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EUROPEANISSUERS FEEDBACK

European Commission's Sustainable Corporate Governance Inception Impact Assessment

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EuropeanIssuers welcomes the opportunity to present its comments on the inception impact assessment (IIA) on sustainable corporate governance.

EuropeanIssuers totally supports the concept of sustainable corporate governance and believes there is a link between sustainable corporate governance and long-term value creation. EuropeanIssuers agrees that sustainability practices help reconcile economic growth, social progress and the protection of the environment. At national level, many European countries have moved forward towards sustainable governance in their Corporate Governance codes, which already recommend that issuers integrate sustainability risks, opportunities, impacts into the business strategy, and to some extent in the law (e.g. Pacte Law in France). At the same time, national company laws models are already developed in an open form which consent such an evolution.

However, **we do not endorse the conclusions of the study on directors' duties** (on which the IIA is founded), which is built upon the assertion that companies tend to favour the short term maximisation of shareholder value to the detriment of the long term development of the company.

We would like to stress several shortcomings of the EY study:

- First of all, there are **methodological remarks about the sample.**

  The study does not provide sufficient information about the selection and the composition of the sample. This appears in contrast with international common practices: studies promoted by international organisations in order to orient policy making give stakeholders, which could be affected by policy choices, enough information to assess the quality of the empirical analysis that supports such choices and provide further evidence. To this end, at least the list of individual companies considered should be made public, with their nationality (clarifying if it is based on the country of incorporation or on the country of listing), their size and sector.

  Moreover, the **selecting criteria do not seem appropriate**, such as:
  - UK companies – which reasonably represent a significant portion of the sample - should not be included, as we need to know if there is a problem related to companies which will apply the future legislation;
  - The selection of some Members State and the exclusion of others is not motivated;
  - The selection of individual companies is not clear (size, sector, type of listing);

- SMEs are neglected : in fact, the study infers from the limited data collection that there is a supposed apathy of SMEs suggesting "that corporate governance is a topic of interest mainly for large (listed) companies with complex ownership structures".

- Secondly, there are **several substantial remarks in the study's conclusions** – namely that EU businesses are short-term oriented due to the increase of dividend payments and share buybacks and to the decrease of business investments – which are based on a scant analysis. In fact, the whole study which is carried out on the basis of limited comparative studies, fails to recognise differences among EU countries and with the US and uses a limited set of indicators, which gives a very partial picture of the role of capital markets in allocating and re-allocating resources.

  To sum up **major problems in the analysis**:
  - The absolute level of pay-outs in the EU is much lower than in the USA and that their growing trend in the EU is concentrated only until the beginning of the 2000s, while US businesses experienced a constant increase.
  - The pay-out considered is a gross one, while a more accurate measure of return to shareholders should consider – as suggested by Fried and Wang[1] – the net value of pay out, including also inward flows, like capital increase.
  - The study considers the increase of pay-outs as a pure indicator of short-termism, while in reality pay-outs are, on the one hand, the translation of past performance and do not reflect an anticipation of future cash-flows, and on the other hand, they are crucial for ensuring companies' future (and cheaper) funding on capital markets.
  - There is actually a positive relationship between the level of dividends and that of corporate investments as revealed by recent figures relating to listed companies in France: while dividends increased during the last three years (2017,2018 and 2019), capital expenditure rose in the same proportion. In 2018 for instance, dividends totalled 60,2 billion euro and corporate expenditures amounted 80,2 billion euro, a 9,7% increase on the previous year. In other words, the higher the level of dividends paid out by listed companies, the more their corporate expenditures increase.[2]
  - As pointed out by Mark Roe,[3] who found that the increase in the pay-out ratio in USA after the financial crisis is also due to the exceptionally favourable conditions in the credit markets: "*after the 2009 financial crisis, corporate borrowings increased greatly.*" These conditions allow firms to increase their profitability by decreasing the cost of their debts. This decrease in the cost of capital is a real turning point in investment policies. It allowed firms both to invest by leveraging on their capital value and to maintain dividends to sustain capital value. Higher returns for shareholders incentivised both retail and institutional investors to invest in European corporates, thus strengthening the equity base of our corporates.

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[1] Fried, J.M., Wang, C.C..Y, 'Are Buybacks Really Short-changing Investment?', in *Harvard Business Review*, March-April 2018, available at : https://hbr.org/2018/03/are-buybacks-really-shortchanging-investment

[2] iccf@HEC PARIS La lettre VERNIMMEN, January 2020, available at https://vernimmen.net/lire/lettre_vernimmen.php

[3] Roe, Mark J., 'Stock Market Short-Termism's Impact (October 22, 2018). European Corporate Governance Institute (ECGI) - Law Working Paper No. 426/2018, Harvard Public Law Working Paper No. 18-28, Available at SSRN: https://ssrn.com/abstract=3171090 or http://dx.doi.org/10.2139/ssrn.3171090.

- In addition, it must be underlined that the circulation of profits in the form of "return to the shareholder" enable investors to arbitrate between different investments. Pay-outs allow investors to finance other (sometimes newly created) companies to allow them to grow. It is therefore short-sighted to consider that pay-outs would not generate investments. Dividends are in fact not necessarily consumed by shareholders, but generally reinvested.
- Furthermore, other empirical studies suggest that decline in capital expenditures may not be the result of short-term pressure but the result of a global recession. "*There is little reason to invest in new equipment when old equipment lies fallow because the firm faces weak demand and the equipment is not yet technologically passé.*"[4]
- The study provides for a rough estimate of EU businesses' CAPEX and R&D investments: for example, it neglects the investments realized indirectly through M&A activities[5] and it over-relies on R&D investments, which classification and disclosure is far from homogenous across EU.[6]
- There is a clear lack of further assessment of the characteristics of different business models and trends in diverse national markets: e.g. while the study considers the level of free-float, it fails to broaden the analysis to the company's ownership model, which is likely to have an impact on the pay-out policies. Also the "maturity" of companies should be considered. Growth companies should have a higher proportion of R&D investments than value companies.

- Thirdly, **other assumptions from the study are too simplistic** and can easily be reverted:
  - Short-termism and long-termism are not necessarily conflicting. For instance, during a crisis, if short-term issues are not addressed, the company will go bankrupt in the long term. Additionally, most long-term decisions also serve short-term objectives.
  - There can be multiple reasons for short-termism, which does not necessarily result from shareholders' pressure. Also internal and external constraints as well as the regulation can have an impact, which shall be considered in the analysis of the market trends of the post-financial crisis.
  - The study does not consider sufficiently initiatives in other fields that have an impact on company's sustainability: environmental legislation, sustainable finance legislation, companies R&D policies, interaction with capital markets, impact on pension funds. A more holistic view is needed.

- Finally, the choice of studies analysed in the EY study is biased toward studies that support its hypotheses[7] and on the contrary the authors undermine studies that indicate alternative readings

[4] Roe, Mark J., Stock market Short Termism's Impact (October 22, 2018)
[5] Please refer, for instance, to the study published by French Central Bank (Banque de France) in its November-December 2017 Edition (Banque de France Bulletin N° 214 - Novembre-décembre 2017) showing that investments from French corporations has increased since 2012 and can be explained by business combinations.
[6] This point has been clearly illustrated in the European Commission, *EU R&D Scoreboard*, available at : https://ec.europa.eu/info/news/2019-eu-industrial-rd-investment-scoreboard-report-2019-dec-18_en, p. 109.
[7] See, e.g. missing studies, mentioned above. Please also note that while the study (p. 32) reads "**Numerous** multijurisdictional studies underline how the prevalence of shareholder primacy in companies hinders their long-term contribution to sustainability and influences the interpretation of the concept of "company's interest"", Annex I where this is elaborated (p. 90) reads "The prominence of the shareholder primacy norm in

without strong arguments.[8] In addition, the EY study itself acknowledges its methodological limitations (p. 5 of the report).

Based on this study's doubtful assertions, the IIA calls for an EU initiative towards two directions:

- Measures to address adverse sustainability impacts through the value chain;
- Measures to take into account all stakeholder interests and corporate sustainability risks, impacts and opportunities into the corporate strategy

1. <u>Measures to address adverse sustainability impacts through the value chain</u>

Excerpt from the IIA *"Companies to take measures to address their adverse sustainability impacts, such as climate change, environmental, human rights (including workers and child labour) harm in their own operations and in their value chain by identifying and preventing relevant risks and mitigating negative impacts (due diligence duty). Such duty could be designed by building on existing authoritative guidelines using well-established definitions as developed by the UN and later expanded by the OECD. The performance standards could be set in line with the goals of relevant international conventions and EU goals, such as those on human rights, climate and environment including biodiversity;"*

EuropeanIssuers considers that the issue of due diligence through supply chains is extremely important. The Association is eager to work together with the European Commission to improve the way companies operate and calls for close cooperation between all stakeholders involved in order to tackle this highly complex and global challenge.

European corporates have made supply chains' due diligence a priority. They have voluntarily taken steps to ensure a better control of risks linked to human rights and sustainability along their supply chains and they are fully committed to improve the situation. They have launched numerous sectorial initiatives in this regard, for example the mutualisation of sustainability audits to make them more efficient.

Regarding the measures <u>to address adverse sustainability impacts through the value chain</u>, companies would like to underline the following challenges which should be taken into account:

- Any measure should not harm the competitiveness of European companies and should foster the emergence of a global standard for responsible business conduct, therefore **it should also cover non-EU companies providing goods or services in the EU.**
- In addition, Trade and Sustainable Development (TSD) chapters under bilateral FTAs should be upgraded to incentivise the EU's trading partners to improve Responsible Business Conduct

business (…) is identified in **several** multijurisdictional studies as the main obstacle to the pursuit of sustainability objectives by companies, driving directors and managers to focus on short-term financial results rather than long-term objectives". In three of the five papers quoted in the footnote, the same professor (Sjafjell) is involved.

[8] For example, the study (p.10) reads "Contrary to this perspective, few authors underline how pay-outs are a way to channel resources towards industries that use them best, and are not replacing investments. However, there is **no evidence** that shareholder pay-outs are being reinvested into more productive sectors of the economy, and the measurement of long-term investments may differ from study to study".

and CSR practices by their domestic companies and foreign-invested companies. TSD chapters could include an obligation to report on actions taken in this respect. We would be in favour of using sanctions in the event of non-compliance with FTAs, as the only way to ensure a fully-fledged enforcement of RBC and CSR over the supply chain without undermining EU companies' competitiveness and EU jobs.

- In order to **avoid legal uncertainties on this very complex issue, measures should make clear what precisely is expected from EU companies so that they are in a position to comply with the rules.**
- **Due diligence obligations should be proportionate to the companies' size, sector and situation.**
- **The publication and communication of the companies' due diligence strategy should respect the principle of materiality and be compatible with the preservation of commercial secrets.**
- **EU companies should not be liable for damages occurring through the supply chain unless they have directly caused the damage or intentionally contributed to it.**

2. Measures to take into account all stakeholder interests and corporate sustainability risks, impacts and opportunities into the corporate strategy

Excerpt from the IIA

- *"Company directors to take into account all stakeholders' interests which are relevant for the long-term sustainability of the firm or which belong to those affected by it (employees, environment, other stakeholders affected by the business, etc.), as part of their duty of care to promote the interests of the company and pursue its objectives; company directors to define and integrate stakeholders' interests and corporate sustainability risks, impacts and opportunities into the corporate strategy – following appropriate procedures – with measurable and time-bound, science-based targets where relevant, including as regards climate targets aligned to the Paris agreement, biodiversity and deforestation targets, etc. and according also to the company's size and activity, and to implement such strategy through proper risk management and impact mitigation procedures;*
- *An appropriate facilitating, enforcement and implementation mechanism accompanying these duties, including possible remediation where necessary;*
- *Other possible corporate governance arrangements for example regarding directors remuneration."*

Company interests

National frameworks already provide rules on directors' duties and responsibilities that ensure the evolution of the company's purpose, in line with the emerging – at a certain extent already operating – best practices. In most national legal frameworks, definitions of the company interest are "open" and are generally supplemented by case law to allow for a better consideration of long-term view and stakeholders' interests. It is the case in Germany, the Netherlands and France where the notion of company interest has not been defined but it has been added in the commercial and civil code that the company should be managed in its social interest taking into account the social and environmental impacts of its activities.

Same approaches have been developed in national Corporate Governance Codes, which already support legal provisions recommending the board to pursue long-term value creation and to consider also the interest of other stakeholders that are relevant for the company's business. Such an approach is already observable in a number of national jurisdictions such as France, the UK, Italy, Belgium, Germany, and the Netherlands:

- The **French** Afep-Medef code has a provision according to which *“the board of directors endeavours to promote long-term value creation by the company by considering the social and environmental aspects of its activities. If applicable, it proposes any statutory change that it considers appropriate”*.
- The **UK** Corporate Governance Code sets as a general principle that a *“successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society”, contemplating further initiatives that shall be considered in encouraging the participation from these parties.*
- The **Italian** Corporate Governance Code has a general and overarching principle recommending the board to *“pursue the sustainable success of the company’s activity”* and defines it as *“the objective that guides the actions of the board of directors and that consists of creating long-term value for the benefit of the shareholders, taking into account the interests of other stakeholders relevant to the company”.* To this end it promotes the board’s *“dialogue with shareholders and other stakeholders which are relevant for the company*” to be developed *“in the most appropriate way”.*
- The **Belgian** 2020 Corporate Governance Code recommends that the board *“pursue[s] sustainable value creation by the company, by setting the company’s strategy, putting in place effective, responsible and ethical leadership and monitoring the company’s performance”.*
- The **German** Corporate Governance Code recommends that the management board assumes *“full responsibility for managing the company in the best interests of the company, meaning that it considers the needs of the shareholders, the employees and other stakeholders, with the objective of sustainable value creation”.*
- The **Dutch** Corporate Governance Code recommends that the management board focusses *“on long-term value creation for the company and its affiliated enterprise, and takes into account the stakeholder interests that are relevant in this context”.*

Furthermore, a complete overview of national legal frameworks points out how legal provisions and best practices are designed to nudge for-profit companies to consider stakeholder interest, maintaining a clear difference between for-profit companies and benefit companies. This is a fundamental guideline that shall be considered by the European Commission in any further evolution of this issue, in order to preserve EU businesses’ capacity to perform on the market and to have access to the capital market.

In this light, we believe that the consideration of the current legal and best practice framework significantly challenges the EY study conclusions about: *“The ability of Public authorities to regulate with the aim of achieving societal goals might be undermined by corporate capture and corporate governance codes that are informed by the shareholder primacy drive or that only superficially address* *sustainability aspects"* (page 42). On the contrary, legal provisions combined with the evolution of the Corporate Governance Codes aimed at enhancing the directors' attention to the interest of all relevant stakeholders already nudge issuers to adopt a wider and more enlightened consideration of the shareholders' value.

- **Therefore, before considering legislative action, we would recommend to better assess the overall governance framework, which is not limited to legal provisions but includes also case law and corporate governance codes, which are both able to evolve and adapt over time, taking into consideration also stakeholders' expectations**.

- Furthermore, any legal intervention should better consider the core profit-making purpose of the company (which shall not be simplistically interpreted as the pursuit of pure shareholder value) and the competitive issues related to the company's capacity to operate on the market and have access to the capital-markets financing.

- Any EU initiative in this field should also be very careful about undermining shareholder rights that have been elaborated, also by EU law, for the last decades. Such a decision may lead to considerable issues in terms of corporate financing, notably capital risk, especially when it comes to impose on companies to involve stakeholders when elaborating the companies (sustainability) strategy or a respective enforcement by NGOs.

<u>Sustainability risks</u>

The first mission of a Board is to determine the strategy of the company taking into account the risks it is confronted to and identified opportunities. Integrating and reporting on risk factors are thus key components of corporate stewardship and have been included in EU legislation for long : in accordance with the Accounting Directive, the management report shall include "a fair review of the development and performance of the undertaking's business and of its position, together <u>with a description of the principal risks and uncertainties that it faces</u>". Furthermore most of the corporate governance codes have developed a link between corporate purpose and the development of the company's strategy. It is therefore unjustified to consider that companies and their boards would not, even before the implementation of the NFRD, integrate material risks – whether financial or non-financial – into their strategy.

The NFRD obviously extended the scope in terms of risks and opportunities assessment by requiring companies to publish a non-financial statement. This statement is part of the management report or published together with the management report and referred to in said report and therefore falls under the responsibility of the Board of directors. As a consequence, we consider that the framework regarding integration of corporate sustainability risks, impacts and opportunities into the corporate strategy is already in place and efficient. This framework will certainly be strengthened following the review of the NFRD and additional measures in this regard do not seem justified.

Finally we would like to insist on the fact that when setting ESG targets and reporting on these targets and, more generally speaking, on ESG topics, companies and their Boards are faced with greater uncertainties than in the field of financial reporting. Precise and reliable data are more difficult to collect and produce on these topics and companies will rely more on estimates and assumptions, sometimes based on long-term time horizons. Margins of errors will necessarily be larger. Risks and opportunities identified at a certain point in time may change and become no longer valid. Targets are not always measurable with a sufficient level of assurance. Another issue regarding targets, and in particular climate targets, is that they are mainly designed for Member States and they have to be adapted to companies in order to be meaningful. In this process, the difficulty is to define which target are meaningful for a given company activity and how targets could be aligned with SDGs. Imposing the obligation to establish, integrate and disclose targets raises therefore many issues, including liability issues for directors, and we consider that any initiative in this area should be assessed with the utmost caution.

- **Therefore we would recommend a Commission guidance document for board in order to launch an experimental phase. Any attempt to standardise best practices that are currently evolving across companies and investors would not be desirable.**

Directors' remuneration

SRD 2 already requires that listed companies include in the remuneration policy non-financial performance criteria relating to corporate social responsibility, where they are material for the company's strategy. This provision already routes the definition of directors' remuneration in accordance with the sustainability goals that contribute to the company's long-term performance thus offering companies sufficient room to set appropriate incentives for its management. In addition, investors are closely monitoring integration of ESG criteria in executive directors' remuneration.

- **Therefore, it should be up to the company to decide which qualitative or quantitative performance criteria are best suited to its sustainable strategy and to provide investors with relevant explanation on how these criteria have been applied and whether the individual targets have been met.**

- **A better linkage between non-financial performance criteria and the indicators reported in the non-financial statement under the NFRD could be explored.**

Liability

Civil liability regimes considerably differ among Member States. Therefore, it would be preferable to leave any decision with regards to liability to the Member States. Any attempt to facilitate the liability of the company and their directors personally by stakeholders must be preceded by a robust impact assessment in order to carefully evaluate the state of play and the conditions that need to be put in place, in particular regarding the capacity and interest in taking legal action.

However, non-judicial grievance mechanisms in line with principle 31 of the United Nations Guiding Principles on Business and Human Rights could be established as part of the due diligence strategy.

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EuropeanIssuers is a pan-European organisation representing the interests of publicly quoted companies across Europe to the EU Institutions. There are approximately 13,225 such companies on both the main regulated markets and the alternative exchange-regulated markets. Our members include both national associations and companies from all sectors in 14 European countries, covering markets worth €7.6 trillion market capitalisation with approximately 8,000 companies.

We aim to ensure that EU policy creates an environment in which companies can raise capital through the public markets and can deliver growth over the longer term. We seek capital markets that serve the interests of their end users, including issuers.

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