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ALERT MEMORANDUM

European Commission Consults On Sustainable Corporate Governance

December 3, 2020

On October 26, 2020, the European Commission launched a public consultation on a possible EU-level regulatory initiative dedicated to sustainable corporate governance. The consultation is open to a wide range of possible stakeholders incorporated or having activities in the EU until February 8, 2021.

The initiative is proposed further to Action 10 of the European Union's 2018 Action Plan on sustainable finance, and stems from the essential premise that sustainability should be embedded into corporate governance so that companies focus on long-term objectives and contribute to a more shock-resilient economy.

The proposal – which is expected to crystalize into a directive – aims to encourage companies to take into account the environmental, social and broader economic impact of their decisions rather than short-term benefits. The consultation touches on topics such as directors' duties and accountability, board remuneration, board composition, and stakeholder involvement.

This alert memorandum explores some of the possible regulatory implications of this initiative and the ways in which it might affect the day-to-day business and internal policies of companies registered or listed in Europe in the near future.

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I. Background

A. Framework initiatives

In March 2018, the European Commission published its landmark "Action Plan for financing sustainable growth".[1] As mentioned, Action 10 ("Corporate governance and undue capital market short-termism") focused on the realisation that, despite the efforts made by several European companies, market pressure on financial performance alone forcibly shortened the overall corporate decision-making time horizon. As a result, opportunities and risks stemming from medium and longer-term environmental and social considerations were found to be often disregarded, and companies unnecessarily exposed to sustainability risks.

Corporate governance has since been the object of several follow-on initiatives by European institutions. Among them, sustainable corporate governance was featured as a key regulatory driver in both the 2019 European Green Deal[2] and (all the more) the post-COVID-19 Next Generation EU recovery plan.[3] Furthermore, the topic was listed among the deliverables of the EU's "Action Plan on a Circular Economy"[4], the "Biodiversity"[5] and "Farm to Fork"[6] strategies and the 2020 "Renewed Strategy on Financing Sustainable Growth.".[7] According to the Commission's plans, EU action in the area of sustainable corporate governance will complement the objectives of the upcoming Action Plan for the implementation of the European Pillar of Social Rights.

Lastly, the initiative is also complementary to the ongoing review of the Non-Financial Reporting Directive (NFRD), which requires certain large public-interest companies to disclose sustainability-related matters to the public as part of their annual reports. A consultation was held between February and May 2020, with the review now scheduled to be completed in the spring of 2021.[8]

B. Preparatory work

The public consultation is an important first step toward the drafting of a more fulsome European regulation in the field of sustainable corporate governance. It is based on a series of dedicated studies undertaken by the competent European delegated institutions.

In the fourth quarter of 2019, in response to a call for advice of the Commission, each of the three European Supervisory Authorities published a report on undue short-term pressure on corporations from the financial sector within their respective areas of oversight.[9]

The Commission also carried out two studies of its own. In February 2020, a first report addressed the findings of its study on due diligence requirements throughout the corporate supply chain.[10]

In July 2020, the Commission published the results of its second study on corporate directors' duties and sustainable corporate governance.[11] According to this study, data suggests that: (i) many European (particularly, listed) companies are under growing short-term financial pressure from investors and lack a strategic perspective over sustainability risks, (ii) current board remuneration structures and directors' expertise pose clear challenges to sustainability across

1 The Action Plan is accessible here.
2 The European Green Deal is accessible here.
3 Next Generation EU is accessible here.
4 The Circular Economy Action Plan is accessible here.
5 The EU's Biodiversity strategy is accessible here.
6 The EU's Farm to Fork strategy is accessible here.
7 The Renewed Strategy is accessible here. The feedback received by the Commission in the context of the Renewed Strategy's public consultation (in the spring of 2020) is a particularly important contributor to the current, more targeted, consultation.
8 The NFRD consultation results are accessible here.
9 The resulting reports of ESMA, the EBA and EIOPA are respectively accessible here, here and here.
10 The Commission's preparatory study on due diligence requirements throughout the supply chain is accessible here. The survey generated more than 600 responses, with results showing broad support for a policy change from all stakeholder groups. For more information on the topic of European supply due diligence regulation you can also access Cleary Gottlieb's dedicated alert memorandum, available here.
11 The Commission's preparatory study on corporate directors' duties and sustainable corporate governance is accessible here.

industry sectors,[12] (iii) stakeholder input in companies' decision making is largely insufficient to cover interests other than those of company shareholders and (iv) company interest and directors duties are interpreted narrowly so as to disproportionately favour the maximisation of short-term financial value and shareholder return. By contrast, recent studies (including dedicated research related to the COVID-19 crisis[13]) were found to show that companies performing well on sustainability criteria tended to outperform their peers and be more competitive and resilient in difficult times.

Together, the two studies served as basis for a preliminary "Inception Impact Assessment" laying down the Commission's preliminary objectives, basis for regulatory intervention and expected regulatory impact.[14] As per the applicable institutional procedures, the Assessment was open for public feedback between July 30 and October 8, 2020.

C. Current initiative roadmap

The current consultation is the outcome of this first phase. Stakeholder views on the Commission's working document may be submitted until February 8, 2021.[15]

A proposal for a directive will likely follow and is currently planned for the second quarter of 2021.[16]

II. The Commission's ongoing sustainable corporate governance consultation

A. Stated reform objectives

Based on the Commission's corporate governance study, short-term financial motives find their root causes in market practices and regulatory frameworks. Against the study's findings, the consultation paper spells out three specific objectives for future intervention:

1) strengthening the role of management boards in pursuing companies' long-term interests, by dispelling current misconceptions in relation to directors' duties causing them to prioritise short-term financial performance over long-term corporate interest;
2) improving directors' accountability towards integrating sustainability into corporate strategy and decision-making; and
3) promoting corporate governance practices that contribute to company sustainability by addressing relevant unfavourable practices (such as in the area of board remuneration, board composition and stakeholder involvement).

B. Other possible takeaways

1. Scope

The initial scope of sustainability regulation (notably, the currently applicable version of the NFRD, as approved in 2014) has tended to focus exclusively on certain European public interest companies – large listed companies and large banks and insurance firms. The potential enlargement of the NFRD's scope of application is one of the aspects that are currently under consideration by EU regulators.

More recently, the Sustainable Finance Disclosure Regulation that has entered into force this year has focused on financial market participants (*i.e.,* those proposing financial products or financial advice), in an effort to target not by size, but by industry. In practice, however, financial firms' obligations to disclose

[12] Significantly, it was found that between 1992 and 2018, the ratio of total shareholder pay-outs (*i.e.*, dividend payments and share buybacks) to corporate net income for listed European companies increased from 20% to 60%. Simultaneously, business investment (in terms of the ratio of capital expenditure and research and development spending to net income) declined by 45% and 38% respectively. Over the last two decades, these indicators seem to have stabilized around high levels of pay-outs and low investment intensity.

[13] Among these, those accessible here and here.

[14] Accessible here.

[15] Answers to the consultation questionnaire may be submitted here.

[16] This initiative is listed in the Commission's Work Program for 2021. The project's overall roadmap is accessible here.

information on their investees will indirectly imply deep scrutiny on companies operating across all industries, and to some extent regardless of size.

At least to a certain degree, the latter approach is likely to be applied with respect to corporate governance sustainability rules. In fact, the consultation paper attempts to frame contributors by size (and considers in particular whether to exclude all SMEs, or micro-enterprises only), in an attempt to diversify feedback and consider also the views of companies that have not been directly targeted so far by any of the abovementioned sustainability regulations.

The same degree of outreach is extended to respondents not necessarily incorporated, but also carrying out their business, within the EU.

2. Benefits pursued

Respondents are surveyed in relation to a range of possible benefits that should be pursued by the new rules. The spectrum includes:

- requiring that companies become aware of any adverse human rights, social and environmental impacts of their business, and any related risks;
- requiring companies to effectively contribute to a more sustainable development, including in non-EU countries;
- simply levelling the playing field within the EU (*i.e.,* avoiding that some companies free-ride on the sustainability related efforts of others);
- increasing legal certainty about how companies should tackle their impacts;
- harmonising EU rules to avoid fragmentation within the single market and emerging national ESG laws; and
- giving SMEs a better chance to be part of EU supply chains.

3. Drawbacks considered

Potential draw-backs to which the Commission would, on the other hand, appear to be sensitive include:

- increased administrative costs and procedural burdens;
- penalisation of smaller companies with fewer resources;
- the creation of a competitive disadvantage vis-à-vis third country companies not subject to similar duties;
- the risk of responsibility for damages that EU companies cannot themselves control;
- decreased or insufficient attention to core corporate activities;
- difficulty in finding suitable suppliers (which may cause lock-in effects and have negative impact on suppliers' own business performance); and
- disengagement from risky markets (which might be detrimental for local economies).

4. Corporate due diligence

The content of any potential corporate due diligence duties is graduated along the following possible approaches:

a. a "principles based approach", requiring general due diligence duty based only on certain key process requirements (*e.g.,* identification and assessment of risks, evaluation of the operations and of the supply chain, risk and impact mitigation actions, alert mechanism, evaluation of the effectiveness of measures, grievance mechanism);

b. a "minimum process and definitions approach", whereby regulations would define a minimum set of requirements applicable across all sectors, and provide harmonised definitions (for example as regards the coverage of adverse impacts that should be the subject of the due diligence obligation);

c. a minimum process and definitions approach (as presented under (b) above) complemented with further requirements in particular for environmental issues (likely aligned with international treaties such as the Paris Agreement);

d. a "sector-specific approach" with dedicated supply due diligence requirements set for key sectors only; and/or

e. a "thematic approach," focusing on specific sustainability aspects (*e.g.,* child labour, employee rights, diversity).

5. **Governance**

In surveying on possible corporate mechanisms more adaptable to sustainability regulation, the Commission asks for respondents' opinions as to whether discussion should rest within advisory bodies, general stakeholder meetings, or be entrusted to dedicated complaint procedures.

6. **Directors' duty of care**

Directors are required to act at all times in the "interest of the company" but that notion is not clearly defined in most EU jurisdictions and narrowly interpreted, focusing primarily on shareholders' financial interests. As far as potential scope of directors' duties, the Commission distinguished between several stakeholders, *i.e.,* shareholders, employees, employees further down the company's supply chain, communities affected by a company's operations, communities affected by a company's supply chain, society and the environment.

The temporal scope of companies' forward looking assessments is also investigated (respondents are asked whether companies should be looking at consequences beyond a three- to five-year time horizon).

7. **Directors' remuneration**

The following options are explored with respect to directors' remuneration, to depart from current practices which often promote short-term financial objectives only:

- restricting executives' ability to sell any shares they receive as pay for a certain period;
- setting a maximum percentage of share-based remuneration;
- limiting possible types of variable remuneration of directors (*e.g.,* only shares but not share options);
- requiring the inclusion of sustainability metrics (including in particular carbon emission targets) in variable remuneration policies;
- altogether mandating that a certain proportion of variable remuneration be linked to non-financial performance criteria;
- requiring that companies take into account workforce remuneration and the related policies when setting directors' remuneration.

8. **Directors' professional requirements**

With respect to mandatory professional competences, respondents are asked whether these should alternatively affect directors' selection and nomination processes, be grounded in minimum board composition requirements, or mandatory training obligations.

9. **Share buy-backs**

Respondents are finally asked whether the Commission should, in their view, take further regulatory action – that is, in addition to Regulation 596/2014 on market abuse (MAR) and Directive 77/1991 (second company law Directive) – with respect to corporate share buy-backs limitations.

III. Conclusion

The deadline for sending contributions will expire on February 8, 2021. The Commission is seeking to hear from a broad range of stakeholders on these issues, including businesses and their directors, groups impacted by such businesses' operations and their global value chains (including employees, consumers, investors and local communities), as well as investors, environmental organisations, trade unions, NGOs, public authorities, international organisations and responsible business-standard setters and assurance providers.

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