GUBERNA
INSTITUUT VOOR BESTUURDERS
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European initiatives on
Sustainable Corporate Governance and Corporate Due Diligence

Reflection note

Introduction – setting the scene

Last year, the EU Commission launched an initiative on Directors' Duties and Sustainable Corporate Governance[1]. It started with the publication of a controversial study by EY, followed by a public consultation on the 'Proposal for an Initiative on Sustainable Corporate Governance'. This proposal was not a standalone action, but is part of a wider drive of the Commission's actions on sustainability, such as the European Green Deal, the Action Plan for Financing Sustainable Growth etc.

In parallel, the Commission launched the Corporate Due Diligence and Corporate Accountability Initiative, and it was announced by Commissioner for Justice Didier Reynders that in 2021 the Commission would take legislative steps on mandatory due diligence for companies. These elements were also taken into account in the above-mentioned public consultation which was closed in February 2021.

More recently, on 10 March 2021, the European Parliament adopted a legislative own-initiative report on Corporate Due Diligence and Corporate Accountability with recommendations to the Commission[2]. This text sheds a new light on the ongoing discussion because it includes both elements of their own sustainability report and of the due diligence initiative. This EP report comes ahead of the Commission's proposal for a directive.

As a knowledge and member institute, GUBERNA closely follows up the EU developments in this matter. Through its involvement in ecoDa, GUBERNA is able to have a voice in the European scenery. In particular, GUBERNA contributed in both ecoDa's responses to the report on due diligence as well as in the public consultation on sustainable governance and participated in several webinars dedicated to this topic.

On the national level, GUBERNA has called upon its Board of Directors, the Academic Council and its Alumni to prepare a response to the public consultation on sustainable governance as well. Moreover, the theme is thoroughly underpinned in a paper by Prof. dr. Eddy Wymeersch, Chairman of the Academic Council while 'sustainability' is a recurring theme in GUBERNA's

[1] This initiative aims to improve the EU regulatory framework on company law and corporate governance. It would enable companies to focus on long-term sustainable value creation rather than short-term benefits. It aims to better align the interests of companies, their shareholders, managers, stakeholders and society. It would help companies to better manage sustainability-related matters in their own operations and value chains as regards social and human rights, climate change, environment, etc.

[2] https://www.europarl.europa.eu/doceo/document/TA-9-2021-0073_EN.html

member events, training programmes and press articles. Finally, the topic is high on the agenda of the Commission Corporate Governance, of which GUBERNA is a member.

As part of GUBERNA's advocacy role, GUBERNA wants to feed the debate and inform its members on its point of view. The objective of this note is twofold. First, it wants to elaborate on key issues that were raised by the initial proposal on sustainable corporate governance of the European Commission ('looking back') and secondly, it wants to provide some 'food for thought' regarding the legislative path that the European Parliament and Commission are taking in this matter ('looking forward')
Responsible Business Conduct - a Look at Upcoming Initiatives, webinar 15 March 2021

1. European Commission's proposal on sustainable corporate governance

The proposal by the European Commission, as issued in 2020, stipulates for largest EU companies an obligation to include 'sustainability' into their decision making and action mechanisms.

The Belgian public opinion and the Belgian industry recognise and share the preoccupations with respect to the need to increase the efforts needed for making our world better, meeting the needs of the population in terms of their health and well-being, and ensure the long-term viability of the planet. Some measures call for urgent action, others call for more in-depth changes on the longer term, after having studied all alternatives.

GUBERNA supports the idea that (listed) companies should contribute to the realisation of sustainability objectives, whether in their decision making or in their industrial or commercial action. It mirrors the adherence to the principle of sustainable value creation, as laid down in the Belgian Corporate Governance Code ('Code 2020').

At a later stage the reflection might usefully be extended to other sources of detrimental environmental behaviour, emanating from local communities, public authorities, not-for-profit organisation and small companies. These entities are already quite aware of the need to contribute to a healthy environment, but their proactive implementation still deserves further attention.

1.1. Mapping sustainability compliant companies

The Commission focuses its attention on the companies whose shares are listed. These are in general the most important economic entities which have the greatest impact on the environment, but have also already started the most ambitious projects to remedy to it. European companies in particular have consistently contributed to the sustainability action: of the worlds' 100 most sustainable companies, 24 were European, 12 from the Nordics, 22 from the US.

Especially in the environmental field, financing of nature related projects has been immensely successful, commonly referred to as green bonds, green funds, green shares, etc. and have attracted important amounts of investment money. ESG is a common criterion for recommending green investments.

Probably the financial sector (banks, insurers, pension funds) is leading the way as much attention is being paid to the ESG features of investments or of products sold to investors: these are based on financial statements of the companies, established according to public guidelines and discussed with the bank's competent department, or the supervisors. The supervisory authorities support ESG and have adopted measures against greenwashing.

Rankings and indices are simple tools to demonstrate that large companies in various sectors are increasingly embracing sustainable business practices, while ESG becomes a common denominator for investors and other stakeholders.

1.2. Demystifying the lack of sustainability funding

According to the Commission, European companies have not invested sufficiently in sustainability projects. This statement is based on the limited amounts of their profits being earmarked for these projects, but are rather reserved for dividends for shareholders, remuneration for directors and top executives. This allegation, which has found its origin in controversial American literature, is related to the dispersed ownership structure of US companies, as this would explain their spending propensity.

The assertion – which is referred to as "short-termism" - is not based on the facts. Firstly, European companies have a concentrated ownership structure, in which a higher percentage of the shares (above 50%, in same states over 80%) are held by families, or by a limited number of jointly active partners. These shareholders use their dividends and other benefits from the companies to reinvest in the company or in other ventures in which they are involved. Secondly, they are also strongly involved in the companies' boards and in their management, of which they are the proud representatives. Put differently, board composition commonly includes the presence of significant shareholders which introduce a more long-term perspective in company policies.

In sum, the short-termism thesis is not confirmed by EU companies' practices and has been strongly denied by leading American writers as well. Consequently, it should not be further developed.

1.3. Voice to long-term stakeholders.

The proposal also contains a plea for more involvement of long-term stakeholders in company management: these are employees, creditors, clients and other parties exposed to the company's action. The importance of giving voice to the long-term stakeholders is not up for discussion, but surprisingly the proposal does not pay much attention to the existing structures, involving employees in company affairs, whether under the form of co-determination or as members of the mandatory work's council.

For the input of other stakeholders, companies have developed different forms of interaction: advisory committees, consultations on their products, dialogue with user or consumer associations, user committees, their composition and functioning being adapted to the specific needs. In parts of the financial sector, user committees are mandatory by regulation (CSDs).

This overview illustrates that in practice, the position of different categories of stakeholders can be more widely considered, albeit through other forms than institutional representation.

1.4. Identified paths for actions and reforms

On the basis of the widespread agreement that action has to be undertaken, the Commission has tabled schemes for reforming the present system which will be discussed in the following paragraphs.

1.4.1. Path of voluntary actions

One path to reduce the negative impact of the evolution on sustainability focuses on voluntary actions by the companies, as due to pressure exercised by local pressure groups, NGOs and other actors, companies may be aware that their inaction would damage their reputation. It is striking that quite a few companies have engaged in this path. Probably, more moral and social pressure, sense of responsibility, increased risk of negative publicity, market reactions and similar developments may help. But the outcome remains purely voluntary.

Another voluntary path is company related, whereby several lines may be followed. Internally, company boards are increasingly aware of their responsibility in their business. It is a matter of internal organisation to identify the issues which may call for attention. This could in some cases be the task of the risk committee, or of a specialised team. Boards could become more vigilant of the gravity of the situation and the possible consequences e.g. in terms of liability.

1.4.2. Path of national regulatory actions

National authorities could define by law the subjects for action under the sustainability label, first in their own jurisdictions, further in the countries where companies under their jurisdictions are active. They would exercise pressure on their own companies or nationals to correct the situation, if needed by using legal means (regulation, taxation etc.) The rule would take the form of a national obligation, applicable to all companies, or to the largest ones.

Depending on the issues involved, local politics would play an important role. Some recent (French) cases seem to point into that direction.

1.4.3. Path of an EU directive

The Commission also identified a path which would remedy the possible inaction of the boards, by declaring the board – and not the company – in charge of dealing with sustainability issues. This requirement would be laid down in a directive. Its objective would be achieved by introducing sustainability considerations in the company's purpose and strategy, requiring sustainability expertise for board members and management, whose remuneration should also be linked to this factor, appointing a value officer, comparable to the risk officer, and involving internal and external stakeholders.

1.5. Interim statement on the identified paths

Obviously, each path has its proponents and opponents. In particular, the path of a directive has been widely criticised by national company's associations, not in the least in the Nordic countries. Nevertheless, the tendency within the European Commission has so far pointed into the direction of a legislative initiative. This is once reinforced by the recent action of the European Parliament although with a due diligence oriented scope (see infra). Before discussing this recent initiative of the European Parliament, GUBERNA would like to underline some challenges regarding the initial path of a EU directive on 'sustainable corporate governance'.

Firstly, a preliminary but indispensable step would consist of clearly defining the objectives: the proposal did not provide an adequate definition of what is to be understood by sustainability as a subject of regulation, and the number of definitions are endless. Besides, there was no clear reference to the EU taxonomy regulation which establishes six environmental objectives. As a consequence, a too wide or too narrow range of possible fields of action are being discussed: such as for example the severe issues of human rights in developing countries, the massive flooding and extreme droughts in several parts of the world, or the Brexit related transport disturbances. Several of these issues relate to non-EU countries and have clear political features. It can be argued that a regulation could only define the general objectives. Defining "sustainability" objectives for an individual company will very much depend on the specific circumstances with which this company is confronted. Put differently, definition and boundaries of concrete sustainability objectives and projects will depend on each company's specific individual position. This means that the relevant sustainability challenges will be very diverse and limited and will differ depending on core company related factors, such as: the company's field of activity, its individual geographical location, its physical and social environment, its business sector, its range of products, its production methods, and so on.

Secondly, the final outcome of such a directive could be a considerable reversal in the priorities of companies, as running the business in a perspective of long-term continuity would be partly absorbed by sustainability objectives, the nature and financial implications of which are still not well known, especially in some climate transition sensitive sectors. This will require new developments in terms of monitoring ongoing developments, engaging the necessary expertise, interaction with other interested parties, and striving to meet the objectives and criteria put forward in the sustainability plan as submitted to the competent authorities. Directly confronted with the issues to be remedied, the company is best placed to make the choices, the more so as it will support the financial risks and will be responsible for the follow-up.

Thirdly, the directive rules will have to be transposed in national law, where they will become regular company law, with all aspects attached, in terms of enforcement in court, civil liability, effects on remuneration, general meeting, reporting, risk of box ticking etc.

Finally, the national supervisory bodies would be confronted with difficulties to verify the relevant disclosures. National supervisory bodies would have to adapt their supervisory methodology to deal with this new type of disclosures.

In this context, GUBERNA put forward an alternative formula and proposes to focus on the enlargement of the company "purpose" – now part of Belgian company law, in the sense that companies, while striving for value creation for their owners and investors, will have a responsibility for the wider environment in which they function, while deciding for themselves how they contribute to these objectives, their priorities in and the financial means affected to them.

Legally, the further interpretation/implementation of the company purpose takes the form of a reference in the corporate governance codes, as a part of the board's duty to pursue sustainable value creation, and follow a similar comply and explain path. Disclosure on the project and on the efforts made should be made public in the annual reports as "integrated reporting", already practiced, measured in terms of KPIs, and financially assessed by the statutory auditors. The enforcement of this regime would largely be put in the hands of the investors and other stakeholders, which today also assess the governance mechanisms.
As far as the shareholders are concerned, this could moreover be shaped as a "say on purpose" mechanism comparable to the "say on pay" vote.

2. **Regulatory initiative by the European Parliament**

On 10 March 2021, the European Parliament moved forward by issuing a text on [Corporate Due Diligence and Corporate Accountability][3]. This proposal reflects a radical change in the developments so far. Striking observations are the following:

[3] https://www.europarl.europa.eu/doceo/document/TA-9-2021-0073_EN.html

- No longer mention of sustainability, governance (relating to the public sector, not to companies, although not clearly defined) is one of the three objectives of due diligence standards to become compulsory, along with human rights and environment.
- Wider scope: The directive rules are addressed to large undertakings (not only companies), their subsidiaries and their value chains. These include listed entities, small and medium sized and high-risk undertakings.
- Focus on "value chains" as defined would include relations with providers of goods and services, and is a technique to extend the directive rules all over the world. Value chains refer to activities of an undertaking with direct or indirect business relations, up- or downstream. But they have to affect the internal market in which "selling goods or services" takes place. There has to be a commercial relation between the EU firm and these foreign providers and or sub-contractors.
- Active role for stakeholders, esp. unions.
- Supervisory regime at national level: national competent authorities with wide powers, there seems to be little room for some sort of self-regulation.
- Strengthened national enforcement including fines, exclusion, liability.

To continue to nourish the debate in a constructive way, GUBERNA will further follow up on the Sustainable Corporate Governance Initiative and will assess more in detail the governance related elements of the Due Diligence Initiative.

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