Brussels, the 29th of January 2021

Subject: Comment letter to ecoDa's Response to the EC Consultation on Sustainable Corporate Governance

Dear Ms. Salla Saastamoinen, acting Director-General,

Dear Ms. Maija Laurila, Head of Unit, A.3 Company law,

ecoDa agrees on the overarching goal of the European Commission to promote sustainable value creation by companies. As a general statement, we welcome all the remarkable work done by the European Commission and the leadership role it plays at the international level to promote sustainable finance and fair competition. The Action Plan on Sustainable Finance has already materialized through important legislative pieces which reinforce the trends observed recently. The engagement of financial actors is creating systemic changes. All these texts, whether they deal with taxonomy or institutional investors' and asset managers' duties, are ultimately impacting company strategy and the operating methods of boards of directors.

Most large investors now emphasize sustainability and there is a huge demand for investment possibilities where sustainability is embedded in the company strategy. This is reflected also in the strong development of share prices among companies building up sustainable operations.

As for remuneration, the use of non-financial criteria, in particular sustainability criteria, has increased rapidly. Besides, it should be noted that in spring 2021 European listed companies will issue remuneration reports for the first time according to the amendments of the shareholders rights directive and this will serve as evidence.

As for stakeholder dialogue, companies have significantly increase their contact with both their shareholders and their relevant stakeholders and in particular Employees Representatives and this development is moving on very visibly.

ecoDa asbl Avenue des Arts 41, 1040 Brussels Tel: +32 498 50 26 87 www.ecoda.org contact@ecoda.org

As a result, companies are currently experiencing a significant transition due to climate change and new values. This transition is happening now and often much faster than legislative changes.

The European Commission announced in Action 10 of its Plan on financing sustainable growth its desire to strengthen directors' duties towards long-term strategic thinking and to promote due diligence throughout the supply chain.

In order to do so, the ambition of the Commission is to legislate on the role of directors *vis-à-vis* stakeholders and on boards' composition, underlying the need for expertise on ESG matters.

For ecoDa, there has never been any doubt that to adequately discharge their duty of care of the company directors need to take a broader range of stakeholder interests into account than only those of the shareholders. In addition, the need for expertise on ESG subjects is becoming a necessity since companies have to respond to the growing demands of not only investors but also rating agencies, insurance companies, banks and obviously the civil society.

However hard law intervention in corporate governance contributing to diffuse and unlimited director liability is likely to have detrimental consequences on the growth ambitions and competitiveness of European companies.

Across Europe, national legislation and/or case law deal with directors' duties and make it clear that they are owed to the company and not to the shareholders. This has a direct impact on directors' liability. Additionally, several Member States have provided for possible forms of companies aiming at other purposes than the sharing of profit. Enhancing such existing legislations could have been achieved through the more flexible tool of a recommendation.

If the Commission intends to go further and to legislate, ecoDa would like to highlight the following points of attention and possible pitfalls:

I- Preliminary points:

1.1. Reference to Sustainable Corporate Governance : ecoDa questions the denomination of « Sustainable Corporate Governance ». Corporate governance is a perennial concept in itself but which is however constantly evolving. ecoDa would prefer to refer to Corporate Governance for sustainable companies.

1.2. Rationale for action : The European Commission should not base its initiative on the EY report[1] insofar as it does not describe the reality on the ground and conveys false

[1]https://op.europa.eu/en/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-en

assumptions (as largely expressed by the academic and business communities)[2]. The European Commission should collect data on European companies as a more reliable base for action and consider other surveys like the European Investment Bank on investments in sustainability issues.

ecoDa would like to emphasize the following points:

- The concepts of Short-termism and Long-termism are treated in the questionnaire and in the study of reference in a way that appears oversimplified and, as a minimum, incomplete. These concepts are fundamental in the line of reasoning that is presented in the questionnaire and they must be considered rigorously. Otherwise, the conclusions derived can be wrong and potentially damaging to the very objective of promoting sustainability and broader corporate responsibilities.
  - The questionnaire implicitly and sometimes, explicitly seems to associate short-termism with the interest of shareholders. The study used as reference, tries to assess the increase of short-termism by measuring the evolution of the relative shares of retained earnings and distribution to shareholders. The underlying reasoning appears to be that "Distributing profits to shareholders is Short-term and therefore, bad. Retaining earnings in the company is Long-term and therefore, good". Conversely, long-termism appears as aligned with the general "interests of stakeholders" without any specific definition of these interests, let alone any metrics associated with whether or not companies are responding to them.
  - This line of reasoning is incomplete with significant flaws. It ignores some basic questions:
    - What determines if a corporate decision is Short or Long-term oriented is not necessarily the nature of the decision but the nature of the criteria used to make the decision. A decision to distribute profits to shareholders can respond to genuine Long-term considerations depending on the specific situation and perspectives of a company. At the risk of stating the obvious, distributed profits mainly serve to recycle funds in the economy and finance companies with better prospects long term, thereby contributing to overall sustainability.
    - The interests of some stakeholders can be absolutely Short-term depending on the circumstances (Some examples are well known like the demand for salary increases that sometimes could be seen in labour negotiations or the attitude of some communities regarding investments in their areas), especially in pre-election periods.
    - This incomplete view of what is Short vs Long-term creates a bias that permeates the questionnaire and might damage its

[2] See ecoDa's response to the EC Impact assessment on Sustainable Corporate Governance. See also the academic repudiation of the report by the European Corporate Governance Institute,

objectivity. It is a fundamental question and it would be important to make efforts to clarify it in Europe and everywhere.

International academic literature has identified excesses of both short and long-termism depending on cycles, the situation of the company, etc.[3]

ecoDa would also like to highlight the conclusions drawn in ESMA Report on Undue short-term pressure on corporations: « *It observes that the Commission's non-binding guidelines on reporting climate-related information state that the definition of short-, medium- and long-term is likely to depend on the company's business model and the life cycle of its assets and liabilities. As regards the suggestion to develop criteria on what constitutes undue short-termism, ESMA has not found sufficiently robust evidence to recommend that such an exercise be undertaken* »[4].

1.3. Questionable wording : The contents and tone of the Questionnaire and of the studies on which it is based, raise some issues about its underlying rationale and equilibrium. Some conclusions whose validity could be questionable are taken as points of departure and some questions are phrased in a way that limits the choices in answering and invites "questioning the question". An illustrative example appears in Question 8: ("Do you believe that corporate directors should balance the interests of all stakeholders, instead of focusing on the short-term financial interests of shareholders, and that this should be clarified in legislation as part of directors' duty of care?"). The way this question is phrased assumes that the "balanced interest of all stakeholders" is the opposite of "short term financial interests of shareholders", which is far from generally true. Hence it is a leading question that cannot be answered without accepting this false contradiction and « questioning the question ».

II- Points addressed in the EC consultation:

2.1. Duty of care: ecoDa questions the advisability of modifying the notion of duty of care through imprecise considerations which risk creating confusion. The more details the duty of care would entail, the greater the risk to create loopholes in terms of all aspects of it which are not mentioned will be. ecoDa strongly encourages the Commission to refer to the conclusions of a report it commissioned from the London School of Economics in 2013 on Directors' Duties and Liability[5]. The report clearly stated that:

- *« In almost all countries, directors' duties are codified.*

[3] D. Denis *Is Managerial Myopia a Persistent Governance Problem?* 2019
[4] ESMA Report on Undue short-term pressure on corporations, p.100 par. 312-313.
[5]https://eprints.lse.ac.uk/50438/1/__Libfile_repository_Content_Gerner-Beuerle,%20C_Study%20on%20directors%E2%80%99%20duties%20and%20liability(lsero).pdf

- *<u>Directors' duties are owed primarily to the company, i.e. to the legal entity and not to its shareholders</u>. This basic principle is universally accepted and undisputed. However, in exceptional circumstances duties may be owed directly to shareholders, creditors, or other stakeholders.*
- *All jurisdictions rely to varying degrees on case law to define and amplify directors' duties. Notwithstanding a country's regular approach, the analysis suggests that the law in most legal systems is elastic enough to allow the courts to derive solutions for novel conflicts that are not addressed by the statute.*
- *Most jurisdictions recognise that directors may become risk averse if the liability risk faced by them is too high, thus forgoing investment opportunities with a positive net present value in favour of less risky alternatives ».*

2.2. Stakeholders' interests: What is referred to as "the interests of stakeholders" is not a clear homogeneous concept but a complex combination of potentially conflicting interests that have to be dealt with in making decisions. The directors must remain in control of their decisions and report them to the market. The European Commission may stimulate board members to engage better with their relevant stakeholders. However, it should be up to board members to define which stakeholders make sense for their business model and how to integrate their interests during their decision-making, as long as they report on their decisions and disclose the chosen engagement methodology. Giving multiple and contradictory objectives is the best way to create agency conflicts, it allows the agent to act in his/her own interest by arguing for the protection of a specific category of stakeholders.
There is a great risk of diluting the energy of the directors in endless lawsuits where each stakeholder who feels aggrieved by a decision could take legal action. The European Commission should think twice before changing the accountability rules. Such provisions would clearly lead to the creation of risk-averse companies in Europe.

2.3. Corporate Purpose: Some Member States are encouraging companies to state their corporate purpose beyond the specification of the technical or sectoral areas in which the companies exercise their activity, as can generally be mandatorily written in their bylaws, and aside the possibility to form companies specifically pursuing other goals than the sharing of profit. The European Commission could consider following the same path and invite companies to review their purpose in the context of sustainability. The concept of corporate purpose could indeed be a way to clarify the scope of directors' fiduciary duties. The Corporate Purpose can serve as a place of safety for directors in the sense that board members would be protected from any compromise between profitability and stakeholders' interests. It can act like an anchor for decision-making. Companies that choose to go in this direction must however understand that defining a corporate purpose is not an end in itself. It should be embedded in the whole strategy and in the KPIs to assess performance.

This being said, stating the corporate purpose does not eliminate some of the practical challenges that boards face in engaging with their stakeholders. Experience in countries

where this is in place shows that it is often a pure communication exercise. Additionally, one cannot forget that companies can be extremely successful without having explicitly stated their purpose.

However, Corporate Purpose should not be legislated. Indeed, if the purpose is mandated by legislation, it will be the purpose of the legislators and not the purpose of the company. Companies should simply be encouraged to express their commitment to sustainability and to respect stakeholders in terms that are as explicit as possible and that can also be applied in practice. These commitments affect their Purpose, their Mission, their Strategy and the way they operate. Legislation should focus on aspects related to the measurable impact on labour, environment, corruption and others.

2.4. Board composition : The European Commission should refrain from laying down prescriptive rules on board composition regarding sustainability. Sustainability means different things to different companies. Imposing a straight jacket would deprive shareholders of their ability to select the board members based on their specificities. In general, the legislator should not intervene to define the necessary expertise, neither at the level of the boards of directors nor of the management teams. Additionally, "expertise in sustainability" is a somewhat fuzzy concept.

2.4. Internal organization of boards of directors to deal with sustainability: Boards are expected to take responsibility for an increasing range of issues. This increased workload of boards has a direct impact on the way boards structure themselves and on the interaction they have with the management. In order for boards to focus on their core functions, they will not be able to ignore a deeper reflection on their internal organization. However, with regard to sustainability, it should be up to the board to determine whether the subject of sustainability motivates the creation of a specific committee for preparatory work, whether the risk or audit committee is better placed or whether the board prefers to handle these issues as a whole. It should be acknowledged that the setting up of board committees to deal with certain matters also comes with a price, e.g. in terms of diluting the accountability of the other directors, which may in fact counteract the intended purpose of the committee.

According to Ethics & Boards[6], approaches in this respect vary greatly in Europe. The preference for a dedicated committee is more predominant in e.g. France, Italy and Spain than in some other European jurisdictions, and the rationale for committees also differs substantially due to the sheer size of the board. In general, it will be noted that companies are constantly innovating and even ahead of the recommendations of corporate governance codes.

[6] See appendix 1- Sustainability Board Committee, *Ethics and Boards' Study* (partner of ecoDa)

2.5. Non-financial reporting: The draft directive might echo the revision of the non-financial reporting directive and the upcoming Non-Financial Reporting Standard. ecoDa shares the Commission's ambition to strengthen the quality of this reporting in the interest of all stakeholders. However, a simplified reporting regime should be put in place for SMEs. Simplification should be a priority in any revision of NFI requirements. This is important for large and small companies, but especially for SMEs. The experience acquired by GAAP and the IFSB in the field of financial and accounting standards should be of great value to develop standards in the field of NFI.

2.6. Remuneration: According to an Ethics & Boards study[7], the integration of extra financial criteria in the CEO annual variable remuneration policy is becoming the norm in many European countries (France: 84%, Netherlands: 76%, Belgium: 65%, Germany: 57% from the top indexes of listed companies). Guidelines for remuneration reports as announced in the Shareholder Rights Directive remain necessary with a particular focus on non-financial aspects to enhance market practices. Those Guidelines have to help companies to take developments forwards. The European Commission must take into account the calendars of general assemblies and leave sufficient time for companies to take them into account. ecoDa is encouraging the European Commission to focus on the implementation of the existing legislation and to provide guidelines before considering new legislation.

2.7. Due diligence: A diligence duty imposed on the entire value chains may result in a relocation or in any case a reduction of value chains since many companies will not have the means to acquire the digital tools or recruit the relevant teams in order to ensure effective screening. To a certain extent, such an initiative would look like a disguised Buy European Act, without it being certain that the consumer will be ready to pay more, especially in times of crisis.

In terms of due diligence, ecoDa supports the pragmatic approach of the OECD, which does not envisage monitoring obligations for companies of each supplier. The OECD recommends that companies have an overview of their value chains and focus more specifically on the riskiest segments. According to the OECD, engagement with stakeholders should not necessarily be made by the company but by its suppliers on its behalf.

ecoDa also favors the approach of the OECD guidelines for multinationals which are negotiated between governments, business representatives, trade unions and NGOs. Finally, these principles are based on an original implementation mechanism that goes through national contact points. They are in charge of promoting the guiding principles nationally and play a mediating role when there is a conflict or when complaints are filed.

---

[7] See appendix 2 - Extra-financial criteria in CEO Remuneration Policy, *Ethics and Boards' Study* (partner of ecoDa)

III- Elements to be considered to move forward:

3.1. Scope of the initiative : ecoDa is afraid that the future legislation will become a catch-all-text. Such a very broad piece of legislation would undoubtedly dilute its primary objective to foster sustainable value creation. The European Commission should ensure coherence among all initiatives in the pipeline, especially the upcoming review of the Non-Financial Reporting Information. ecoDa considers that the Non-Financial Reporting Information is the right tool to ensure that board members provide a proper oversight of companies processes and define the right KPIs for sustainability materiality.

3.2. Possible EU-level legislation : There are other ways to force companies to pay for the externalities caused. ecoDa would not exclude the interest of EU-level legislation in some areas. This is in itself a very broad question that touches on many aspects of company law, like for instance, questions of labour and fiscal regulations. It should not be approached only under the scope of sustainability and related concepts.

3.3. Board members' education : At ecoDa, we strongly believe that a change in mindset on ESG matters will happen through education of board members. It is preferable to rely on the training of directors to embrace sustainability issues. This approach would prevent creating loopholes in terms of all aspects that would not be specified in a legislation.
The future EC initiative should therefore make a clear reference to the importance of certification and in the interest of the internal market to arrive at some common criteria in terms of ESG education for board members.
ecoDa invites the European Commission to release a budget line for the training of directors on ESG matters as it was done, sometimes ago, for the training / mentoring of women directors.

We remain at your disposal for any further discussion concerning sustainable corporate governance and directors' duties.

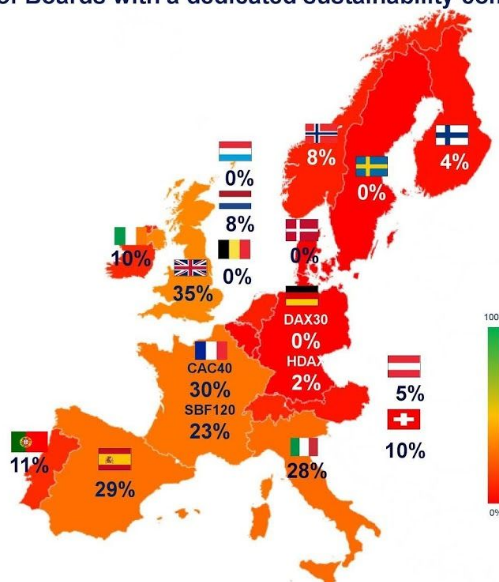
Sincerely yours,

Béatrice Richez-Baum
Director General of ecoDa

Michel de Fabiani
Chair of ecoDa's Policy Committee

APPENDICES

Appendix 1 - Sustainability Board Committee, *Ethics and Boards' Study* (partner of ecoDa)



Appendix 2 - Extra-financial criteria in CEO Remuneration Policy, *Ethics and Boards' Study* (partner of ecoDa)