins by noting that it is governed by the Swedish Companies Act (2005:551). The Statement then goes on to say,

... Atlas Copco recognizes going beyond this, extending it to integrating sustainability into its business, creates long-term value for all stakeholders, which is ultimately in the best in the best interest of the company, the shareholders and society. The significant stakeholder audience, as outlined in the Atlas Copco Business Code of Practice, includes representatives of society, employees, customers, business partners, and shareholders.

The positive effects of increases in employee morale and efficiency might take as long as five years to show up in financial statements. And a five-year horizon is, of course, very different than a one-year horizon. Again, the board, entrusted with the interest of the corporate entity, has the right—and indeed the responsibility—to determine this time horizon. It also needs to be clear with the investment community—and with all its other significant audiences—about the time frames that are relevant for such stakeholder investments.

In sum, it is the right of the corporation to make these judgments and it is the responsibility of the board to do so. The Statement is the basis for an open and honest conversation between the corporation and all of its stakeholders. What is important is that The Statement clearly communicates the board’s view of the company’s priorities by identifying the limited number audiences which it regards as significant and, by implication, those which are not. This way, the company’s shareholders (of all kinds and classes), bondholders, and its many other audiences can make their own resource allocation decisions in terms of the extent to which they will commit themselves to contributing to the success of the corporation.

Exercising the judgment needed to make such a determination requires board discipline, a willingness to be transparent, and an acceptance of the fact that audiences not deemed significant are likely to object. They will want to challenge the corporation on this judgment, and the corporation has an obligation to respond to such challenges by making clear the limits of its support for such “important but not significant” audiences, and the reason for such limits. But the board doesn’t have an obligation to change its mind in response to challenges from “important but not significant” audiences. Clearly there are other audiences that are important to varying degrees, and the issues they care about, however socially significant, may not be material to the company. The company should continue to report on these issues in its sustainability report. But the material issues based on the chosen significant audiences and timeframes belong in the annual financial, or integrated, report.

Conclusion

Recent research provides persuasive evidence of a latent investor appetite for the reporting of material ESG information that goes beyond conventional financial statements. The Statement of Significant Audiences and Materiality proposed in this paper can serve as a means for meeting the demand by this audience for value-relevant, nonfinancial information. According to a 2014 survey by EY titled “Tomorrow’s Investment Rules,” institutional investors want a clearer view of what is material, and they want it directly from the company. “Materiality,” as the survey’s authors conclude:

31. Ibid.
32. For information on a new tool that corporations may use to help the evaluation of audience significance, see Chapter 6, “The Sustainable Value Matrix” in: Eccles, et al.
The Integrated Reporting Movement: Meaning, Momentum, Motives and Materiality.

Robert G. Eccles is a Professor of Management Practice at Harvard Business School and non-executive Chairman of Arabesque Partners and Tim Youmans is a Researcher at Harvard Business School and Research Director for the Strategic Investor Initiative at CECP. They are research collaborators and global experts in materiality. They can be reached at tyoumans@hbs.edu and reccles@hbs.edu.

Appendix I – Global Legal Research: The Duty of Board Directors

We have argued that the board’s primary duty is to the interests of the corporation as a separate legal entity, rather than maximizing shareholder value, as is widely believed. While the board can choose to deem shareholders as the only significant audience, it does not have to do so. The board must simply decide which audiences are most significant for the ability of the corporation to create value over the short, medium, and long term. Once the board has done so, it has laid the foundation of the materiality determination process for corporate reporting.

Unlike most academic papers, this one doesn’t simply end in a call for further research, although we certainly plan to do that. Rather, this paper is one element of an action-initiative called “The Statement of Significant Audiences and Materiality Campaign (The Statement Campaign)” whose aim is to ensure that the ideas in this paper get translated into practice. The Statement Campaign is articulated in a post titled in the “Big Ideas: Sustainability” section of the MIT Sloan Management Review website. After conducting considerable research into the concept of director fiduciary duty with respect to significant audiences… our preliminary findings are “without exception, that the board directors’ primary duty is to the corporation itself as a separate legal person.”

We are conducting this ongoing research project jointly with The American Bar Association’s Sustainable Development Task Force (Task Force) and with support from and in coordination with the UN Global Compact. Other steps in this campaign include mobilizing investors to ask company boards to issue The Statement and finding companies who will lead in doing so.

This research has produced database of legal memos from 32 countries on director fiduciary duty, which are freely available to all on the Task Force web site, which will also contain new country memos as they are added, as well as updates of existing memos will continue to be updated as more country memos are added and existing ones updated. It is our hope that this global collection of legal memos on director fiduciary duty will become a resource for other researchers, advisors, investors, board members, executives, regulators, and other stakeholders, sparking a global discourse on the role of the corporation in society.

These legal memos lend themselves to much deeper analysis and we welcome others to do so. Among many areas for research that may arise from The Statement Campaign we see immediate research opportunities in four specific areas:

1. Variations in the extent to which country laws require directors take account of other stakeholders’ interests,
2. Differences in civil vs. common law jurisdictions,
3. Differences in developed vs. developing countries, and
4. Digging deeper into “dual primacy.”

The goal of the Statement Campaign, further propelled by complementary and, frankly, by opposing, research, is that by 2025 the board of directors of every listed company will be issuing an annual Statement of Significant Audiences and Materiality. Given the growing demand for improved corporate accountability to audiences other than shareholders, the Statement is the starting point for a company to do so.
