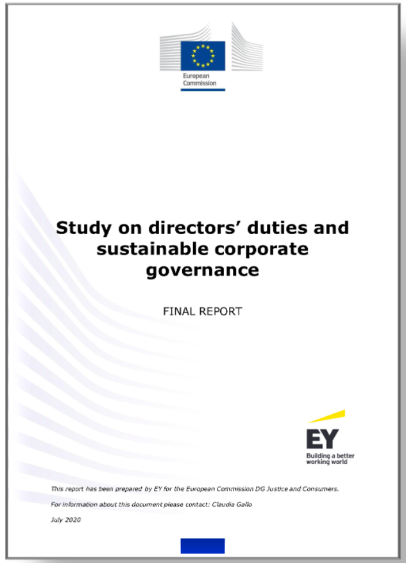
Leading Research with Global Impact


European Commission

Study on directors' duties and sustainable corporate governance

FINAL REPORT

EY Building a better working world

This report has been prepared by EY for the European Commission DG Justice and Consumers.

For information about this document please contact: Claudia Gallo

July 2020

Directors' Duties and Sustainable Corporate Governance

11 – 13 November 2020 I Online

ecgi
european corporate governance institute

EUROPEAN COMMISSION STUDY BY ERNST & YOUNG (EY)

Directors' Duties and Sustainable Corporate Governance

11 - 13 November 2020 • Online Policy Workshop

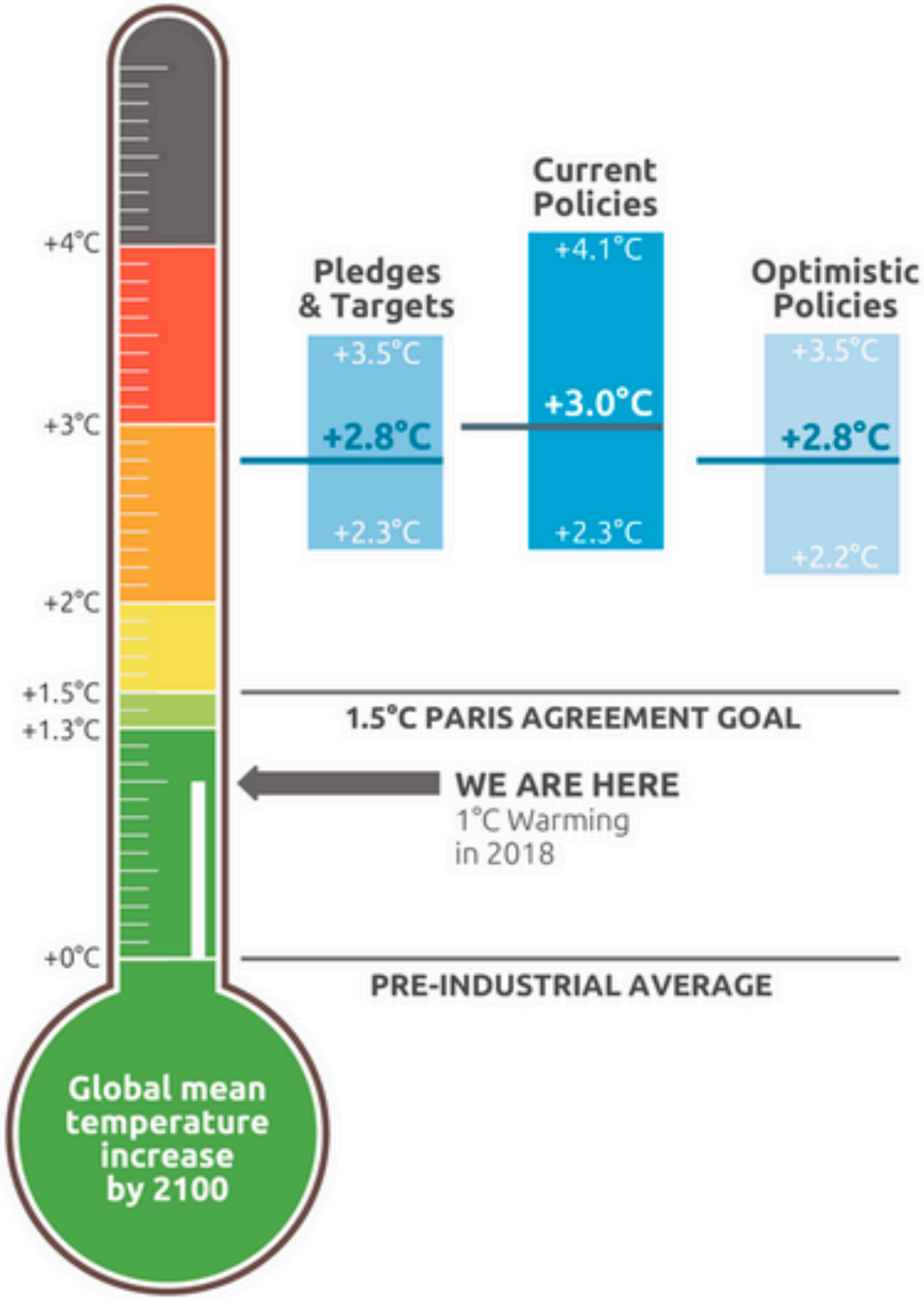
Introduction

Marco Becht and Luca Enriques

1. Outline

1. General Policy Objective
2. Sustainable Finance Action Plan
   - Definition
   - Action 10
   - Impact assessments
3. Summary of the EY Report
4. Sustainable Corporate Governance Initiative (2021 -)

25 September 2015



Climate Action Tracker

CAT warming projections

Global temperature increase by 2100

December 2019 Update

UNITED NATIONS

PARIS CLIMATE AGREEMENT

SIGNING CEREMONY

22 APRIL 2016

High-Level Expert Group on Sustainable Finance (HLEG)

- At the **end of 2016**, the Commission appointed a High-Level Expert Group on **sustainable finance**. On 31 January 2018 the group published its report.
- In March 2018 the European Commission published an **action plan** based on the report.
  Action Plan: Financing Sustainable Growth
  (Brussels, 8.3.2018 COM(2018) 97 final)

https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN

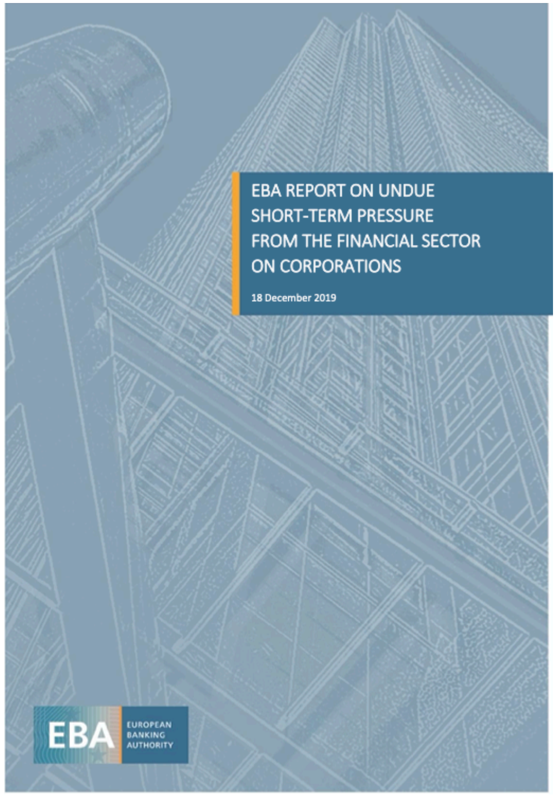
Action 10: Fostering sustainable corporate governance and attenuating short-termism in capital markets

1. To promote corporate governance that is more conducive to sustainable investments, by Q2 2019, the Commission will carry out analytical and consultative work with relevant stakeholders to assess: (i) **the possible need to require corporate boards to develop and disclose a sustainability strategy,** including appropriate due diligence throughout the supply chain, **and measurable sustainability targets**; and (ii) **the possible need to clarify the rules according to which directors are expected to act in the company's long-term interest**.
2. **The Commission invites the ESAs to collect evidence of undue short-term pressure** from capital markets on corporations and consider, if necessary, further steps based on such evidence by Q1 2019. More specifically, the Commission invites ESMA to collect information on undue short-termism in capital markets, including: (i) portfolio turnover and equity holding periods by asset managers; (ii) whether there are any practices in capital markets that generate undue short-term pressure in the real economy.

ESAs – European Supervisory Authorities

ESA’s 2019 advice

18 Dec 2019



18 Dec 2019

18 Dec 2019

“Under the Action Plan ‘Financing Sustainable Growth’, in the beginning of 2019 the European Commission (Commission) invited the three European Supervisory Authorities (ESAs) to each develop a report presenting evidence and possible advice on potential undue short-termism. In its call for advice (see Annex I), the Commission asked the three ESAs to investigate potential sources of undue short-termism on corporations from the financial sector and provide advice on areas which regulators should address.”

ESMA Report

ESMA reviewed the relevant financial literature and identified six potential contributors to “undue short-termism”:

1. Investment strategy and investment horizon;
2. Contribution of disclosure of Environmental, Social and Governance (ESG) factors to long-term investment strategies;
3. Role of fair value in better investment decision-making;
4. Institutional investor engagement;
5. Remuneration of fund managers and corporate executives; and
6. Use of Credit Default Swaps (CDS) by investment funds.

Home > Events > DG Justice and Consumers Conference "Sustainable Corporate Governance"

DG Justice and Consumers Conference "Sustainable Corporate Governance"

24 January 2019

Bruxelles/Brussel, Belgium

Academic input

Towards Sustainability:
Clarifying the Role of the Corporate Board

Professor Beate Sjåfjell, University of Oslo

Brussels, 24 January 2019

Sustainable Market Actors for Responsible Trade (SMART)

Corporate Governance
for
Sustainable Prosperity

William Lazonick

The Academic-Industry Research Network
(william.lazonick@gmail.com)

Conference on
Sustainable Corporate Governance
European Commission DG JUST

Brussels, January 24, 2019

https://ec.europa.eu/info/events/conference-sustainable-corporate-governance-2019-jan-24_en

A Union that strives for more

My agenda for Europe

By candidate for President of the European Commission

Ursula von der Leyen

POLITICAL GUIDELINES FOR THE NEXT EUROPEAN COMMISSION 2019-2024

These Political Guidelines draw on the common ideas and priorities that unite us. They are not an exhaustive work programme but rather aim to frame our common work. Within each chapter you will find the policies I intend to use to help us deliver on our goals. The Political Guidelines focus on six headline ambitions for Europe over the next five years and well beyond:

- ✓ **A European Green Deal**
- ✓ **An economy that works for people**
- ✓ **A Europe fit for the digital age**
- ✓ **Protecting our European way of life**
- ✓ **A stronger Europe in the world**
- ✓ **A new push for European democracy**

The European Green Deal

2.2.1.Pursuing green finance and investment and ensuring a just transition

[…]

The private sector will be key to financing the green transition. Long-term signals are needed to direct financial and capital flows to green investment and to avoid stranded assets. The Commission will present a renewed sustainable finance strategy in the third quarter of 2020 that will focus on a number of actions.

First, the strategy will strengthen the foundations for sustainable investment. […] ***Sustainability should be further embedded into the corporate governance framework, as many companies still focus too much on short-term financial performance compared to their long-term development and sustainability aspects***.

(bold italics added)

Brussels, 11.12.2019 - COM(2019) 640 final

EUROPEAN COMMISSION

Europe's moment: Repair and Prepare for the Next Generation

[…]

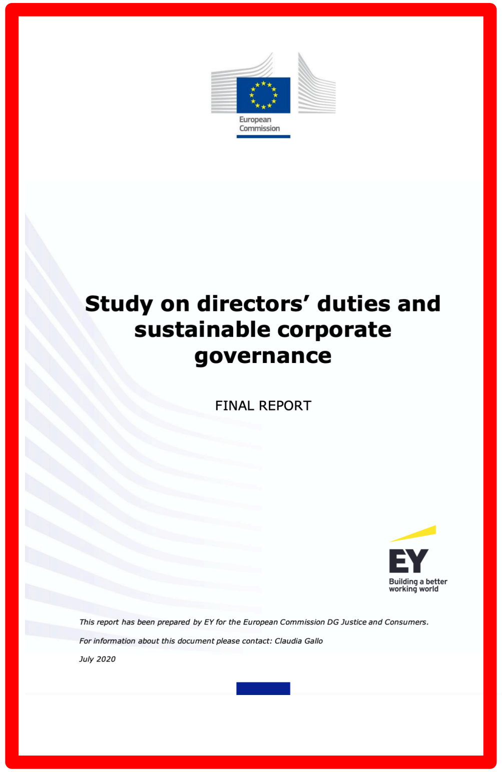
To help unlock the private investment needed, long-term certainty and predictability are essential. This underlines the importance of the Climate Law and the upcoming proposals for more ambitious emissions reduction targets for 2030. The EU sustainable finance taxonomy will guide investment in Europe's recovery to ensure they are in line with our long-term ambitions. This will be supported with a Renewed Sustainable Finance Strategy later this year. ***To ensure environmental and social interests are fully embedded into business strategies, the Commission will put forward a new initiative in 2021 on sustainable corporate governance.***

Brussels, 27.5.2020
COM(2020) 456 final

European Commission Better Regulation Guidelines: Impact Assessments

The questions an impact assessment should answer	
1.	***What is the problem and why is it a problem?***
2.	***Why should the EU act?***
3.	***What should be achieved?***
4.	***What are the various options to achieve the objectives?***
5.	***What are their economic, social and environmental impacts and who will be affected?***
6.	***How do the different options compare (effectiveness, efficiency and coherence)?***
7.	***How will monitoring and subsequent retrospective evaluation be organised?***

Source : Better regulation guidelines - Impact assessment
https://ec.europa.eu/info/sites/info/files/better-regulation-guidelines-impact-assessment.pdf



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"Legislation on sustainable corporate governance will be proposed to foster long-term sustainable and responsible corporate behaviour."

Commission Work Programme **2021**. A Union of vitality in a world of fragility

Brussels, 19.10.2020
COM(2020) 690 final

european corporate governance institute

2. Summary of the EY Study's Findings and Recommendations

Starting Point

"The focus of corporate decision-makers on short-term shareholder value maximisation rather than on the long-term interests of the company reduces the long-term economic, environmental and social sustainability of European businesses."

Abstract, pg. i

Report’s Objective

“The objective of this study is to

- **assess the root causes of “short termism” in corporate governance**, discussing their relationship with current market practices and/or regulatory frameworks,
- and to **identify possible EU-level solutions**, also with a view to contributing to the attainment of the UN Sustainable Development Goals and the goals of the Paris Agreement on climate change.”

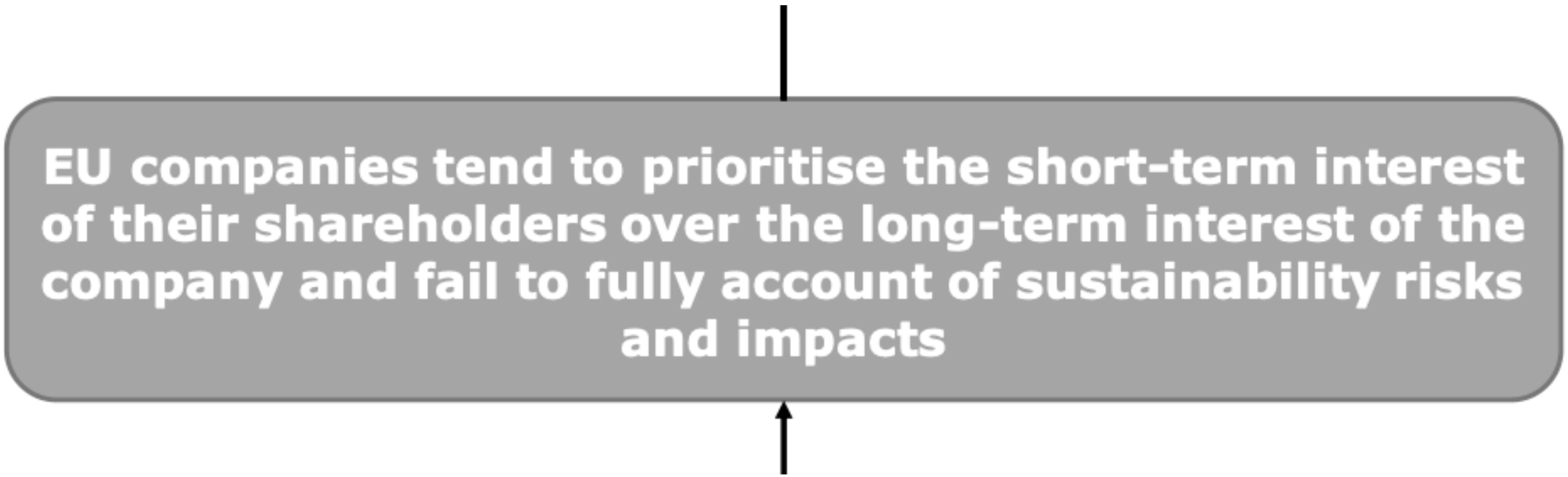
Abstract pg. i (without emphasis) and Executive Summary, pg. vi

Empirical Methodology

“[…] **Short-termism can be assessed by looking at the evolution of the amount of net corporate funds being used for pay-outs to shareholders** (in the form of dividends or shares buybacks) **compared with the evolution of the amount used for the creation of value over the life cycle of the firm**, namely through investment in infrastructure, workers training, Research and Development (R&D), and investments in sustainability.” (page 9)

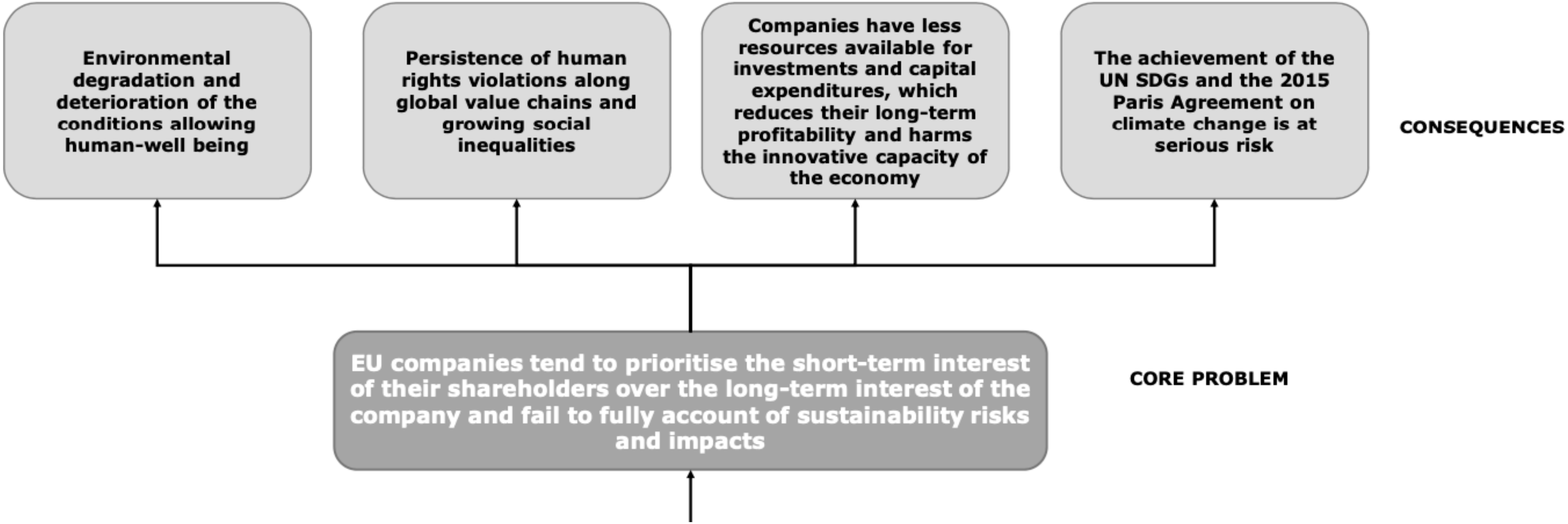
Empirical Finding

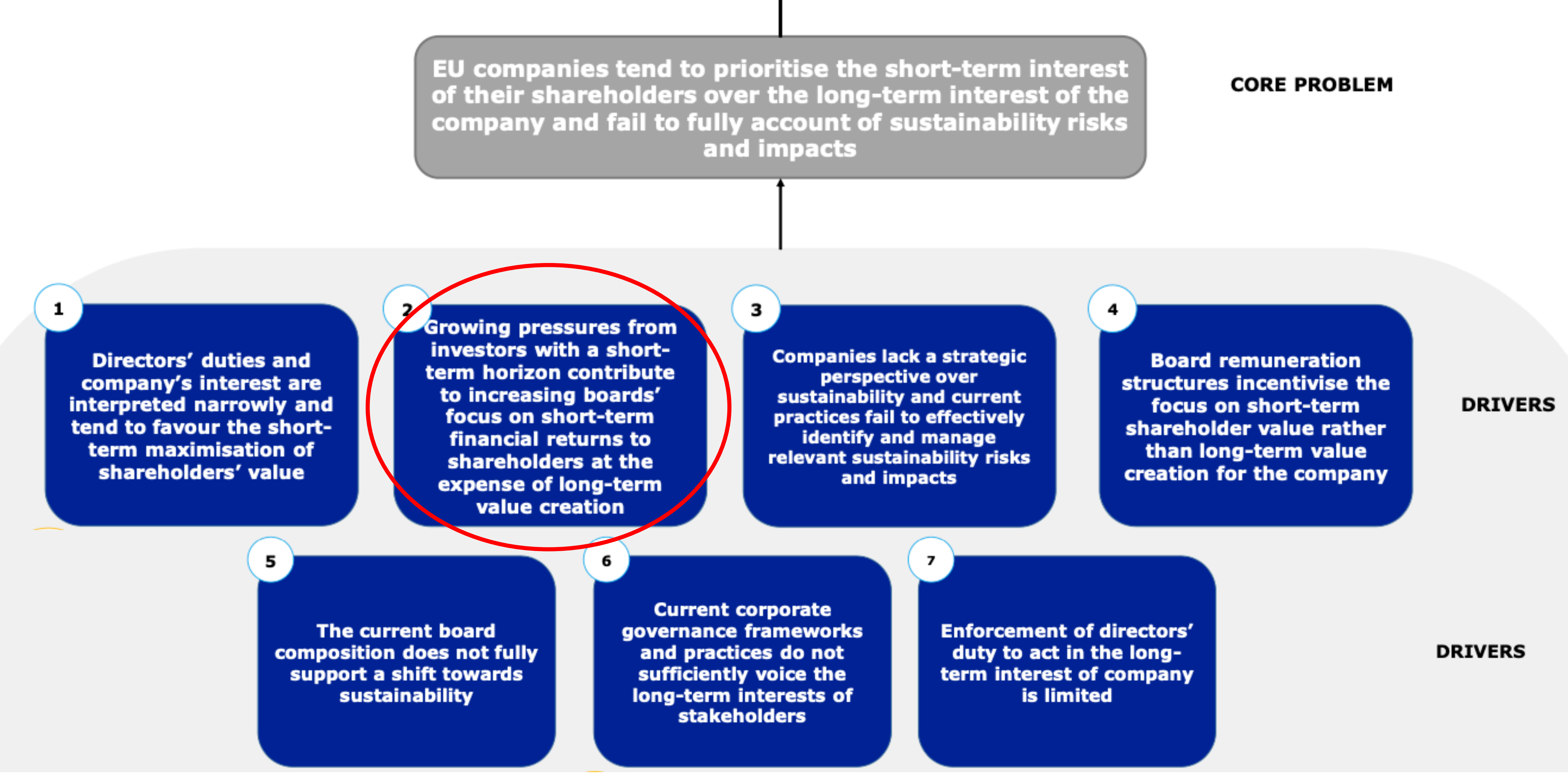
"Data indicate an upward trend in shareholder pay-outs, which increased fourfold, from less than 1% of revenues in 1992 to almost 4% in 2018. Moreover, the ratio of CAPEX and R&D investment to revenues has been declining since the beginning of the 21st century." (page vi)



CORE PROBLEM

Figure 16 – Problem tree




EU companies tend to prioritise the short-term interest of their shareholders over the long-term interest of the company and fail to fully account of sustainability risks and impacts
CORE PROBLEM
1
Directors' duties and company's interest are interpreted narrowly and tend to favour the short-term maximisation of shareholders' value
2
Growing pressures from investors with a short-term horizon contribute to increasing boards' focus on short-term financial returns to shareholders at the expense of long-term value creation
3
Companies lack a strategic perspective over sustainability and current practices fail to effectively identify and manage relevant sustainability risks and impacts
4
Board remuneration structures incentivise the focus on short-term shareholder value rather than long-term value creation for the company
DRIVERS
5
The current board composition does not fully support a shift towards sustainability
6
Current corporate governance frameworks and practices do not sufficiently voice the long-term interests of stakeholders
7
Enforcement of directors' duty to act in the long-term interest of company is limited
DRIVERS

Report Summary: Drivers

"The study shows that, to some extent, corporate "short-termism" finds its root causes in regulatory frameworks and market practices. These trends work together to promote a focus on short-term financial return rather than on long-term sustainable value creation."
(pg. vi)

Table 4 – Overview of the areas of analysis and the related sources of information

Areas of analysis	Factors	Literature review	State of play in 12 Member States	
			Legal review	Survey
Directors' duties and company's interest	Definition and interpretation of directors' duties and "company's interest"	√	√	√
Pressures from investors	Changes in share ownership structures and emergence of activist investors	√		
	Disclosure of quarterly returns and earning guidance	√		
Sustainability strategy and estimation of sustainability risks and impacts	Existence of a sustainability strategy and targets	√	√	√
	Estimation of sustainability risks and impacts	√	√	√
Board remuneration	Directors' remuneration linked to financial performance	√	√	√
	Directors' remuneration linked to sustainability metrics	√	√	√
Board composition	Expertise of the board members	√	√	√
	Independence of the board	√		
Stakeholder involvement	Stakeholder involvement in corporate decision-making	√	√	√
Enforcement	Stakeholder rights to hold the board or its members accountable	√	√	√
Non-financial reporting	Disclosure of non-financial statements	√	√	√

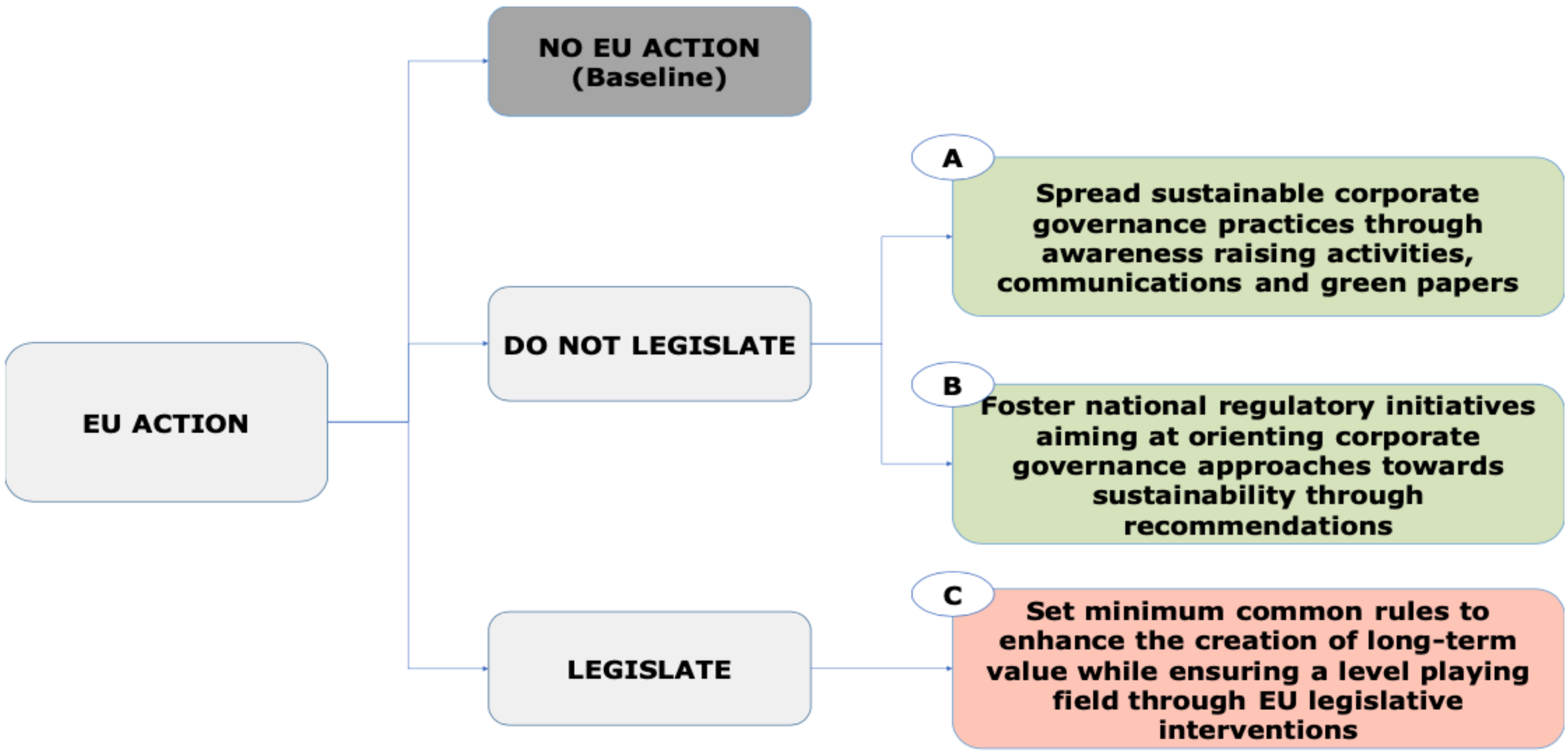
Source: Report pg. 31

“Drivers” and ”Issues” associated with each Driver

	1	2	3	4
DRIVERS	**Directors’ duties and company’s interest are interpreted narrowly and tend to favour the short-term maximisation of shareholders’ value**	**Growing pressures from investors with a short-term horizon contribute to increasing boards’ focus on short-term financial returns to shareholders at the expense of long-term value creation**	**Companies lack a strategic perspective over sustainability and current practices fail to effectively identify and manage relevant sustainability risks and impacts**	**Board remuneration structures incentivise the focus on short-term shareholder value rather than long-term value creation for the company**
ISSUES	1.1 The formulations of director’s duties and “company’s interest” in which board members are required to act as part of their fiduciary duty/duty of care are unclear, and this leaves room for interpretations that tend to prioritise shareholders’ interests over long-term company’s objectives, in light of the prevalence of the shareholder primacy norm	2.1 The growing importance of institutional investors with a limited length of share ownership and the rise of activist investors looking to maximise short-term share price create pressure on boards to focus on short-term market value of the shares	3.1 When present, sustainability targets included in sustainability strategies are not aligned with high-level objectives (such as SDGs) and are not systematically monitored through dedicated KPI	4.1 Share-based remuneration exacerbate executives’ focus on shareholder value maximisation
	1.2 The identification and mitigation of sustainability risks and impacts is rarely included in the board duties	2.2 The disclosure of quarterly returns and earnings guidance tend to reinforce board members focus on the short-term financial performance	3.2 Companies show different levels of maturity as concerns the identification and management of sustainability risks and impacts, including along the whole value chain	4.2 The integration of ESG metrics into board remuneration structures is still a limited practice

Figure 18 below shows the structure of the options identified for each driver.

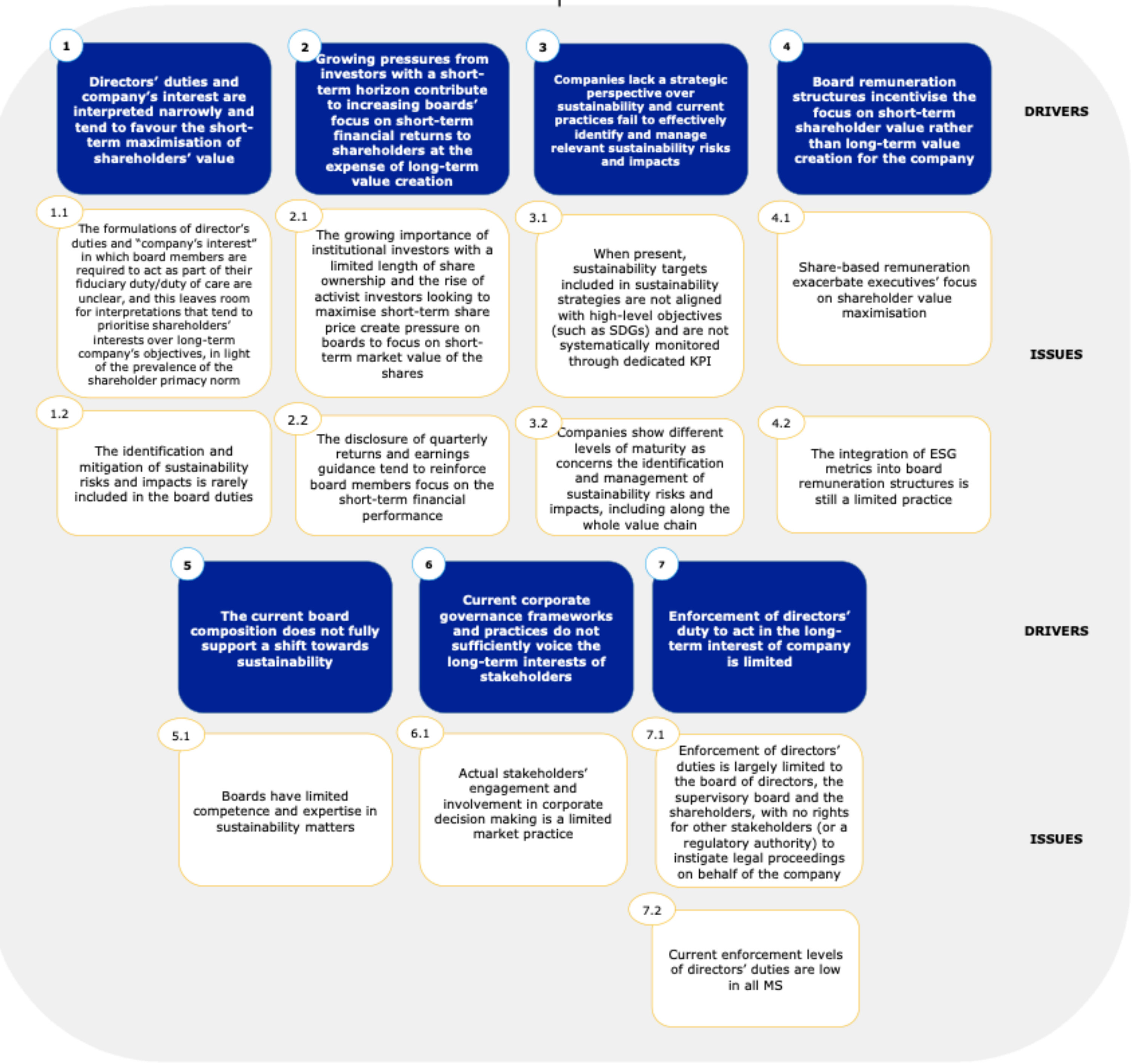
Figure 18 - Overview of the identified options



Policy Options for each of the 7 "Drivers" – Example Driver 2 Issue 2.1

4.4.2 Driver 2 – Growing pressures from investors with a short-term horizon contribute to increasing boards' focus on short-term financial returns to shareholders at the expense of long-term value creation

Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A1	Option B2	Option C2
Issue 2.1: The growing importance of institutional investors with a limited length of share ownership and the rise of activist investors looking to maximise short-term share price create pressure on boards to focus on short-term market value of the shares	Consider mechanisms to give longer term shareholders more control over companies or incentivise investors to take a longer-term approach, such as: - Setting voting rights proportional to the time of presence in a firm's capital	M2.1: **Commission green paper** to stimulate public debate on how to **foster long-term shareholder engagement** and **longer shareholding periods**	M2.3: **Commission recommendation** for Member States to amend their national regulatory frameworks and provide for mechanisms to **incentivise longer shareholding periods**	M2.4: **Commission proposal to amend the Shareholder Rights Directive II** to introduce binding rules requiring Member States to **introduce mechanisms to incentivise longer shareholding periods**



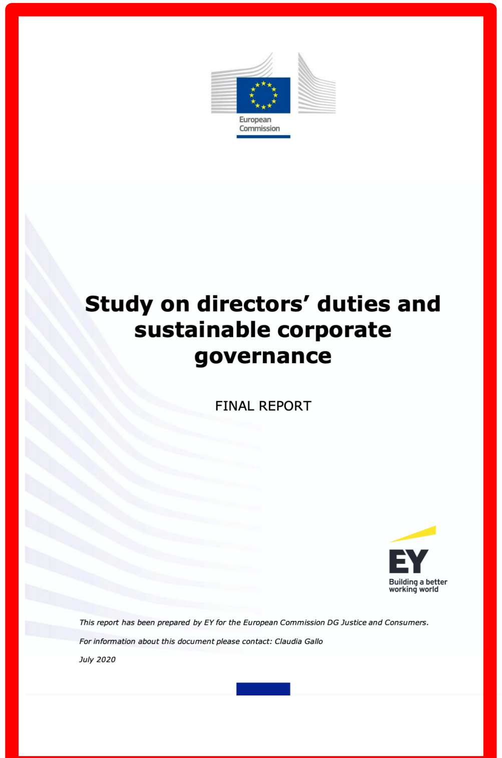
7 Drivers
12 Issues
36 Policy Options

Assessment of the options

i) impacts, including expected degree of change in the national regulatory frameworks; impacts on companies; economic, social, and environmental impacts; impacts on fundamental rights; and impacts on public administrations

ii) effectiveness, efficiency, coherence and proportionality

(pg. 61)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3. The Sustainable Corporate Governance Initiative Consultation

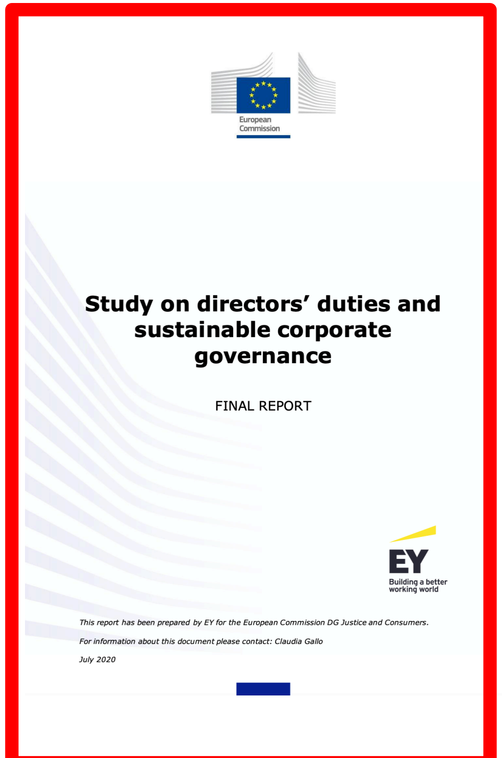
(26 October 2020 – 08 February 2021)

Questions for the public (1)

1. Do you think companies and their directors should **take account of stakeholders' interests in corporate decisions** alongside financial interests of shareholders, beyond what is currently required by EU law?
2. Should the requirement **to act "in the interest of the company"** be clarified to **include the interests** of **employees**, of **customers**, of persons and **communities affected** by the operations of the co, of the **environment**, of **society**, or other?
3. Should companies **identify their stakeholders**?
4. Do you believe that corporate directors should be required by law to **set up adequate procedures** and where relevant, measurable (science-based) **targets** to ensure that **possible risks and adverse impacts on stakeholders**, ie. human rights, social, health and environmental impacts are identified, prevented and addressed?

Questions for the public (2)

5. 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**?
6. Do you consider that **stakeholders**, such as for example employees, the environment or people affected by the operations of the company as represented by civil society organisations, **should be given a role** in the **enforcement of directors' duty of care**?
7. Should there be a legal requirement for companies to **establish and implement adequate processes** with a view to **prevent, mitigate and account for human rights** (including labour rights and working conditions), **health and environmental impacts**, including relating to **climate change**?
8. Do you believe that the EU should require directors to establish and apply mechanisms or, where they already exist for employees for example, use existing information and consultation channels for **engaging with stakeholders** in the area of sustainability?
9. Should **remuneration practices** be reformed to make them **consistent with the goal of sustainability**?
10. Should action be taken to **limit buybacks**?



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