aisbl - ivzw
Rue Belliard 4-6
B-1040 BRUSSELS
Tel : +32 (0)2 289 25 70
Fax : +32 (0)2 502 15 60
info@europeanissuers.eu
www.europeanissuers.eu

POSITION PAPER ON DIRECTORS' DUTIES AND SUSTAINABLE CORPORATE GOVERNANCE

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In the framework of the study on directors' duties and sustainable corporate governance, a second phase consisting in interviews aims at discussing with stakeholder's possible policy options. This second phase is based on "drivers" which are highly subjective and non-scientifically proven assertions. Rather than corresponding to the reality of business, they all sound based on views that are hostile to business (see the self-explanatory drivers' titles below).

In addition, some ideas seem rather destabilising for business in Europe : reviewing the concept of corporate interest at European level despite the different legal frameworks existing in Europe, putting shareholders and stakeholders on the same footing and ignoring the positive impact of corporate governance codes on sustainability.

Driver 1 – "Company's interest is interpreted narrowly and tends to favor the maximisation of shareholders' value"

Issue 1.1: "the formulation of directors' duties and company's interest in which board members are required to act as part of their fiduciary 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."

For EuropeanIssuers, Issue 1.1 is based on a wrong and biased assumption. National frameworks already provide for rules on directors' duties and responsibilities. In addition, Corporate Governance Codes 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.

The combination of a legal "open" definition of the company's interest and 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. 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 endeavors 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 **British** 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 new **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 Goverenance 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"*.

➢ Therefore, 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.

➢ We have to be careful about introducing a definition of directors' duties. All stakeholder interests (interests of employees, of customers, of shareholders…) cannot be put on the same level as some of these interests might be contradictory.

➢ Moreover, Corporate Governance Codes have recetly evolved on these matters, namely through an approach that ensures both a harmonised best practice framework and each national Corporate Governance Code's compatibility with its reference national company law framework. Any further EU provision considering the stakeholders' interest could be thus harmful *vis à vis* such a bottom-up evolution as well as inappropriate with respect to national company law features.

Issue 1.2: "the identification and mitigation of sustainability risks and impacts is rarely included in the board duties"

We do not agree with this idea. The identification and mitigation of sustainability risks and impacts is covered by different governance tools:

- the Directive on the disclosure of non-financial information, which addresses directly companies' boards;
- international non-financial reporting standards (e.g. GRI, SASB, TCFD…), which are widely used by companies;
- corporate governance codes, which already recommend that the board and the company implement adequate internal controls and risk management procedures that ensure due

consideration and management of sustainability risks that are material for company's business. For instance, the French Corporate Governance Code states that the opportunities and risks such as financial, legal, operational and environmental risks are at the heart of the remits of the board. The Italian Corporate Governance Code recommends that the board defines "*the nature and level of risk compatible with the company's strategic objectives, including all the elements that can be relevant for the company's sustainable success*".

Issue 1.3: "the growing importance of institutional investors with a limited length of share ownership brings to an increased focus of companies on short-term financial return."

We understand the importance of fostering long-term oriented investors. In this case we would favour option M1.2, a Commission green paper to stimulate public debates on how to foster long-term shareholder engagement and longer shareholding periods, whilst considering issuers, investors and other stakeholders' expectations on this issue. Other measures, such as the decreasing capital gains tax over time could be also considered.

Driver 2 – "Companies lack a strategic perspective over sustainability and current practices fail to effectively identify and manage relevant sustainability risks and impacts"

Issue 2.1 : "When present, sustainability targets included in sustainability strategies are not aligned with high level objectives (such as SDGs) and not systematically monitored through dedicated KPIs." Issue 2.2: "Companies show different levels of maturity as concerns the identification and management of sustainability risks and impacts, including along the value chain."

The main issue with this item is about the target-setting process. In fact, SDGs are major goals mainly designed for States and they have to be adapted to companies in order to be meaningful. In this process, the difficulty is to define which SDGs are meaningful for a given company activity and how company targets can be "aligned" with relevant SDGs. It is not an easy process.

Also in this case, national Corporate Governance Codes could represent an appropriate tool, as they already recommend issuers to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy.

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

Driver 3 – "Market communication and reporting practices create pressures to focus on the short-term financial performance of the companies"

Issue 3.1: "the disclosure of quarterly returns and earnings guidance tend to reinforce board members focus on the short-term financial performance."

We do not think that companies publishing quarterly reports are unlikely to have a sustainable strategy. Even if we share the need for eliminating any mandatory requirement to publish both quarterly and half-year reporting, we support the companies' freedom of choice to issue any reporting that they consider appropriate to satisfy their investors' expectation.

However, short-term pressure from investors can have adverse impacts on sustainability strategies of corporations. For instance, pressure from some activist funds can undermine the work of the board of public companies and delay or disrupt the implementation of their strategy. Pressure from other investors searching for yield, in a low-interest environment, can in some cases force companies to pay more dividends at the expense of investment.

Issue 3.2 : "Corporate non-financial reporting requirements leave too much room for discretion to companies which eventually translates in the disclosure of information that are not fully relevant or comparable."

Europe should play a central role in building a more coherent system of non-financial reporting, because multiple private initiatives co-exist today without converging.

- **A harmonised non-financial reporting framework developed under EU leadership** is needed to stop the proliferation of various public or private reporting initiatives which are not aligned and make reporting extremely time-consuming and confusing for corporates which are confronted with numerous questionnaires and ratings, based on different methodologies and definitions.
- **It is hard to properly assess responsible business conduct when non-financial ratings vary so widely.** A research team from MIT Sloan found that the correlation among ESG ratings is on average 0.61 whereas financial ratings are correlated at 0.991. 50 % of overall divergence is explained by measurement divergences. The comparability of data underlying ESG ratings is therefore key to improve the quality of ratings, as well as increased transparency of ESG rating agencies about their methodologies.
- **Companies should be put at the heart of the standardisation process.** The non-financial reporting framework needs to be elaborated in close collaboration with companies to make sure it is operational and reflects the sustainability policies implemented by companies.
- **Non-financial reporting obligations should be extended to non-EU companies operating in the EU if they exceed a certain threshold of global turnover**. This is essential to avoid unfair competition. Small and medium sized companies should not be included in the scope because it would create too high compliance costs for them.

Driver 4 – "Board remuneration structures incentivise the focus on short-term shareholder value rather than long-term value creation for the company"

Issue 4.1: "Share-based remuneration exacerbates executives' focus on shareholder value maximization"

Issue 4.1 is ill-based: Long-term Incentive plans based on share-based remuneration are an effective tool to align directors' and company's interest. When used appropriately, they can provide a vehicle for linking an executive's pay to company performance. In this light, no action is needed as the revised Shareholders Rights Directive (SRD II) has already introduced in national legal frameworks the request

for listed companies to disclose in their remuneration policy how it contributes to the company's business strategy and long-term interest and sustainability and they shall explain how it does so.
This general goal is already integrated in hard law or by specific best practice recommendations contained in corporate governance codes such as: the prevalence of long-term-oriented variable components, best practice of vesting and holding periods of such components, inclusion of challenging qualitative and quantitative performance criteria etc.

For instance, regarding bonus shares and stock options, according to French Law, the board of directors either decides that these shares cannot be sold or exercised by the interested parties before the termination of their office, or sets the amount of these shares that they are required to keep on a registered basis until the end of their office. The corresponding information is published in the report.

- Therefore, no additional regulation is needed.

Issue 4.2: "The integration of ESG metrics into board remuneration structures is still a limited practice."

As for Issue 4.2, based on Afep's or Assonime's analysis, a number of large listed companies have already integrated ESG metrics into board remuneration structures. At the same time, the SRD II already recommends linking the remuneration policy also to different criteria, including non-financial and CSR-related ones, where relevant for the company's business. Moreover it prescribes the inclusion of ex-post information on the use of the possibility to reclaim variable remuneration (such best practice is already recommended by main EU corporate governance codes also as a result of the Commission Recommendation 2009/385/EC). Some of the aims and principles of the SRD II are covered and developed also on recommended and implemented best practices level. Any consideration regarding the implementation of the SRD II and the evaluation of related market practices (corporate governance codes and best practices) should be therefore postponed until after a full and consolidated application of the whole framework.

- Therefore, there is no need for an action on this point, considering also that the Commission is still to publish non-binding guidelines for the implementation of the SRD II (namely for the remuneration report).

Driver 5 – "The current board composition does not fully support a shift towards sustainability"

Issue 5.1: "Boards have limited competence and expertise in sustainability matters."

We strongly oppose any action regarding Issue 5.1, as it is biased. It is up to the board to decide the skills needed within their membership. In the Non-Financial Reporting Directive there is already a provision regarding diversity policy on the board (gender representation, nationalities, age qualifications, professional experience). We have to keep in mind that the first quality of a board member is to be honest, competent with the meaning of knowing the business, active, regularly attending and engaged.

In order to develop integrated and effective sustainable business plans, companies need directors who are expert in the business sector with a long-term view and a developed perception of sustainability issues. To this end, companies should ensure appropriate support to the board, also by specific internal functions, such as CSR managers etc.

Driver 6 – "Current corporate governance frameworks and practices do not sufficiently voice the long-term interests of stakeholders"

Issue 6.1: "National regulatory frameworks leave room for different levels of protection of stakeholders' interests and the prevalence of shareholders' primacy norm brings directors to underestimate them." Issue 6.2: "Actual stakeholders' involvement in corporate decision making is a limited market practice."

We strongly disagree with the assertion according to which boards are managing according to the principle of shareholder primacy. This assertion overlooks the fact that in many jurisdictions, for instance in Germany or France, employees are involved in the decision-making process. In addition, some companies have put in place stakeholders' committees with various composition and remits. Furthermore, the French Law on the duty of care states that the vigilance plan must be developed associating stakeholders.

However, we believe all stakeholders cannot be considered as equals. Any attempt to grant the same rights to all stakeholders in the governance of corporates would be a severe infringement to the freedom of enterprise, which is unacceptable in our market economy model.

We believe a regulation on that matter would be counterproductive: who would be these stakeholders? How to define them? How to check if their action is legitimate? How to avoid conflicts of interests...? It might lead to contradictory approaches, since the interests of suppliers or clients might not be the same as the interests of employees or shareholders. The liability regime in force in all jurisdictions is sufficient to sanction misconducts or harm to the environment.

- Therefore, we would support an initiative such the M6.1 (Commission advisory group to identify good practices on stakeholder engagement and involvement by companies, including at board level).

Driver 7 – "Enforcement of directors' duty to act in the long-term interest of company is limited"

Issue 7.1 : "Enforcement of director's duties is limited to the board of directors, the supervisory board and the shareholders, with no rights for other stakeholders to instigate legal proceedings on behalf of the company." Issue 7.2: "Current enforcement levels of directors' duties are low in all Member States."

Whilst it is clear that stakeholders should be able to instigate legal proceedings according the civil and criminal law procedures against a company that would not respect the law, corporate governance is a different matter where all stakeholders cannot be considered as equals. Any attempt to grant the same rights to all stakeholders in the governance of corporates would be a severe infringement to the freedom of enterprise, which is unacceptable in our market economy model.

Any proposal in this field would need first an in-depth analysis of the directors' civil liability across Europe. According to the current framework, some stakeholders may bring actions toward directors.

From the French companies' perspective, where a mandatory due diligence obligation coupled with civil liability has been introduced in 2017. The drawbacks of such legislation are clear, while the actual benefits are not yet demonstrated. The French Law on the duty of care creates considerable legal uncertainty. The vagueness and extremely broad scope of the law, which has been even critically scrutinised by the French *Conseil constitutionnel* (n. 750 DC/2017), may be source of numerous, lengthy and costly judicial proceedings, which would create a climate of distrust.

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