



# **Study on directors' duties and sustainable corporate governance**

FINAL REPORT



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

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# **Study on directors' duties and sustainable corporate governance**

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## **ABSTRACT (EN)**

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.

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.

The study focuses on issues contributing to "short-termism" in company law and corporate governance, which have been grouped around seven key problem drivers, covering aspects such as directors' duties and their enforcement, board remuneration and composition, sustainability in the business strategy, and stakeholder involvement.

The study suggests that a possible future EU action in the area of company law and corporate governance should pursue the general objective of fostering more sustainable corporate governance and contributing to more accountability for companies' sustainable value creation. For this reason, for each driver, alternative options characterised by an increasing level of regulatory intervention have been assessed against the baseline scenario (no policy change).

## **RESUME (FR)**

L'accent mis par les instances décisionnelles au sein des entreprises sur la maximisation à court terme du profit réalisé par les parties prenantes, au détriment de l'intérêt à long terme de l'entreprise, porte atteinte, à long terme, à la durabilité des entreprises européennes, tant sous l'angle économique, qu'environnemental et social.

L'objectif de cette étude est d'évaluer les causes du « court-termisme » dans la gouvernance d'entreprise, qu'elles aient trait aux actuelles pratiques de marché et/ou à des dispositions réglementaires, et d'identifier d'éventuelles solutions au niveau de l'UE, notamment en vue de contribuer à la réalisation des Objectifs de Développement Durable fixés par l'Organisation des Nations Unies et des objectifs de l'accord de Paris en matière de changement climatique.

L'étude porte principalement sur les problématiques participant au « court-termisme » en matière de droit des sociétés et de gouvernance d'entreprises, lesquelles problématiques ayant été catégorisées autour de sept facteurs, recouvrant des aspects tels que les devoirs des administrateurs et leur application, la rémunération et la composition du Conseil d'administration, la durabilité dans la stratégie d'entreprise et l'implication des parties prenantes.

L'étude suggère qu'une éventuelle action future de l'UE dans le domaine du droit des sociétés et de gouvernance d'entreprise devrait poursuivre l'objectif général de favoriser une gouvernance d'entreprise plus durable et de contribuer à une plus grande responsabilisation des entreprises en matière de création de valeur durable. C'est pourquoi, pour chaque facteur, des options alternatives, caractérisées par un niveau croissant d'intervention réglementaire, ont été évaluées par rapport au scénario de base (pas de changement de politique).

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## LIST OF ABBREVIATIONS

CAGR	Compound Annual Growth Rate
CAPEX	Capital expenditures
CDP	Carbon Disclosure Project
CEO	Chief Executive Officer
COACCH	CO-designing the Assessment of Climate Change costs project
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CSR	Corporate Social Responsibility
DG JUST	Directorate General for Justice and Consumers
EBA	European Banking Authority
EEA	European Environment Agency
EIOPA	European Insurance and Occupational Pensions Authority
EPS	Earnings Per Share
ERM	Enterprise Risk Management
ESG	Environmental, Social and Governance
ESMA	European Securities and Markets Authority
ETS	Emission Trading System
EU	European Union
GHG	Greenhouse Gases
GDP	Gross Domestic Product
GRI	Global Reporting Initiative
ILO	International Labour Organization
IPBES	Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services
IPCC	Intergovernmental Panel on Climate Change
ISO	International Organization for Standardization
KPI	Key Performance Indicator
M&A	Merger and Acquisitions
NACE	Statistical Classification of Economic Activities in the European Community
NGO	Non-Governmental Organisation
OECD	Organisation for Economic Co-Operation and Development
OEF	Organisation Environmental Footprint
R&D	Research and Development
SDGs	Sustainable Development Goals
SMART	Sustainable Market Actors for Responsible Trade
SMEs	Small and Medium-Sized Enterprises
TCFD	Task Force on Climate-related Financial Disclosures
TFEU	Treaty on the Functioning of the European Union
TEU	Treaty on European Union
UK	United Kingdom
UN	United Nations
UNEP	United Nations Environment Programme
US	United States
WBCSD	World Business Council for Sustainable Development



**EU Member States**

AT	Austria
BE	Belgium
BG	Bulgaria
CY	Cyprus
CZ	Czechia
DE	Germany
DK	Denmark
EE	Estonia
EL	Greece
ES	Spain
FI	Finland
FR	France
HR	Croatia
HU	Hungary
IE	Ireland
IT	Italy
LT	Lithuania
LU	Luxembourg
LV	Latvia
MT	Malta
NL	Netherlands
PL	Poland
PT	Portugal
RO	Romania
SE	Sweden
SI	Slovenia
SK	Slovakia

## EXECUTIVE SUMMARY (EN)

The objective of this study is to **assess the root causes of "short termism" in corporate governance**, gauging whether they are related to 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 United Nations Sustainable Development Goals (UN SDGs) and the goals of the Paris Agreement on climate change. The output from this study will help the Commission identify possible actions needed for an optimal EU level sustainable company law and corporate governance framework.

The study consisted of two main **tasks**: 1) the analysis of the state of play and potential problems, examining sustainable corporate governance practices and national regulatory frameworks in the EU, and 2) the identification of possible options, starting from the problems highlighted in Task 1, and analysing their potential impacts against the baseline scenario with no EU action.

### Issues at stake and need to act at EU level

#### *The core problem*

Evidence collected over the 1992-2018 period shows that there is a **trend for publicly listed companies within the EU to focus on short-term benefits of shareholders** rather than on the long-term interests of the company. 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 21<sup>st</sup> century.

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.

#### *Problem drivers*

The study identified the following **seven key problem drivers**:

1. Directors' duties and company's interest are interpreted narrowly and tend to favour the short-term maximisation of shareholder value;
2. Growing pressures from investors with a short-term horizon contribute to increasing the 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;
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 the directors' duty to act in the long-term interest of company is limited.

#### *Why should the EU act?*

An EU policy intervention is required to lengthen the time horizon in corporate decision-making and promote a corporate governance that is more conducive to sustainability. The social norm of **shareholder primacy and short-term pressures from the financial markets will likely continue to influence corporate decision-making**. In this way directors and executives of most companies will continue to feel the pressure to maximise shareholder value and distribute earnings through dividends and buybacks, at the same time sacrificing investments (in R&D, CAPEX, employee development, etc.) that are much needed for a transition to sustainable value creation.

However, **the consequences of unsustainability are very serious and have EU-wide (and global) implications**. Short-term time horizons that fail to capture the full extent of long-term sustainability risks and impacts could amount to overwhelming environmental, social and economic consequences for companies, shareholders, investors, and society at large. Moreover, the achievement of the goals of the Paris Agreement on climate change and the UN SDGs is unlikely, given

the status quo. Finally, **only EU action can ensure a level playing field for European companies**. Corporate governance frameworks in Europe vary significantly between Member States, and an EU action alone seems to have the prerequisite scale and scope needed to achieve a higher level of corporate responsibility for long-term sustainable value creation and to set a minimum common ground for dealing with sustainability while avoiding market distortions.

## Objectives and options

### *Objectives of a possible EU intervention*

A possible future EU action in the area of company law and corporate governance should pursue the **general objective** of **fostering more sustainable corporate governance and contributing to more accountability for companies' sustainable value creation**. In doing so, EU intervention should seek to reach a balance between the need to attenuate short-term pressures on company directors and to promote the integration of sustainability into corporate decision-making on the one hand, and the need for enough flexibility to take into account the different national regulatory frameworks on the other.

To achieve this general objective, any future EU intervention should pursue the following three **specific objectives**:

- **Strengthening the role of directors in pursuing their company's long-term interests:** the EU intervention should dispel current misconceptions and errors in relation to the purpose of the company and the duties of directors, which lead directors to prioritise short-term financial performance over the long-term interest of the company;
- **Improving directors' accountability towards integrating sustainability into corporate decision-making:** the EU intervention should bring about a higher level of responsibility for sustainable value creation by making directors more accountable for the sustainability of their business conduct;
- **Promoting corporate governance practices that contribute to company sustainability:** the EU intervention should address corporate governance practices that favour short-termism and hinder the integration of sustainability into company decision-making (e.g. in the area of corporate reporting, board remuneration, board composition, stakeholder involvement).

### *Options*

The Study identified a list of measures to be considered for a detailed assessment.

Depending on their nature, measures were grouped into possible **options** characterised by an increasing level of regulatory intervention compared to the baseline scenario (status quo). Besides the baseline, the options identified are the following:

- **Option A** (*non-legislative/soft*) – Spread sustainable corporate governance practices through awareness raising activities, communications and green papers;
- **Option B** (*non-legislative/soft*) – Foster national regulatory initiatives aimed at orienting corporate governance approaches towards sustainability through recommendations;
- **Option C** (*legislative/hard*) – Set minimum common rules to enhance the creation of long-term value while ensuring a level playing field through EU legislative interventions.

For each driver, the options retained for the detailed assessment are shortly described in the table below:

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Driver	Options		
	Non-legislative/Soft		Legislative/Hard
	Option A	Option B	Option C
#1	<p><b>Commission-led/funded awareness-raising campaign</b> aimed at:</p> <ol style="list-style-type: none"> <li>1. Clarifying that, when acting in the interests of the company, <b>directors should properly balance the following interests, alongside the interest of shareholders:</b> long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global environment; interest of society at large</li> <li>2. Promoting the principle that <b>identifying and mitigating sustainability risks and impacts</b>, both internal and external, is part of directors' duty of care</li> </ol>	<p><b>Commission recommendation that provides a uniform interpretation of directors' duties and company's interest</b> to the Member States and recommends them to:</p> <ol style="list-style-type: none"> <li>1. Clarify in their respective national frameworks that, when acting in the interests of the company, <b>directors should properly balance the following interests, alongside the interest of shareholders:</b> long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global environment; interest of society at large</li> <li>2. Introduce in their respective national frameworks an <b>explicit directors' duty to identify and mitigate sustainability risks and impacts</b>, both internal and external, connected to the company's business operations and value chain</li> </ol>	<p>Commission proposal for a <b>new EU directive providing an EU-wide formulation of directors' duties and company's interest</b>, requiring directors to:</p> <ol style="list-style-type: none"> <li>1. <b>Properly balance the following interests, alongside the interest of shareholders</b>, when acting in the interest of the company: long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global environment; interest of society at large</li> <li>2. <b>Identify and mitigate sustainability risks and impacts</b>, both internal and external, connected to the company's business operations and value chain</li> </ol>
#2	<p><b>Commission green paper</b> to stimulate public debate on how to <b>foster long-term shareholder engagement and longer shareholding periods</b></p> <p><b>Commission led/funded campaign to discourage</b> listed companies to <b>publish earnings guidance</b> and returns on a quarterly basis</p>	<p><b>Commission recommendation</b> for Member States to amend their national regulatory frameworks and provide for mechanisms to <b>incentivise longer shareholding periods</b></p> <p><b>Commission led/funded campaign to discourage</b> listed companies to <b>publish earnings guidance</b> and returns on a quarterly basis</p>	<p><b>Commission proposal to amend the Shareholder Rights Directive II</b> to introduce binding rules requiring Member States to <b>introduce mechanisms to incentivise longer shareholding periods</b></p> <p><b>Commission proposal to amend the Transparency Directive to prohibit both earning guidance and quarterly reporting</b> for listed companies</p>
#3	<p><b>Commission guidance document for boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy</b>, to <b>identify and set</b> as part of the business strategy <b>measurable, specific, time-bound, and science-based sustainability targets</b> aligned with overarching goals (such as the SDGs and the goals of the Paris Agreement on climate change), and to <b>disclose</b> appropriate information.</p> <p>The guidance document would be accompanied by a dissemination <b>campaign</b>.</p>	<p><b>Commission recommendation for Member States</b> to introduce in their respective national frameworks:</p> <ol style="list-style-type: none"> <li>1. A requirement for boards to <b>integrate sustainability aspects (risks, opportunities, impacts) into the business strategy</b></li> <li>2. A requirement for boards to <b>identify and set</b> as part of the business strategy <b>measurable, specific, time-bound, and science-based sustainability targets</b> aligned with overarching goals (such as the SDGs and the goals of the Paris Agreement on climate change),</li> <li>3. A requirement to <b>disclose</b> appropriate information.</li> </ol>	<p>Commission proposal for a <b>new EU directive requiring corporate boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy</b>, to <b>identify and set</b> as part of the business strategy <b>measurable, specific, time-bound, and science-based sustainability targets</b> aligned with overarching goals (such as the SDGs and the goals of the Paris Agreement on climate change), and to <b>disclose</b> appropriate information.</p>

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<b>#4</b>	<b>Commission led/funded campaign</b> aimed at companies to encourage them <b>link board remuneration to long-term, sustainable value creation</b> for the company	<b>Commission recommendation</b> for Member States to introduce in their respective national frameworks: 1. A provision to <b>restrict executives' ability to sell shares they receive as pay</b> 2. A provision to make compulsory the inclusion of <b>non-financial, ESG metrics</b> , linked to a company's sustainability targets, <b>in executive pay scheme</b>	<b>Commission proposal to amend the Shareholder Rights Directive II to align executive remuneration policy with the long-term and sustainability goals</b> , in particular by: 1. Regulating executives' ability to sell the shares they receive as pay 2. Making compulsory the inclusion of non-financial, ESG metrics, linked to a company's sustainability targets, in executive pay scheme
<b>#5</b>	Commission information campaign in collaboration with relevant stakeholders (in particular business associations) to <b>promote the consideration of sustainability-related expertise in the board nomination</b> process of companies (including by creating a new board role, the Chief Value Officer)	Commission recommendation for Member States to introduce in their respective national frameworks a provision to <b>ensure that sustainability-related expertise is systematically considered in the board nomination</b> process of companies	Commission proposal for a <b>new EU directive laying down rules on board composition</b> of listed companies, including a requirement for companies to <b>consider sustainability criteria in the board nomination</b> process
<b>#6</b>	Establishment of a Commission <b>Advisory Group on Sustainable Corporate Governance</b> to identify good practices on stakeholder engagement and involvement. Practices identified could be eventually disseminated through a dedicated <b>campaign</b> .	<b>Commission recommendation for Member States</b> to introduce in their respective national frameworks a requirement for companies to <b>engage with and involve both internal and external stakeholders</b> in identifying, preventing and mitigating sustainability risks and impacts as part of their business strategy.	Commission proposal for <b>new EU binding rules requiring corporate boards to establish mechanisms for engaging with and involving internal and external stakeholders</b> in identifying, preventing and mitigating sustainability risks and impacts as part of their business strategy.
<b>#7</b>		<b>Commission recommendation for Member States to consider measures to strengthen enforcement of directors' duty to act in the interest of the company</b> in their respective national frameworks.	Commission proposal for <b>new EU binding rules to strengthen the enforcement of the directors' duty to act in the interest of the company</b> .

### Assessment of the options

#### *Assessment by impacts*

The impacts of each option have been assessed against the baseline scenario in view of their neutral (e.g. 0), incremental positive (e.g. +1) and negative (e.g. -1) effects. For each type of impact considered, scores ranged from -3 to +3. The following table summarises the possible impacts of each option.

Driver	Impacts	Option A	Option B	Option C	Remarks on the assessment
<b>#1 Directors' duties and company's interest</b>	Impacts on companies	0	-0.5	-0.5	An EU intervention in the area of director's duties, at the core of corporate governance, would have a remarkable impact in improving sustainability, especially binding option C1. An EU-wide formulation of directors' duties and company interest would impact all ESG dimensions positively. However, option C1 could create some difficulties for companies to adapt to the new concepts and review their governance in the short term, which
	Economic impacts	+0.5	+0.5	+1.5	
	Social impacts	+0.5	+1	+3	
	Environmental impacts	+0.5	+1	+3	
	Impacts on fundamental rights	+0.5	+0.5	+3	

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Driver	Impacts	Option A	Option B	Option C	Remarks on the assessment
	Impacts on public administrations	-0.5	0	0	would be compensated by more sustainable value-creation in the long term.
<b>#2 Pressures from investors</b>	Impacts on companies	0	0	-1	By limiting short-term pressures from investors, all options would have some limited positive social and environmental impacts, as well as on fundamental rights. However, the impacts of option C2 on the economy and on companies could be slightly negative, as this measure risks reducing the perceived transparency of listed companies and the liquidity of assets, with possible adverse effects on EU capital markets.
	Economic impacts	0	-0.5	-1	
	Social impacts	+0.5	+0.5	+1	
	Environmental impacts	+0.5	+0.5	+1	
	Impacts on fundamental rights	0	+0.5	+1	
	Impacts on public administrations	-0.5	0	0	
<b>#3 Lack of a strategic perspective over sustainability</b>	Impacts on companies	0	-1	-1	All options would have positive impacts economically, socially and environmentally, as they would push companies to adapt their business models to become more sustainable, including by setting measurable and time-bound sustainability targets. By virtue of its binding nature, option C3 would be particularly impactful in promoting the inclusion of sustainability elements into business strategies. At the same time, both option C3 and B3 are expected to raise compliance costs for companies.
	Economic impacts	+0.5	+0.5	+1.5	
	Social impacts	+1	+1	+3	
	Environmental impacts	+1	+1	+3	
	Impacts on fundamental rights	+1	+1	+3	
	Impacts on public administrations	-0.5	-0.5	-0.5	
<b>#4 Board remuneration</b>	Impacts on companies	-0.5	-0.5	-1.5	Remuneration policy directors is a key area of intervention because linking executive pay to sustainability targets can create incentives to take more sustainable business decisions. All options considered, in particular option C4, would have a positive impact on the society, the environment, and the economy, as executives would be incentivised to focus on sustainability. At the same time, all options are expected to increase compliance costs for companies to some extent.
	Economic impacts	+0.5	+0.5	+1.5	
	Social impacts	+0.5	+0.5	+2	
	Environmental impacts	+0.5	+0.5	+2	
	Impacts on fundamental rights	+0.5	+0.5	+1	
	Impacts on public administrations	-0.5	0	0	
<b>#5 Board composition</b>	Impacts on companies	0	-1	-1.5	By contributing to increasing the presence of sustainability expertise in the board, all options, and in particular option C5, would have a positive impact at social, environmental, and fundamental rights level. However, both options B5 and C5 could have a negative impact on companies by making board recruitment more complex, especially considering that there might be a limited availability of sustainability knowledge and expertise on the market.
	Economic impacts	+0.5	-0.5	-1	
	Social impacts	+0.5	+0.5	+2	
	Environmental impacts	+0.5	+0.5	+2	
	Impacts on fundamental rights	+0.5	+0.5	+1	
	Impacts on public administrations	-0.5	0	0	
<b>#6 Involvement of corporate stakeholders</b>	Impacts on companies	-0.5	-1	-2	By supporting stakeholder engagement and involvement, all options are expected to have positive effects on society, the environment, and fundamental rights. Option C6 would have a remarkable positive social impact, as it would guarantee greater involvement of corporate stakeholders on sustainability matters, while the impacts on the economy and on companies are expected to be negative, especially in sectors with long supply chains and a broad range of stakeholders to be identified and involved.
	Economic impacts	+0.5	-0.5	-1.5	
	Social impacts	+0.5	+0.5	+2	
	Environmental impacts	+0.5	+0.5	+1.5	
	Impacts on fundamental rights	+0.5	+0.5	+1.5	
	Impacts on public administrations	-0.5	0	0	
<b>#7</b>	Impacts on companies	N/A	-1	-1.5	Option B7 and C7 would be closely related to measures on directors' duties and on the integration of sustainability in the business strategy, as both
	Economic impacts	N/A	-1	+1	

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Driver	Impacts	Option A	Option B	Option C	Remarks on the assessment
<b>Enforcement of directors' duties</b>	Social impacts	N/A	+1	+2	options would support the enforcement of the new requirements and create positive social and environmental impacts, with option C7 having more far reaching effects due to its binding nature. Considering the impacts on businesses, a rise in the number of legal actions might be expected, with an increase of administrative and compliance costs borne by companies.
	Environmental impacts	N/A	+1	+2	
	Impacts on fundamental rights	N/A	+1	+2	
	Impacts on public administrations	N/A	-0.5	-2	

### *Assessment by criteria*

Each option has been assessed in terms of effectiveness, efficiency, coherence and proportionality, by getting a score (from -3 to + 3) or a judgement (Yes/No). The following table provides an overview of the assessment.

Driver	Criteria	Option A	Option B	Option C	Remarks on the assessment
<b>#1 Directors' duties and company's interest</b>	Effectiveness	+1	+1	+2.5	By virtue of its binding force and its generalised application across the EU territory, option C1 would be most effective in clarifying and strengthening the role and responsibility of directors for taking into consideration the interests of company stakeholders (alongside shareholders) in promoting the long-term interest of the company, and for identifying and mitigating sustainability risks and impacts as part of their duties. The main implementation obstacle relates to clearly articulating a formulation of directors' duties and company's interest that could be widely accepted, without creating confusion for corporate boards on how to perform their duties.
	Efficiency	0	0	+1.5	
	Coherence	Yes	Yes	Yes	
	Proportionality	Yes	Yes	Yes	
<b>#2 Pressures from investors</b>	Effectiveness	+0.5	+1	+1.5	Option C2 would apply to all European issuers and address a key source of short-term pressures on corporate boards in all Member States. Due to its obligatory power and generalised application, option C2 would be more effective than option A2 and B2 in this regard. However, due to the limitations it would impose on companies and the likely adverse consequences in terms of transparency and attractiveness for investors, option C2 would be disproportionate vis-à-vis the problem of reducing pressures from investors on boards and promote long-termism in companies.
	Efficiency	0	0	0	
	Coherence	Yes	Yes	Yes	
	Proportionality	Yes	Yes	No	
<b>#3 Lack of a strategic perspective over sustainability</b>	Effectiveness	+0.5	+1	+2.5	Option C3 would ensure that equal requirements apply to corporate boards of all large companies, with the possibility for Member States to extend its application to SMEs. Thanks to its binding force and its generalised application, option C3 would be most effective in driving a change in business-as-usual and make EU companies more sustainable and "future proof", consistently with the sustainability transition promoted by the European Green Deal. Cost increase for companies in the short term might be off-set by medium and long-term benefits (e.g. in terms of reduced materiality risks, increased financial returns, positive reputational effects) and value creation for shareholders.
	Efficiency	+0.5	0	+1	
	Coherence	Yes	Yes	Yes	
	Proportionality	Yes	Yes	Yes	

## Study on directors' duties and sustainable corporate governance

Driver	Criteria	Option A	Option B	Option C	Remarks on the assessment
<b>#4 Board remuneration</b>	Effectiveness	+1	+1	+2.5	Option C4 would be most effective in strengthening the link between remuneration and sustainable value creation within listed companies, contributing to better aligning the interests of directors to the long-term interests of the company and its stakeholders at large. This option would create some compliance and adjustment costs for companies, however in the long term it would create positive effects for the competitiveness of businesses, encouraging sustainability-oriented investments and greater attention to ESG risks and opportunities.
	Efficiency	0	0	+0.5	
	Coherence	Yes	Yes	Yes	
	Proportionality	Yes	Yes	Yes	
<b>#5 Board composition</b>	Effectiveness	+1	+1.5	+2.5	By introducing an obligation for listed companies to consider sustainability-related expertise and competence as a selection criterion in the board nomination process, option C5 would be more effective than softer options in promoting sustainable corporate governance. Such approach would be similar to the one already adopted in the financial sector, where management bodies must meet 'fit and proper requirements'. However, it seems important to leave companies free to define the sustainability expertise more relevant for them, so as to avoid "box ticking" approaches. An implementation obstacle might be represented by the limited availability of suitable profiles.
	Efficiency	0	0	0	
	Coherence	Yes	Yes	Yes	
	Proportionality	Yes	Yes	Yes	
<b>#6 Involvement of corporate stakeholders</b>	Effectiveness	+0.5	+1	+2.5	By requiring corporate boards to establish mechanisms for engaging with and involving corporate stakeholders at board level, option C6 would effectively contribute to greater consideration of the sustainability concerns of stakeholders into the business strategy. It would enable internal and external stakeholders to express their views to the boards on sustainability-related aspects, and to contribute to defining and supervising the effective integration of sustainability into the companies' business strategies. Even though option C6 would be relatively costlier than option A6 and B6, it is not expected to create disproportionate burdens for companies and public administrations.
	Efficiency	0	0	0	
	Coherence	Yes	Yes	Yes	
	Proportionality	Yes	Yes	Yes	
<b>#7 Enforcement of directors' duties</b>	Effectiveness	N/A	+1	+2	Taken in conjunction with option C1, option C7 would be most effective and proportionate to the objective of improving companies' sustainability. Together, these measures would promote a more consistent EU level approach in the area of director's duties, remedies and liabilities, strengthening directors' accountability to stakeholders when acting in the long-term interest of the company. Option C7 would not create direct requirements for companies, but would modify the legal framework within which their directors operate, bringing indirect costs. In the long term, stronger enforcement mechanisms would incentivise directors to take greater account of sustainability risks and impacts in their decisions, with positive effects for the competitiveness of EU businesses.
	Efficiency	N/A	0	+0.5	
	Coherence	N/A	Yes	Yes	
	Proportionality	N/A	Yes	Yes	



## NOTE DE SYNTHÈSE (FR)

L'objectif de cette étude est **d'évaluer les causes à l'origine du « court-termisme » en matière de gouvernance d'entreprise**, en déterminant si elles sont liées aux pratiques de marché et/ou aux cadres réglementaires actuels, et d'identifier des solutions potentielles au niveau de l'Union Européenne (UE), également en vue de contribuer à la réalisation des Objectifs de Développement Durable (ODD) fixés par l'Organisation des Nations Unies (ONU) et des objectifs de l'accord de Paris sur le changement climatique. Les résultats de cette étude appuieront la Commission européenne pour identifier les potentielles actions nécessaires à l'élaboration d'un cadre réglementaire durable en matière de droit des sociétés et de gouvernance d'entreprise.

Cette étude est structurée autour de deux **tâches** : 1) l'analyse de l'état des lieux et des problèmes potentiels, qui examine les pratiques de gouvernance durable et les cadres réglementaires nationaux au sein de l'UE, et 2) l'identification d'options possibles, en partant des problématiques identifiées dans la phase 1), et en analysant leurs impacts potentiels par rapport au scénario de base sans action.

### Enjeux et nécessité d'une intervention au niveau de l'UE

#### *Description de la problématique centrale*

Les données collectées pendant la période allant de 1992 à 2018, révèlent **tendance des sociétés cotées dans l'UE à se concentrer sur les profits à court-terme réalisés par les actionnaires, au détriment des intérêts à long terme de l'entreprise**. Les données illustrent une tendance à la hausse des dividendes versées aux actionnaires, qui ont été multipliées par quatre, passant de 1% des bénéfices en 1992 à près de 4% en 2018. De plus, le ratio des investissements en capital et en R&D par rapport aux bénéfices décline depuis le début du XXI<sup>ème</sup> siècle.

Cette étude montre que, dans une certaine mesure, le « court-termisme » en matière de gouvernance d'entreprise prend principalement sa source dans les cadres réglementaires et dans les pratiques de marché. Ces tendances se conjuguent pour promouvoir l'accent mis sur le rendement financier à court terme plutôt que sur la création de valeur durable à long terme.

#### *Facteurs de problèmes*

L'étude a identifié les **sept principaux facteurs de problèmes suivants** :

1. Les devoirs des administrateurs et l'intérêt de la société sont interprétés de manière restrictive et tendent à favoriser la maximisation des profits des actionnaires à court-terme ;
2. Une pression grandissante exercée par des investisseurs concentrés sur des horizons à court-terme tend à accroître l'attention portée par le Conseil d'Administration aux bénéfices à court-terme pour les actionnaires, au détriment de la création de valeur durable ;
3. Les entreprises n'ont pas de stratégies et de perspectives durables et les pratiques actuellement mises en œuvre ne permettent ni d'identifier efficacement les risques et impacts associés à une stratégie durable, ni de les gérer ;
4. Les barèmes de rémunération du Conseil d'Administration favorisent le court-termisme et les profits des actionnaires, au détriment de la création de valeur durable au profit de l'entreprise ;
5. La composition actuelle du Conseil d'Administration ne participe pas pleinement à une transition vers un système plus durable ;
6. Les cadres actuels régissant la gouvernance d'entreprise, de même que les pratiques observées, ne font pas suffisamment place aux intérêts à long-terme des parties prenantes ;
7. La mise en application des devoirs des administrateurs d'agir dans l'intérêt à long terme de l'entreprise est limitée.

#### *Justification d'une intervention au niveau européen*

Une intervention de l'UE est nécessaire pour étendre l'horizon temporel qui prévaut en matière de prise de décision à l'échelle d'une entreprise, et pour promouvoir une gouvernance davantage propice à la durabilité. **La norme sociale du primat des intérêts de l'actionnaire et les pressions à court-terme générées par les marchés financiers continueront probablement à influencer sur les modes de prise de décision à l'échelle des entreprises**. En ce sens, la plupart des administrateurs et des dirigeants d'entreprises continueront à être incités à accroître les bénéfices des

actionnaires et à distribuer les bénéfices sous forme de dividendes et de rachats, tout en sacrifiant dans le même temps les investissements nécessaires à une transition vers une création de valeur durable (R&D, investissement en capital, perfectionnement des employés).

Toutefois, **l'absence de durabilité en matière de gouvernance d'entreprise a des conséquences sérieuses**, qui s'étendent à l'échelle européenne et mondiale. Les horizons temporels à court terme qui échouent à englober les risques et impacts liés à la durabilité à long-terme pourraient avoir des conséquences environnementales, sociales et économiques considérables pour les entreprises, les actionnaires, les investisseurs, et la société dans son ensemble. De plus, l'atteinte des objectifs en matière de changement climatique figurant dans l'Accord de Paris et des ODD fixés par l'ONU, semble peu probable dans la situation actuelle. Enfin, **seule une intervention à l'échelle de l'UE peut garantir des conditions de concurrence équitables pour les entreprises européennes**. Les cadres de gouvernance d'entreprise réglementaires en Europe varient considérablement d'un Etat membre à l'autre, et seule une intervention de l'UE semble pouvoir accroître la responsabilité sociale des entreprises pour la création de valeur durable et pour établir la base commune nécessaire à la prise en compte de la durabilité tout en évitant les distorsions de marché.

## Objectifs et options

### *Objectifs d'une éventuelle intervention de l'UE*

Une intervention de l'UE en matière de droit des sociétés et de gouvernance d'entreprise devrait poursuivre **l'objectif général visant à encourager une gouvernance d'entreprise durable et contribuer à accroître la responsabilité des entreprises en matière de création de valeur durable**. Se faisant, l'intervention de l'UE doit rechercher un équilibre entre la nécessité d'atténuer les pressions à court terme pesant sur les administrateurs d'entreprise et de promouvoir la durabilité dans le cadre de la prise de décision à l'échelle des entreprises d'une part, et, d'autre part, la nécessité d'une flexibilité suffisante à la prise en compte des différents cadres réglementaires nationaux.

Afin d'atteindre cet objectif général, toute intervention future de l'UE devrait poursuivre les trois **objectifs spécifiques** suivants :

- **Renforcer le rôle des administrateurs en matière de poursuite des intérêts à long-terme de l'entreprise** : l'intervention de l'UE devrait dissiper les conceptions biaisées et les erreurs actuelles quant à la raison d'être de l'entreprise et aux devoirs des administrateurs, ces derniers conduisant à faire prévaloir la performance financière à court-terme, au détriment de l'intérêt à long terme de la société ;
- **Améliorer la responsabilité des administrateurs en matière de prise en compte de la durabilité dans le processus décisionnel de l'entreprise** : l'intervention de l'UE devrait introduire un niveau de responsabilité accrue en matière de création de valeur durable, en rendant les administrateurs davantage responsables de la prise en compte de la durabilité de leur conduite commerciale ;
- **Promouvoir des pratiques de gouvernance d'entreprises qui participent de la durabilité de l'entreprise** : l'intervention de l'UE devrait permettre de faire émerger des pratiques de gouvernance alternatives à celles qui favorisent le « court-termisme » et empêchent l'intégration de la durabilité dans le processus de décision (par exemple dans le domaine des rapports d'entreprises, de la rémunération du Conseil d'Administration, de la composition du Conseil d'Administration et de l'intéressement des parties prenantes).

### *Description des options envisagées*

L'étude a identifié une liste de mesures à envisager pour une évaluation détaillée.

En fonction de leur nature, les mesures ont été regroupées selon **options**, caractérisées par un niveau croissant d'intervention réglementaire, par opposition à un scénario de base (situation actuelle).

Outre le scénario de base, les options identifiées sont les suivantes :

- **Option A (non contraignante / Droit « mou »)** – Diffuser des pratiques de gouvernance d'entreprise durables par le biais d'actions de sensibilisation, de communications de la Commission européenne et de « Livres Verts » ;

- **Option B (non contraignante/Droit « mou »)** : Favoriser les initiatives réglementaires à l'échelle nationale visant à orienter les approches en matière de gouvernance d'entreprise vers la durabilité, par le biais de recommandations ;
- **Option C (Contraignante)** – Fixer un socle commun de règles minimales visant à renforcer la création de valeur à long terme, tout en garantissant des conditions de concurrence équitables par le biais d'interventions législatives à l'échelle de l'UE.

Pour chaque facteur, les options retenues pour l'évaluation détaillée sont brièvement décrites dans le tableau ci-dessous :

Facteurs de problèmes	Option		
	Non contraignante/Non législative		Contraignante/Législative
	Option A	Option B	Option C
#1	<p><b>Campagnes de sensibilisation conduites/financées par la Commission</b> visant à :</p> <ol style="list-style-type: none"> <li>Clarifier le fait que, lorsqu'ils agissent dans l'intérêt de l'entreprise, les administrateurs doivent concilier adéquatement les intérêts suivants, outre les intérêts des actionnaires : les intérêts de l'entreprise à long terme (au-delà de 5 ou 10 ans) ; les intérêts des employés ; les intérêts des clients ; les intérêts de l'environnement local et mondial ; l'intérêt de la société dans son ensemble</li> <li>Promouvoir le principe selon lequel l'identification et l'atténuation des risques et impacts liés à la durabilité, aussi bien en interne que dans le cadre des relations extérieures, relèvent de l'obligation diligence des administrateurs.</li> </ol>	<p><b>Recommandation de la Commission relative à une interprétation commune des devoirs des administrateurs et de la notion d'intérêt social</b> à destination des Etats membres et leur recommandant de :</p> <ol style="list-style-type: none"> <li>Clarifier, dans leur législation respective, le fait que les administrateurs doivent concilier adéquatement les intérêts suivants, outre les intérêts des actionnaires : les intérêts de l'entreprise à long terme (au-delà de 5 ou 10 ans) ; les intérêts des employés ; les intérêts des clients ; les intérêts de l'environnement local et mondial ; l'intérêt de la société dans son ensemble</li> <li>Introduire dans leur législation respective un devoir explicite incombant aux administrateurs d'identifier et d'atténuer les risques et impacts liés à la durabilité, aussi bien en interne que dans le cadre des relations extérieures, dans le cadre des opérations commerciales de l'entreprise et de la chaîne de valeur.</li> </ol>	<p>Proposition de la Commission en vue de l'adoption <b>d'une nouvelle directive établissant à l'échelle européenne le champ des devoirs des administrateurs et une définition de la notion d'intérêt social</b>, imposant aux administrateurs :</p> <ol style="list-style-type: none"> <li>De concilier adéquatement les intérêts suivants, outre les intérêts des actionnaires : les intérêts de l'entreprise à long terme (au-delà de 5 ou 19 ans) ; les intérêts des employés, les intérêts des clients, les intérêts de l'environnement local et global ; l'intérêt de la société dans son ensemble</li> <li>D'identifier et d'atténuer les risques et impacts liés à la durabilité, aussi bien en interne que dans le cadre des relations extérieures, dans le cadre des opérations commerciales et de la chaîne de valeur</li> </ol>
#2	<p><b>Livre Vert de la Commission</b> visant à stimuler le débat public relatif aux moyens de favoriser l'intéressement à long-terme des actionnaires et l'extension des périodes de détention des actions.</p> <p><b>Campagne conduite/financée par la Commission visant à décourager les sociétés cotées de publier leurs résultats prévisionnels</b> et rendements sur une base trimestrielle</p>	<p><b>Recommandation de la Commission relative à des mécanismes visant à encourager l'extension des périodes de détention des actions</b>, à destination des Etats membres afin de leur permettre d'amender leur législation respective.</p> <p><b>Campagne conduite/financée par la Commission visant à décourager les sociétés cotées de publier leurs résultats prévisionnels</b> et leurs rendements sur une base trimestrielle.</p>	<p><b>Proposition de la Commission en vue d'amender la Directive SRD II</b> et visant à introduire des dispositions contraignantes exigeant des Etats membres qu'ils introduisent des <b>mécanismes promouvant l'extension des périodes de détention de actions</b>.</p> <p><b>Proposition de la Commission en vue d'amender la Directive Transparence afin d'interdire la publication des résultats prévisionnels</b> et des rendements sur une base trimestrielle.</p>

#3	<p><b>Guides de la Commission européenne destinés aux Conseils d'Administration afin d'intégrer les aspects de durabilité (risques, opportunités, impacts) à la stratégie commerciale, d'identifier et de fixer</b>, au sein de la Stratégie, des objectifs mesurables, précises, à atteindre dans un délai déterminé et scientifiquement fondées en matière de durabilité, alignées avec des objectifs généraux (tels que les ODD et les objectifs de l'Accord de Paris sur le changement climatique), et de rendre publiques les informations pertinentes.</p>	<p><b>Recommandation de la Commission européenne destinée aux Etats membres</b> afin de leur permettre d'introduire dans leur législation respective :</p> <ol style="list-style-type: none"> <li>1. L'obligation pour les Conseils d'Administration <b>d'intégrer les aspects relatifs à la durabilité (risques, opportunités, impacts) dans la stratégie commerciale.</b></li> <li>2. L'obligation pour les Conseils d'Administration d'identifier et de fixer, au sein de la stratégie commerciale, des objectifs mesurables, précises, à atteindre dans un délai déterminé et scientifiquement fondées en matière de durabilité, alignées avec des objectifs généraux (tels que les ODD et les objectifs de l'Accord de Paris sur le changement climatique).</li> <li>3. L'obligation faite aux Conseils d'Administration de <b>rendre publiques</b> les informations pertinentes.</li> </ol>	<p><b>Proposition de la Commission en vue d'adopter une nouvelle Directive européenne imposant aux Conseils d'Administration d'intégrer les aspects de durabilité (risques, opportunités, impacts) au sein de la stratégie commerciale</b>, d'identifier et de fixer des objectifs mesurables, précises, à atteindre dans un délai déterminé et scientifiquement fondées en matière de durabilité, alignées avec des objectifs généraux (tels que les ODD et les objectifs de Paris sur le changement climatique), et de rendre publiques les informations pertinentes.</p>
#4	<p><b>Campagne conduite/financée par la Commission européenne</b> destinée aux entreprises et visant à les encourager à <b>établir un lien entre la rémunération du Conseil d'Administration et la création de valeur à long terme</b> pour l'entreprise</p>	<p><b>Recommandation de la Commission</b> destinée aux Etats membres afin de leur permettre d'introduire dans leur législation respective :</p> <ol style="list-style-type: none"> <li>1. Une disposition visant à limiter la capacité des cadres dirigeants à vendre les actions reçues au titre de rémunération</li> <li>2. Une disposition rendant obligatoire l'inclusion au <b>barème de rémunération des cadres dirigeants des indicateurs ESG et non financiers</b></li> </ol>	<p><b>Proposition de la Commission en vue d'amender la Directive SRD II afin d'aligner la politique de rémunération des cadres dirigeants</b> avec les objectifs de durabilité à long terme, en particulier en :</p> <ol style="list-style-type: none"> <li>1. Régulant la capacité des cadres dirigeants à vendre les actions reçues au titre de la rémunération</li> <li>2. Rendre obligatoire l'inclusion au barème de rémunération des cadres dirigeants des indicateurs ESG et non financiers</li> </ol>
#5	<p>Campagne d'information de la Commission, en lien avec les parties prenantes concernées (en particulier les associations d'entreprises) visant à <b>promouvoir la prise en compte de l'expertise en matière de durabilité dans le cadre de la procédure</b></p>	<p><b>Recommandation de la Commission à destination des Etats membres</b> afin de leur permettre d'introduire dans leur législation respective une disposition garantissant la prise en compte de l'expertise en matière de durabilité dans le</p>	<p><b>Proposition de la Commission en vue de l'adoption d'une nouvelle Directive établissant des règles relatives à la composition du Conseil d'Administration</b> dans les sociétés cotées, comprenant une disposition imposant aux entreprises la prise en</p>

	<b>de nomination du Conseil d'Administration</b> (y compris en créant une nouvelle fonction au sein du Conseil d'Administration, de chef de la Direction « Valeurs »)	cadre de la procédure de nomination du Conseil d'Administration.	compte du critère de la durabilité dans le cadre du processus de nomination du Conseil d'Administration
#6	Mise en place d'un <b>Groupe d'experts au sein de la Commission en matière de gouvernance durable d'entreprise</b> , afin d'identifier les bonnes pratiques relatives à l'engagement et l'intéressement des parties prenantes. Les pratiques identifiées pourraient éventuellement être diffusées par le biais d'une <b>campagne</b> dédiée.	<b>Recommandation de la Commission</b> à destination des Etats membres visant à envisager d'intégrer à leur législation respective une <b>obligation faite aux entreprises d'impliquer des parties prenantes internes et externes dans le cadre de l'identification, la prévention et l'atténuation des risques et impacts de la durabilité</b> dans le cadre de leur stratégie	<b>Proposition de la Commission en vue de l'adoption d'une nouvelle Directive visant à intégrer des dispositions contraignantes imposant aux Conseils d'Administration d'impliquer des parties prenantes internes et externes</b> dans l'identification, la prévention et l'atténuation des risques et impacts liés à la durabilité dans le cadre de leur stratégie.
#7		<b>Recommandation de la Commission</b> à destination des Etats membres visant à <b>l'adoption</b> dans leur législation respective de <b>mesures renforçant la mise en exécution de l'obligation faite aux administrateurs d'agir dans l'intérêt de l'entreprise.</b>	<b>Proposition de la Commission en vue de l'adoption d'une nouvelle Directive introduisant des règles contraignantes visant à renforcer la mise en exécution de l'obligation faite aux administrateurs d'agir dans l'intérêt de l'entreprise.</b>

## Evaluation des options

### *Evaluation au regard des impacts*

Les impacts de chaque option ont été évalués au regard du scénario de base afin de rendre compte leur effet probable : neutre (par exemple 0), positif (par exemple, + 1) ou négatif (par exemple, -1). Pour chaque type d'impact pris en compte, les résultats s'échelonnent de -3 à +3. Le tableau ci-dessous synthétise les éventuels impacts de chaque option.

Facteurs	Impacts	Option A	Option B	Option C	Observations sur l'évaluation
<b>#1 Devoirs des administrateurs et intérêt social</b>	Impacts sur les entreprises	0	-0.5	-0.5	Une intervention de l'UE dans le domaine des devoirs des administrateurs, au cœur de la gouvernance d'entreprise, aurait un impact remarquable sur l'amélioration de la durabilité, en particulier l'option contraignante C1. Une formulation à l'échelle européenne des devoirs des administrateurs et de l'intérêt de l'entreprise aurait un impact positif sur toutes les dimensions ESG. Cependant, l'option C1 pourrait créer certaines difficultés aux entreprises pour s'adapter
	Impacts économiques	+0.5	+0.5	+1.5	
	Impacts sociaux	+0.5	+1	+3	
	Impacts environnementaux	+0.5	+1	+3	
	Impacts sur les droits fondamentaux	+0.5	+0.5	+3	

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Facteurs	Impacts	Option A	Option B	Option C	Observations sur l'évaluation
	Impacts sur les administrations publiques	-0.5	0	0	aux nouveaux concepts et pour revoir leur gouvernance à court terme, ce qui serait compensé par une création de valeur plus durable à long terme.
<b>#2 La pression des investisseurs</b>	Impacts sur les entreprises	0	0	-1	En limitant les pressions à court terme des investisseurs, toutes les options auraient un impact positif limité sur le plan social et environnemental, ainsi que sur le plan des droits fondamentaux. Cependant, les effets de l'option C2 sur l'économie et sur les entreprises pourraient être légèrement négatifs, car cette mesure risque de réduire la transparence perçue des sociétés cotées et la liquidité des actifs, avec des possibles effets négatifs sur les marchés de capitaux de l'UE.
	Impacts économiques	0	-0.5	-1	
	Impacts sociaux	+0.5	+0.5	+1	
	Impacts environnementaux	+0.5	+0.5	+1	
	Impacts sur les droits fondamentaux	0	+0.5	+1	
	Impacts sur les administrations publiques	-0.5	0	0	
<b>#3 Absence de perspective stratégique vers la durabilité</b>	Impacts sur les entreprises	0	-1	-1	Toutes les options auraient des répercussions positives sur les plans économique, social et environnemental, car elles pousseraient les entreprises à adapter leurs modèles commerciaux pour devenir plus durables, notamment en fixant des objectifs de durabilité mesurables et circonscrits dans le temps. En raison de sa nature contraignante, l'option C3 aurait un impact particulier sur la promotion de l'inclusion des éléments de durabilité dans les stratégies commerciales. Dans le même temps, les options C3 et B3 pourraient toutes deux augmenter les coûts de conformité pour les entreprises.
	Impacts économiques	+0.5	+0.5	+1.5	
	Impacts sociaux	+1	+1	+3	
	Impacts environnementaux	+1	+1	+3	
	Impacts sur les droits fondamentaux	+1	+1	+3	
	Impacts sur les administrations publiques	-0.5	-0.5	-0.5	
<b>#4 Rémunération du Conseil d'Administration</b>	Impacts sur les entreprises	-0.5	-0.5	-1.5	La politique de rémunération des directeurs constitue un domaine d'intervention clé, car lier la rémunération des dirigeants aux objectifs de durabilité peut inciter les entreprises à prendre des décisions commerciales plus durables. Toutes les options envisagées, en particulier l'option C4, auraient un impact positif sur la société, l'environnement et l'économie, car les dirigeants seraient incités à se concentrer sur la durabilité. Dans le même temps, toutes les options devraient augmenter dans une certaine mesure les coûts de mise en conformité pour les entreprises.
	Impacts économiques	+0.5	+0.5	+1.5	
	Impacts sociaux	+0.5	+0.5	+2	
	Impacts environnementaux	+0.5	+0.5	+2	
	Impacts sur les droits fondamentaux	+0.5	+0.5	+1	
	Impacts sur les administrations publiques	-0.5	0	0	
<b>#5 Composition du Conseil d'Administration</b>	Impacts sur les entreprises	0	-1	-1.5	En contribuant à accroître la présence d'une expertise en durabilité au sein du conseil, toutes les options, et en particulier l'option C5, auraient un impact positif au niveau social, environnemental et des droits fondamentaux. Cependant, les deux options B5 et C5 pourraient avoir un impact négatif sur les entreprises en rendant le recrutement des conseillers d'administration plus complexe,
	Impacts économiques	+0.5	-0.5	-1	
	Impacts sociaux	+0.5	+0.5	+2	
	Impacts environnementaux	+0.5	+0.5	+2	
	Impacts sur les droits fondamentaux	+0.5	+0.5	+1	

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Facteurs	Impacts	Option A	Option B	Option C	Observations sur l'évaluation
	Impacts sur les administrations publiques	-0.5	0	0	surtout si l'on considère que les connaissances et l'expertise en matière de durabilité pourraient être limitées sur le marché.
<b>#6 Implication des parties prenantes de l'entreprise</b>	Impacts sur les entreprises	-0.5	-1	-2	En soutenant l'engagement et l'implication des parties prenantes, toutes les options devraient avoir des effets positifs sur la société, l'environnement et les droits fondamentaux. L'option C6 aurait un impact social positif remarquable, car elle garantirait une plus grande implication des parties prenantes chez les entreprises sur les questions de durabilité, tandis que les impacts sur l'économie et les entreprises devraient être négatifs, en particulier dans les secteurs avec des longues chaînes d'approvisionnement et où un large éventail de parties prenantes doit être identifié et impliqué.
	Impacts économiques	+0.5	-0.5	-1.5	
	Impacts sociaux	+0.5	+0.5	+2	
	Impacts environnementaux	+0.5	+0.5	+1.5	
	Impacts sur les droits fondamentaux	+0.5	+0.5	+1.5	
	Impacts sur les administrations publiques	-0.5	0	0	
<b>#7 Application des devoirs des administrateurs</b>	Impacts sur les entreprises	N/A	-1	-1.5	Les options B7 et C7 seraient étroitement liées aux mesures relatives aux devoirs des administrateurs et à l'intégration de la durabilité dans la stratégie d'entreprise, car les deux options favoriseraient l'application des nouvelles exigences et créeraient des impacts sociaux et environnementaux positifs, l'option C7 ayant des effets plus larges en raison de sa nature contraignante. Compte tenu des impacts sur les entreprises, on peut s'attendre une augmentation du nombre d'actions en justice, avec une hausse des coûts administratifs et de mise en conformité supportés par les entreprises.
	Impacts économiques	N/A	-1	+1	
	Impacts sociaux	N/A	+1	+2	
	Impacts environnementaux	N/A	+1	+2	
	Impacts sur les droits fondamentaux	N/A	+1	+2	
	Impacts sur les administrations publiques	N/A	-0.5	-2	

### *Evaluation par critère*

Chaque option a été évaluée au regard de l'efficacité, de l'efficacité, de la cohérence et de la proportionnalité, résultant dans l'attribution d'une note (allant de -3 à +3) ou la formulation d'un jugement (Oui/Non). Le tableau ci-dessous synthétise l'évaluation.

Facteurs	Critère	Option A	Option B	Option C	Observations sur l'évaluation
<b>#1 Devoirs des administrateurs et intérêt social</b>	Efficacité	+1	+1	+2.5	En raison de sa force contraignante et de l'application généralisée sur tout le territoire de l'UE, l'option C1 serait la plus efficace pour clarifier et renforcer le rôle et la responsabilité des administrateurs dans la prise en compte des intérêts des parties prenantes de l'entreprise (aux côtés des actionnaires) dans la promotion de l'intérêt de l'entreprise à long terme, et pour identifier et atténuer les risques et impacts en matière de durabilité dans le cadre de leurs fonctions. Le principal obstacle à sa mise en œuvre concerne l'articulation claire d'une formulation des devoirs des administrateurs et de l'intérêt de la société, qui pourrait être largement acceptée, sans créer de confusion pour les conseils d'administration sur la manière d'exercer leurs fonctions.
	Efficience	0	0	+1.5	
	Cohérence	Oui	Oui	Oui	
	Proportionnalité	Oui	Oui	Oui	



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Facteurs	Critère	Option A	Option B	Option C	Observations sur l'évaluation
<b>#2 La pression des investisseurs</b>	Efficacité	+0.5	+1	+1.5	L'option C2 s'appliquerait à tous les émetteurs européens et répondrait à une source clé des pressions à court terme sur les conseils d'administration de tous les États membres. En raison de son caractère obligatoire et de son application généralisée, l'option C2 serait plus efficace que les options A2 et B2 à cet égard. Cependant, en raison des limites qu'elle imposerait aux entreprises et des conséquences négatives probables en termes de transparence et d'attractivité pour les investisseurs, l'option C2 serait disproportionnée par rapport au problème de la réduction des pressions exercées par les investisseurs sur les conseils d'administration et de la promotion du long-termisme dans entreprises.
	Efficience	0	0	0	
	Cohérence	Oui	Oui	Oui	
	Proportionnalité	Oui	Oui	Non	
<b>#3 Absence de perspective stratégique vers la durabilité</b>	Efficacité	+0.5	+1	+2.5	L'option C3 garantirait que des exigences identiques s'appliquent aux conseils d'administration de toutes les grandes entreprises, avec la possibilité pour les États membres d'étendre leur application aux PME. Grâce à sa force contraignante et à son application généralisée, l'option C3 serait la plus efficace pour favoriser un changement du status quo et rendre les entreprises de l'UE plus durables et « à l'épreuve du temps », conformément à la transition durable promue par le Green Deal européen. L'augmentation des coûts pour les entreprises à court terme pourrait être compensée par des avantages à moyen et long terme (par exemple en termes de réduction des risques de matérialité, d'augmentation des revenus financiers, d'effets positifs sur la réputation) et par la création de valeur pour les actionnaires.
	Efficience	+0.5	0	+1	
	Cohérence	Oui	Oui	Oui	
	Proportionnalité	Oui	Oui	Oui	
<b>#4 Rémunération du Conseil d'Administration</b>	Efficacité	+1	+1	+2.5	L'option C4 serait la plus efficace pour renforcer le lien entre la rémunération et la création de valeur durable au sein des entreprises cotées, en contribuant à mieux aligner les intérêts des administrateurs avec les intérêts à long terme de l'entreprise et de ses parties prenantes au sens large. Cette option entraînerait certains coûts de mise en conformité et d'ajustement pour les entreprises, mais sur le long terme, elle créerait des effets positifs sur leur compétitivité, en encourageant les investissements axés sur la durabilité et une plus grande attention aux risques et opportunités ESG.
	Efficience	0	0	+0.5	
	Cohérence	Oui	Oui	Oui	
	Proportionnalité	Oui	Oui	Oui	
<b>#5</b>	Efficacité	+1	+1.5	+2.5	En introduisant une obligation pour les entreprises cotées de considérer l'expertise et les compétences liées au développement durable comme critères de sélection dans le processus de

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Facteurs	Critère	Option A	Option B	Option C	Observations sur l'évaluation
<b>Composition du Conseil d'Administration</b>	Efficienc	0	0	0	recrutement du conseil d'administration, l'option C5 serait plus efficace que les options plus souples pour favoriser une gouvernance d'entreprise durable. Cette approche serait similaire à celle déjà adoptée dans le secteur financier, où les organes de direction doivent répondre à des «conditions adaptées et appropriées». Cependant, il semble important de laisser aux entreprises la liberté de définir l'expertise de durabilité la plus pertinente pour elles, afin d'éviter les approches de «à la carte». Un obstacle à la mise en œuvre pourrait être la disponibilité limitée de profils appropriés.
	Cohérence	Oui	Oui	Oui	
	Proportionnalité	Oui	Oui	Oui	
<b>#6 Implication des parties prenantes de l'entreprise</b>	Efficacité	+0.5	+1	+2.5	En exigeant que les conseils d'administration établissent des mécanismes permettant d'engager et d'impliquer les parties prenantes des entreprises au niveau du conseil, l'option C6 contribuerait efficacement à une plus grande prise en compte des préoccupations des parties prenantes en matière de durabilité dans la stratégie d'entreprise. Elle permettrait aux parties prenantes internes et externes d'exprimer leurs points de vue aux conseils d'administration sur les aspects liés au développement durable, et de contribuer à définir et à superviser l'intégration effective de la durabilité dans les stratégies commerciales des entreprises. Malgré l'option C6 serait relativement plus coûteuse par rapport aux options A6 et B6, elle ne devrait pas créer de charges disproportionnées pour les entreprises et les administrations publiques.
	Efficienc	0	0	0	
	Cohérence	Oui	Oui	Oui	
	Proportionnalité	Oui	Oui	Oui	
<b>#7 Application des devoirs des administrateurs</b>	Efficacité	N/A	+1	+2	Prise conjointement avec l'option C1, l'option C7 serait la plus efficace et la plus proportionnée à l'objectif d'amélioration de la durabilité des entreprises. Ensemble, ces mesures favoriseraient une approche plus cohérente au niveau de l'UE dans le domaine des devoirs, des solutions et des garanties des administrateurs, en renforçant leur responsabilité envers les parties prenantes lorsqu'ils agissent dans l'intérêt à long terme de l'entreprise. L'option C7 ne créerait pas d'obligations directes pour les entreprises, mais elle pourrait modifier le cadre juridique dans lequel leurs administrateurs opèrent, ce qui entraînerait des coûts indirects. À long terme, des mécanismes de mise en œuvre plus solides inciteraient les administrateurs à tenir davantage compte des risques et des impacts en matière de durabilité dans leurs décisions, ce qui aurait des effets positifs sur la compétitivité des entreprises de l'UE.
	Efficienc	N/A	0	+0.5	
	Cohérence	N/A	Oui	Oui	
	Proportionnalité	N/A	Oui	Oui	

## 1 INTRODUCTION

This is the final report of the request for service JUST/2018/MARK/FW/CIVI/0177 2019/03 on the Study on directors' duties and sustainable corporate governance.

This report is structured as follows:

- **Chapter 1, Introduction**, describes the objectives and scope of the study;
- **Chapter 2, Research methodology**, describes the data collection plan implemented to feed the study together with the main difficulties encountered, and illustrates the methodology followed for the assessment of the impacts of the identified options;
- **Chapter 3, State of play and potential problems**, illustrates "short-termism" in corporate governance in EU listed companies (including economic evidence), and its main underlying factors;
- **Chapter 4, Problem definition and options**, presents the problem and the related drivers, their impact on different categories of stakeholders, the reasons why EU action might be necessary, the general and specific objectives of the future EU intervention, and an inventory of potential options for EU action;
- **Chapter 5, Assessment of options**, presents the impacts of the identified options, and their assessment according to some key criteria;
- **Annexes**, including: Analysis of the possible effects of corporate "short-termism" on the attainment of the SDGs (Annex I.1); General screening of the situation in EU27 (Annex I.2); Analysis of gaps in the estimation of sustainability risks by listed companies (Annex I.3); Analysis of gaps in the estimation of sustainability impacts by listed companies (Annex I.4); Relevant sustainable corporate governance initiatives in third countries (Annex I.5); Analysis of best practices (Annex I.6); Detailed evidence on factors contributing to corporate short-termism (Annex I.7); Detailed description of options (Annex I.8); Bibliographic references (Annex I.9); Analysis of the regulatory frameworks in 12 Member States (Annex II).

### 1.1 Objectives

The overall objective of the study is to **assess the root causes of short termism in corporate governance**, being them related to current market practices and/or regulatory frameworks and **identify possible European Union (EU) level solutions**, including with a view to contributing to the attainment of the United Nations (UN) Sustainable Development Goals (SDGs) and the goals of the Paris Agreement on climate change.

Findings from this study should support the European Commission in identifying the need for a possible reform in corporate law and board duties to foster sustainable corporate governance.

### 1.2 Scope

#### Content

The study covered:

- **Corporate governance regulatory frameworks and market practices that might explain the orientation of companies towards sustainability<sup>1</sup> or short-termism.**

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<sup>1</sup> Prof. Beate Sjøfjell of the University of Oslo defines corporate sustainability as "[W]hen business in aggregate creates value in a manner that is (a) *environmentally* sustainable in that it ensures the long-term stability and resilience of the ecosystems that support human life, (b) *socially* sustainable in that it facilitates the respect and promotion of human rights and of good governance, and (c) *economically* sustainable in that it satisfies the economic needs necessary for stable and resilient societies (see Sjøfjell, B. (2017), 'When the Solution Becomes the Problem: the Triple Failure of Corporate Governance Codes', in J.J. du Plessis and C.K. Low (eds.), *Corporate Governance Codes for the 21st Century*, Springer, Geneva, p. 28). In line with this understanding, in the context of this report sustainability is intended as the capacity of companies to pursue and manage their economic, social and environmental risks, opportunities and impacts, and to build resilience over time. It is understood that this is compatible with creating long-term value for the shareholders as well as other company stakeholders, the environment and the society at large.

These encompassed existing laws, guidelines and codes of conduct in the area of corporate governance and more specifically on directors' duties, sustainability strategy and targets, stakeholder involvement, enforcement, board remuneration, share buybacks and board composition. As for company market practices the study looked at non-regulatory initiatives at the company/business sector level related to the adoption of sustainable or non-sustainable corporate governance approaches.

- The **evolution over the last 30 years of key indicators on the economic performance of listed companies**, which were used as proxies for their short or long-term focus.
- **10 business sectors** for the analysis of practices of identification of some of the most relevant sustainability risks and impacts:<sup>2</sup>
  1. *Garment* (Manufacture of textiles, Manufacturing of wearing apparel, Manufacture of leather and related products);
  2. *Telecommunications* (Telecommunications);
  3. *Construction* (Construction of buildings; Civil engineering);
  4. *Power and utilities* (Electricity, gas, steam and air conditioning supply, Water collection, treatments and supply, Waste collection, treatments and disposal activities, material recovery);
  5. *Oil and gas* (Extraction of crude petroleum and natural gas, Manufacture of coke and refined petroleum products);
  6. *Pharmaceutical* (Manufacture of basic pharmaceutical products and pharmaceutical preparations);
  7. *Food* (Manufacture of food products; Manufacture of beverages);
  8. *Car manufacture* (Manufacture of motor vehicles, trailers and semi-trailers);
  9. *Transport* (Land transport and transport via pipelines; Water transport; Air transport);
  10. *Chemical industry* (Manufacture of chemicals and chemical products).
- **Different sizes of companies**, including large and Small and Medium-Sized Enterprises.<sup>3</sup>
- **Different types of companies**, with a focus on EU listed companies but investigating differences between listed and non-listed companies where relevant.

### Stakeholders involved

EU officials; experts and academics, public authorities (company registrars; financial regulatory authorities); companies; business organisations (EU and national employer associations); investors (national associations of fund and asset management, of insurance companies, of pension funds, institutional investors, private equity and venture capital firms); trade unions (national and EU/international); non-Governmental Organisations (NGOs) in the development, environmental and social field; legal practitioners (bar associations; law firms; notaries).

### Territory

The territorial coverage of the study depends on the type of analysis:

- All EU 27 Member States plus the UK,<sup>4</sup> for a general screening of the situation;

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<sup>2</sup> Sectors in scope of the study have been identified starting from those suggested in the Technical Annex (p. 13) and endorsed by the Commission. The list does not encompass some sectors with large sustainability impacts (e.g. agricultural activities, aquaculture, fisheries and similar processes), which however partially belong to the supply chain of some sectors in scope (e.g. agriculture for food).

<sup>3</sup> Based on the definition of SME available at [https://ec.europa.eu/growth/smes/business-friendly-environment/sme-definition\\_en](https://ec.europa.eu/growth/smes/business-friendly-environment/sme-definition_en), large companies refer to staff headcount≥250, turnover>€50 million or balance sheet total>€43 million, SMEs to staff headcount<250, turnover≤€50 million or balance sheet total≤€43 million.

<sup>4</sup> Both the general screening of the situation and the analysis of the economic evidence on EU listed companies have been performed while the UK was still part of the EU.

- 15 Member States (AT, BE, DE, ES, FI, FR, HR, HU, IT, NL, PL, PT, SI, SE, SK) plus the UK as regards the analysis of the economic evidence of the extent to which listed EU companies and their management prioritise the short-term interest of the shareholders;
- 12 Member States (BE, DE, ES, FI, FR, HU, IT, NL, PL, PT, SI, SE) for the in-depth analysis of the regulatory framework and market practices;
- Five selected third countries to identify good practices, and namely: Canada, New Zealand, Australia, US and the UK.<sup>5</sup>

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<sup>5</sup> The UK is considered as a third country for this project.

## 2 RESEARCH METHODOLOGY

### 2.1 Data collection plan

#### Desk research

Desk research focused on:

- **Financial and business databases** (e.g. S&P Capital IQ and Bureau van Dijk's Amadeus) to extract data over the period 1992-2018 to feed indicators for 4,719 listed companies from the 15 Member States in scope plus the UK;
- **Relevant legislation and policy documents at EU and international level**, in particular to define and understand the policy framework surrounding sustainable corporate governance and relevant policy developments;
- **National company law and corporate governance frameworks in the 12 selected Member States**, to define and understand national regulatory frameworks (including company law, securities law, corporate governance codes and other relevant regulatory sources);
- **Scientific literature** (e.g. books, edited volumes, articles published in scientific journals, academic papers, etc.), to investigate the long-term economic, social and environmental consequences of corporate short-termism, the possible factors (either regulatory aspects or market practices) behind this phenomenon, and possible options;
- **Reports, studies and other documents** (e.g. publications by international organisations, business organisations, NGOs, think tanks, individual companies, etc.), for the same purposes above, and to collect sector-specific and company-specific information on sustainability risks and impacts and initiatives to address them;
- **Websites** and grey literature, for the same purposed above.

The full list of sources consulted is reported in Annex I.9 and Annex II.

#### Field research

A total of **128 stakeholders<sup>6</sup> were consulted** as follows:

- 10 (EU officials and experts and academics) through **scoping interviews**;
- 62<sup>7</sup> (all stakeholder categories) through a **web-survey** covering the 12 Member States and the 10 economic sectors in scope;
- 16 through interviews performed within **10 case studies** (5 sector-based<sup>8</sup> and 5 company-based<sup>9</sup>) and involving 5 representatives from companies (for the company-based case studies), and 6 NGOs and 5 EU sectoral business associations (for the sector-based case studies focused on transport, food, garment, oil and gas, and chemical industry);
- 48 (EU and national stakeholders from the 12 Member States in scope) through **interviews for the assessment of the impacts of the options**. Specifically, interviews were performed with representatives from companies (16), corporate governance code committees (11), investors (11), trade unions (3), NGOs (6) and other (1 *EU-level association*).

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<sup>6</sup> Stakeholders consulted with more than one instrument have been counted just once.

<sup>7</sup> 85 responses were collected. However, only 62 were in scope in terms of countries and sectors selected.

<sup>8</sup> Sectors covered: food, garment, oil and gas, chemical, transport.

<sup>9</sup> Companies covered: a company subject to the obligations of Directive 2014/95/EU and with strong record of non-financial reporting publications, including several years of voluntary reporting on sustainability issues and TCFD-aligned report; a company subject to the obligations of Directive 2014/95/EU but showing gaps in dealing with sustainability risks, impacts and opportunities properly; a company not subject to the obligations of Directive 2014/95/EU but showing substantial gaps in dealing with sustainability risks, impacts and opportunities properly; a SME to highlight specific aspects, which can differentiate small and medium companies from the large ones; a benefit company aimed at investigating the approaches followed by Benefit companies when dealing with sustainability aspects related to their strategy.

The Team also participated in two conferences: the 2019 Italy Corporate Governance Conference (9-10 December 2019, Milan) and the 24th European Corporate Governance Conference (12 December 2019, Helsinki).

### Difficulties encountered during data collection

The study encountered some difficulties in both desk and field research.

- The **limited availability of empirical studies on the** (long-term) **effects of corporate short-termism** impacted the investigation of this phenomenon in Europe from an empirical standpoint. Given the complexity of the phenomenon and the co-existence of several factors associated with persisting corporate short-termism and unsustainability, it was difficult to provide an assessment of the long term (environmental, social and economic) impacts of corporate short-termism in the EU independently from other issues. Moreover, most of the available studies either have a wider geographical scope or do not focus on Europe.
- The **heterogeneous nature and the wide scope of the rules addressing corporate governance and sustainability**. The literature review highlighted that a wide range of legislative and self-regulatory measures (also beyond the area of company law and corporate governance) come into play to shape the complex relation between corporate governance and sustainability. This should be taken into account when considering the findings of the legal review which focused instead on national corporate governance frameworks. Even focusing on these latter, the heterogeneity in national regulatory frameworks (featuring a combination of statutory law, case law and self-regulatory measures and characterised by different legal traditions), combined with the absence of a common EU legal framework (namely as concerns directors' duties, company's interest, and sustainability strategies), complicated the identification and cross-cutting analysis of relevant provisions;
- **The limited engagement of stakeholders**. Difficulties were mainly due to: (i) the existence of large and heterogeneous stakeholder constituencies that made it difficult to identify the right contact persons within national associations and subsequently negatively affected the dissemination of the survey to relevant national stakeholders; (ii) the vast and complex nature of topics covered and related questionnaires, and (iii) the scarce interest of stakeholders in being consulted and a more general "consultation fatigue" resulting from previous consultations<sup>10</sup> on closely related topics addressed to the same categories of stakeholders over the past few months. While being overall satisfactory, the number of stakeholders who replied to the web-survey or participated in the interviews fell short of initial expectations and limited the granularity in the analysis of the market practices and of the estimation of sustainability risks and impacts and related gaps, which remains high-level and mainly desk-based. Difficulties in stakeholder engagement affected also the overall project timeline and brought to a slight extension of the initial deadlines in order to increase the response rate by extending the survey duration (from three to five weeks) and performing several rounds of follow ups through different channels (e.g. phone, email, support of EU and national associations, publication of the survey links on the specific organisations' websites).
- The **limited evidence on SMEs rules and practices**. The low response rate to the web-survey by SMEs, combined with the very limited availability of relevant desk-based resources and the failure to engage EU business associations representing SMEs in ad-hoc consultation activities (i.e. dedicated interviews), limited to a large extent the investigation of the interplay between corporate governance arrangements and sustainability in SMEs. While the little interest shown by SMEs in this study suggests that corporate governance is a topic of interest mainly for large (listed) companies with complex ownership structures, this remains an aspect for further and dedicated investigation.

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<sup>10</sup> By the ESMA on short-term pressures from financial markets, the British Institute of International and Comparative Law (BIICL) on human rights due diligence, and more recently, by the Commission on the review of the Non-Financial Reporting Directive.

- **Stakeholders were not able to assess options against all criteria.** In general, assessing the options proved a challenging exercise for interviewees. Stakeholders found it challenging to predict the economic, environmental and social impacts of the options and found it difficult to translate qualitative comments on the options and solutions into quantitative scoring. Moreover, stakeholders often provided insights on specific measures within the option, and did not address systematically and with the same level of detail all options.
- **Stakeholders found it difficult to quantify and qualify costs.** Despite the efforts and repeated attempts by the Team to obtain more precise and quantifiable information about costs by the stakeholders consulted, stakeholders proved generally unable or uncomfortable in providing detailed information and precise quantification of the costs (especially in monetary terms) associated either to the current status quo or to possible options. Therefore, information about costs and their quantification fell short of expectations and has somewhat narrowed the depth of the analysis of the efficiency and economic consequences of the options.

Data and information collected through desk and field research are, broadly speaking, satisfactory in terms of both quality and representativeness of different Member States. As for the analysis of the potential problems, the lack of data from the survey has been – at least partly – compensated by the large availability of information and data from the literature review and by the findings resulting from the legal review. As for the assessment of the impacts of the options, the main limitation is the partial amount of information and data gathered to quantify and qualify the costs associated with both the baseline situation and the consequences of the options. In this view, the Team started from the limited information collected and elaborated its own judgement based on the understanding of the functioning of the options and the related context. The assessment was then discussed and validated internally with all the Team members and externally with the Quality Assurance reviewers.

## 2.2 Methodology for the assessment of the impacts

Options have been analysed according to the following steps: *i)* Identification of relevant potential impacts; *ii)* Interviews with national stakeholders in the 12 selected Member States; *iii)* Assessment by impacts; *iv)* Assessment by key selected criteria.

### Identification of relevant potential impacts

Table 1 describes the relevant impacts identified.

**Table 1 – Overview of the impacts considered**

Impacts	Rationale for the assessment
<b>Impacts on companies</b>	<p>Degree to which the option brings:</p> <ul style="list-style-type: none"> <li>• Benefits in the form of cost savings and improved long-term economic and financial performance, risk mitigation, competitive advantage, improved reputation and legitimacy, synergistic value creation;</li> <li>• Costs of compliance with possible new measures (e.g. charges, administrative costs, substantial compliance costs).</li> </ul>
<b>Economic impacts</b>	<p>Degree to which the option has consequences with respect to:</p> <ul style="list-style-type: none"> <li>• Competitiveness of business (e.g. costs of inputs, capital and labour; capacity and incentives to innovate and produce higher quality products; market share in international context and international competitiveness);</li> <li>• Trade (e.g. import, export, investment flows);</li> <li>• Competition (e.g. change in consumer choice, change in prices due to impacts on competition, barriers for new suppliers and service providers, facilitation of anti-competitive behaviour or emergence of monopolies, market segmentation);</li> <li>• Consumption, jobs and growth.</li> </ul> <p>Where relevant and possible, the assessment included also a focus on SMEs (e.g. costs and burdens on the operation and competitiveness of SMEs, new market opportunities)</p>



Impacts	Rationale for the assessment
<b>Social impacts</b>	Degree to which the option has consequences with respect to: <ul style="list-style-type: none"> <li>• Employees (working conditions, social security and protection, health and safety, training and development);</li> <li>• Communities (e.g. income and wealth distribution, poverty; social inclusion);</li> <li>• Consumers (e.g. prices, quality, availability, sustainability of consumer goods/services; consumer information, knowledge, trust, protection).</li> </ul>
<b>Environmental impacts</b>	Degree to which the option has consequences with respect to: <ul style="list-style-type: none"> <li>• Climate;</li> <li>• Natural capital (water, air, land biodiversity);</li> <li>• Circular economy and resource efficiency.</li> </ul>
<b>Impacts on fundamental rights</b>	Degree to which the option ensures the following rights: <ul style="list-style-type: none"> <li>• Property rights (e.g. assets) and the right to conduct business;</li> <li>• Dignity (e.g. integrity of the person and forced labour in third countries);</li> <li>• Rights of the child;</li> <li>• Equal treatment and opportunities (e.g. promotion of gender balance in the board).</li> </ul>
<b>Impacts on public administration</b>	Degree to which the option has budgetary consequences for public authorities at different levels of government (EU own resources, national, regional, local), introduces additional governmental administrative burden (e.g. new responsibilities, new monitoring or enforcement activities), and causes the creation or restructuring of specific bodies/authorities. <sup>11</sup>

The assessment of all the impacts listed above is framed within the broader **analysis of the expected degree of change in the national regulatory frameworks**.<sup>12</sup> Drawing on the findings of the legal review performed for this study, this analysis describes to what extent each option introduces changes in the national regulatory frameworks and in the areas of remedies and/or penalties, and thus allows to better understand and calibrate the assessment of the other impacts described.

### Interviews with national stakeholders in the 12 selected Member States

**48 interviews** were undertaken to gather information on the impacts of the identified options. They mainly addressed national stakeholders in the 12 selected Member States, and some key EU level stakeholders. 22 stakeholders also provided written synthetic rates on the different options in an excel sheet that was shared prior to the interview.<sup>13</sup>

### Assessment by impacts

Each option was assessed both qualitatively and (where possible) quantitatively *vis-à-vis* the main impacts identified and according to the following steps:

- Qualitative estimates of the likelihood (e.g. high, medium, low) that each selected impact would occur (or conversely the risk that the impact will not occur);
- Qualitative estimates of their absolute magnitude;
- Qualitative estimates of their evolution over time (e.g. increase, decrease, stable);

<sup>11</sup> In line with the definition of "impacts on public administration" provided by the Better Regulation Toolbox (Tool #19), budgetary consequences linked to potential reform processes that Member States may launch to implement the different options are not considered. Costs related to these aspects are indeed highly dependent on national legal frameworks and linked to implementation decisions that will be made by Member States (modification of the existing legislation or update of existing self-regulatory measures) that cannot be anticipated.

<sup>12</sup> Assessed from small to medium and large by considering the scale of the change (linked to the number of Member States that would need to modify their national regulatory framework to implement the specific option) and the probability of the change (linked to the binding or non-binding nature of the option).

<sup>13</sup> The files were received from 2 companies, 7 investors, 2 trade unions, 8 corporate governance committees, 2 NGOs and 1 EU-level association. Among those who provided the files, not all the options and/or types of impacts were assessed.

- Qualitative estimates of their relative size for specific stakeholders, differentiating per group of players involved (e.g. companies, SMEs, public authorities, etc.).

Impacts of each option have been assessed against the baseline scenario ("No policy change" option), to estimate the neutral (e.g. 0), incremental positive (e.g. +1) and negative (e.g. -1) effects. For each type of impact scores ranged from -3 to +3 as shown in Table 2.

**Table 2 – Overview of the scoring system for the assessment of the impacts**

Score interval	0	(+/-) 0.1 - 1	(+/-) 1.1 - 2.0	(+/-) 2.1 - 3.0
Impacts	No impacts	Small impact	Moderate impact	Large impact

The quantity and quality of the information collected from stakeholders during the interviews affected the feasibility of the initially proposed methodology, that was therefore adjusted. The revised methodology envisaged a deeper qualitative assessment of the potential impacts and their relative strength by analysing feedback provided by stakeholders, and considered the frequency in the use of key terms by stakeholders as a proxy to signal the perceptions of stakeholders with respect to the most likely impacts.

### Assessment by selected criteria

Options were scored and judged against the criteria described in Table 3.

**Table 3 – Criteria for the assessment of the options and related scale**

Criteria	Rationale	Scale
<b>Effectiveness</b>	Extent to which the option contributes to achieving the specific objectives (SO) of the EU intervention	-3/+3 (as illustrated above)
<b>Efficiency</b>	The relation between direct and indirect <sup>14</sup> costs (especially costs on companies and public administrations) and benefits (especially those resulting from the analysis of economic, social, environmental impacts and impacts on fundamental rights) and their distribution across the stakeholder categories.	
<b>Coherence</b>	Coherence with other EU policies in the field of corporate governance and sustainability more generally.	Dichotomous scale: Yes/No
<b>Proportionality</b>	The relation between the options considered and the nature, scale and intensity of the problems and related drivers that the options are meant to address.	

Ratings and judgements were used to compare the options between each other and against the baseline. The main source of information for the assessment was the consultation with the stakeholders and the analysis of relevant studies that address the implementation of initiatives that are similar to the measures under investigation and that support the existence of some causal linkages between variables in scope. Reference to the evidence base is done (where appropriate) in the description of the rationale behind each score/judgement. When no sources are explicitly mentioned, the rationale illustrates the Team's assessment and the logical assumptions made.

<sup>14</sup> Indirect costs and benefits are those costs and benefits borne by stakeholders that are not directly targeted by the implementation of the specific option. According to the Better Regulation Toolbox #58, indirect regulatory benefits could include, for instance: spill-over effects related to third-party compliance with legal rules (so-called "indirect compliance benefits"); wider macroeconomic benefits, including GDP improvements, productivity enhancements, greater employment rates, improved job quality etc.; and other non-monetisable benefits, such as protection of fundamental rights, social cohesion, reduced gender discrimination, international and national stability, etc. Indirect regulatory costs are experienced by consumers, government agencies or other stakeholders that are not directly targeted by the initiative/regulation. This category also includes the so-called "indirect compliance costs" (i.e. cost related to the fact that other stakeholders have to comply with legislation) and negative impacts on market functioning such as reduced competition or market access, or reduced innovation or investment.

### 3 STATE OF PLAY AND POTENTIAL PROBLEMS

Section 3.1 provides evidence of the problem of corporate short-termism in the EU. Section 3.2 investigates the main factors behind the problem.

#### 3.1 Short-termism in EU corporate governance

##### 3.1.1 Economic evidence of short-termism in EU listed companies

This section provides a detailed picture of short-termism trends in the 15 Member States and the UK and 10 sectors in scope (see section 1.2) and their evolution over the last three decades.

###### 3.1.1.1 Indicators to assess short-termism

Corporate short-termism is widely debated, and a variety of indicators to measure it have been developed over the years. **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)<sup>15</sup> **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.<sup>16</sup> The hypothesis underlining this approach is that companies decide to use their net income either to fund their shareholders, or to invest in future earnings. Therefore, the increasing payments to shareholders will decrease the available resources to invest, in R&D, human capital or other kinds of capital expenditures (CAPEX), thus jeopardising future productivity growth.

The indicators listed above mirror key positions of academics and experts in the field. Specifically, literature makes a wide use of **pay-outs**, both dividend payment and share buybacks, as an indicator of short-termism.<sup>17</sup> The hypothesis that pay-outs "crowd out" real investments was primarily proposed by US scholars Lazonick and O'Sullivan.<sup>18</sup> They maintain that the increasing orientation towards shareholder value, fostered by both institutional and organisational changes occurred in the 1980s (such as the increasing role of institutional investors and the introduction of share-based remuneration for executives) resulted in a shift in corporate strategy from "retain-and-reinvest" to "downsize-and-distribute". If firms used to retain and reinvest most of their profits in the production, from then on, they have become increasingly encouraged to downsize the labour force and distribute earnings to shareholders by means of dividends and share buybacks. Moreover, by committing large amounts of their cash flow to dividends and share buybacks, companies have less resources available for investment in R&D,<sup>19</sup> which may reduce the long-term profitability of the company and harms the innovative

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<sup>15</sup> A share buyback, or repurchase, is a decision by a company to buy back its own shares (either directly from the open market, or by offering shareholders the option to sell their shares to the company at a fixed price). A share repurchase reduces the number of outstanding shares, making each share worth a greater percentage of the corporation. Consequently, a share repurchase increases both the price of the shares and the EPS. Together with dividend payment, it is used as a way to remunerate shareholders.

<sup>16</sup> See Alcida, H., Fos, V., Kronlund, M. (2015), 'The Real Effects of Share Repurchases', *Journal of Financial Economics*; Galston, W.A., Kamarck, E.C. (2015), 'More builders and fewer traders: a growth strategy for the American economy', Brookings Institution; Gutiérrez, G., Philippon, T. (2016), 'Investment-Less Growth: An empirical investigation', NBER Working Paper 22897; Kahle, K., Stulz, R.M. (2016), 'Is the U.S. Public Corporation in Trouble', NBER Working Paper 22857; Lazonick, W. and O'Sullivan, M. (2000), 'Maximizing shareholder value: a new ideology for corporate governance', *Economy and Society*, Vol. 29, Issue 1, pp. 13–35; Lazonick, W. (2014), 'Profits without prosperity', *Harvard Business Review*, Vol. 92, Issue 9, pp. 46–55; Lipton, M. (2015), 'Some Thoughts for Boards of Directors', Harvard Law School Forum on Corporate Governance; Sakiç, M.E. (2017), 'Share Repurchases in Europe – A Value Extraction Analysis', ISI Growth Working Paper 16/2017; Palladino, L. (2018), 'Stock Buybacks: Driving a High-Profit, Low-Wage Economy', Roosevelt Institute.

<sup>17</sup> Sjøfjell, B., Johnston, A., Anker-Sørensen, L., Millon, D. (2015), 'Shareholder primacy: the main barrier to sustainable companies,' in Sjøfjell, B., Richardson, B. (eds.), *Company Law and Sustainability*, Cambridge.

<sup>18</sup> Lazonick, W. and O'Sullivan, M. (2000), cit. See also Lazonick, W. (2014), cit., pp. 46–55.

<sup>19</sup> Lazonick, W. (2007), 'The US Stock Market and the Governance of Innovative Enterprise', *Industrial and Corporate Change*, Vol 16, Issue 6, pp. 983-1035.

capacity of the economy as a whole and the capacity of companies to adequately face the sustainability transition.<sup>20</sup>

Pay-outs have also been widely cited to explain underinvestment in innovation, skilled workforces or essential CAPEX necessary to sustain long-term growth.<sup>21</sup> Other authors have focused in particular on the use of share buybacks to manage earnings to meet short-term performance targets, such as Earnings Per Share (EPS) forecasts,<sup>22</sup> or to increase the value of shares when the vesting of share-options for executives is close.<sup>23</sup>

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.<sup>24</sup> For instance, according to a Goldman Sachs report,<sup>25</sup> growth investment (measured as CAPEX, R&D, and cash Merger and Acquisitions (M&A)) by S&P 500 companies accounted for a larger share of spending than shareholder return (buybacks and dividends) every year since at least 1990. However, the use of M&A as an indicator of long-termism is questionable, as the literature suggests that certain acquisitions boost short-term performance at the expense of long-run value<sup>26</sup> and are a sign of hyperactivity and too much attention to financial market issues by boards.<sup>27</sup>

With regard to **investment indicators**, cutbacks in companies' CAPEX might harm the long-term productivity of a company. As observed in the literature, significant decline in investment and employment expenditures in plants causes a drop in firm-level productivity, in particular considering that these cuts are not focused, as an efficiency motivation would require, on unproductive plants, especially where labour is strongly organised.<sup>28</sup> Furthermore, reduced R&D investments dampens innovation and, in the long-run, reduces competitive advantage.<sup>29</sup> This, in turn, could lead to a lower economic growth for the economy as a whole.<sup>30</sup>

### 3.1.1.2 Scope and dataset

Following the considerations made above, economic evidence of short-termism in this section focuses on the evolution of the following indicators:

- **Net income (or profit)**, indicator of a company's profit, i.e. the amount by which total revenues exceed total expenses;
- **Corporate pay-outs to shareholders (or shareholder payouts)**, indicator of how much money the corporations pay out to their shareholders, encompassing both "dividends" (distribution of reward from a portion of the company's earnings), and "buy backs"

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<sup>20</sup> For instance, the Commission estimates that at least €170 billion of additional investments is needed each year for priorities such as renewable energy generation and efficient buildings in Europe (Source: EU High Level Expert Group on Sustainable Finance (2018), 'Financing a sustainable European economy', p. 9).

<sup>21</sup> BlackRock (2015), 'Larry Fink's 2015 Letter to CEOs'.

<sup>22</sup> See Almcida, H., Fos, V., Kronlund, M. (2015), cit.; Almeida, H., Ersahin, N., Fos, V., Irani, R.M., Kronlund, M. (2019), 'Do Short-Term Incentives Affect Long-Term Productivity?', CEPR Discussion Paper 13894.

<sup>23</sup> Edmans, A., Fang, V.W., Huang, A.H. (2019), 'The Long-Term Consequences of Short-Term Incentives', ECGI Finance Working Paper No. 527/2017.

<sup>24</sup> Mason, J.W. (2015), 'Understanding Short-Termism – Questions and Consequences', Roosevelt Institute.

<sup>25</sup> Goldman Sachs (2019), 'Buyback Realities', *Top of Mind*, Issue 77.

<sup>26</sup> Agrawal, A., Jaffe, J.F., Mandelker, G.N. (1992), 'The Post-Merger Performance of Acquiring Firms: A Re-examination of an Anomaly'; Edmans, A., Fang, V.W., Huang, A.H. (2019), cit., p. 3.

<sup>27</sup> Kay, J. (2012), *The Kay Review of the UK Equity Markets and Long-term Decision Making (Final Report)*, Department for Business, Innovation and Skills, London, p. 16. Available at [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf).

<sup>28</sup> Almeida, H., Ersahin, N., Fos, V., Irani, R.M., Kronlund, M. (2019), cit.

<sup>29</sup> Veldman, J., Gregor, F., Morrow, P. (2016), 'Corporate Governance for a Changing World', Final Report of a Global Roundtable Series, Frank Bold and Cass Business School.

<sup>30</sup> Terry, S.J. (2017), 'The Macro Impact of Short-Termism', SIEPR Discussion Paper No. 15-022.

(corporations' repurchases of their own shares including the repurchases of both the common and preferred stocks);

- **Investments**, proxied by CAPEX and R&D investment. The CAPEX represents the cash outflows used by firms to purchase, upgrade, and maintain physical assets such as plants, properties and equipment.<sup>31</sup> R&D investment includes the development of new products, the upgrading of existing ones or even the innovation related to technology formulation and the development of a service line.<sup>32</sup>

As the scope of analysis includes 16 countries (15 Member States and the UK) and a time span of three decades, the evolution of the absolute values of these indicators can be misleading, given the effects of inflation and the firms' growth. Therefore, to isolate the analysis from these effects, these indicators are firstly divided by total revenues. This ratio allows to understand how the profits, the pay-outs and the investment efforts have been evolving against the overall amount of funds generated through sales.

Throughout the analysis, the indicators of pay-outs and investment are also presented divided by net income to better illustrate the amount of net corporate funds being allocated for pay-outs to shareholders or long-term investment.

The analysis at aggregate level presents all the indicators while the analysis focusing on countries or industries adopts a more parsimonious approach and includes only the more meaningful indicators for the sake of clarity.

Lastly, it is important to notice that **there is not any defined threshold above which one can state that the focus on short term is excessive**. Instead, the short-termism hypothesis is evaluated in relative terms, assessing the evolution over the time span (an upward trend of corporate pay-outs to net income or to total revenues is perceived as a rise in short-termism practices) and comparing between different companies, sectors or countries.

This analysis is based on the available financial information from 1992<sup>33</sup> to 2018 of **4,719 listed companies in the 16 countries in scope (15 Member States plus the UK)**. This sample only includes companies currently listed on the stock exchanges of the selected EU Member States.

To validate the main findings and ensure that the results are not affected by the composition of the sample, some trends were crosschecked with the ones arising from two distinct samples: one including only the 800 companies listed throughout the period and another one with S&P Europe 350 constituents.<sup>34</sup> The robustness of findings presented below is confirmed by the convergence between the results from the different samples.

The financial information is obtained from two databases: S&P Capital IQ and Amadeus. The first database, S&P Capital IQ, is produced by Standard & Poor's and provides financial information (Income Statement, the Balance Sheet and the Cash Flow) of international public and private companies as well as investment firms. Amadeus is a database published by Bureau van Dijk and Moody's Analytics of comparable financial and business information on Europe's largest public and private companies. Amadeus was used to validate some of the findings about the evolution of financial information aggregates and to identify the Statistical Classification of Economic Activities in the European Community (NACE) code of each company.

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<sup>31</sup> More specifically, capital expenditures consist of the funds that companies use to purchase major physical goods or services that the company will use for more than one year. They can include plant and equipment purchases (e.g. machines, health and safety equipment, environmental equipment), building expansion, hardware and software, vehicles, R&D investment, intangible assets (e.g. patents, trademarks, and copyrights).

<sup>32</sup> Investments in R&D is one of the components of CAPEX. As this type of investment is reported autonomously in company accounts it is possible to isolate its behaviour.

<sup>33</sup> The scarcity of data before 1992 does not allow to go further back in time while assuring robustness of data.

<sup>34</sup> The results arising from this validation are not included in the analysis presented below. Moreover, these samples do not cover the 30 years considered in this section, neither all indicators provided by Capital IQ database.

### 3.1.1.3 Key findings

There is an increase in shareholders pay-outs in EU listed companies as shown by the upward trend of **total pay-outs as percentage of revenues** between 1992 and 2018, which went from less than 1% of revenues in 1992 to almost 4% in 2018. Total pay-outs as a share of revenues increased until 2007 at a Compound Annual Growth Rate (CAGR) of 14.9%. The 2007-2008 global financial crisis represented an inflexion point to this growth but the ratio of total shareholder payouts to corporate revenues were rising again after 2010, even if at a more moderate pace. Although dividends continue being the largest form of pay-outs, the evolution of the payments in the form of buybacks has been sharper.

The evolution of the **ratio between total pay-outs to net income**, indicating the amount of earnings that companies distribute, supports these findings. Its evolution reveals a steep rise during the nineties, followed by twenty years of significant fluctuation around a stable structural trend.

Concerning business **investments**, notwithstanding the higher levels of CAPEX and R&D investment in absolute terms, the ratio of these two variables to revenues has been declining since the beginning of the 21<sup>st</sup> century, with more amplified oscillations in the case of R&D investment.

**The evolution of these indicators suggests the presence of short-termism behaviours in EU listed companies.** It is possible to identify a steep upward trend in short-termism in the nineties, namely in relation to the pay-outs indicator. Over the last two decades the indicators that proxy short-termism seem to have stabilised around high levels of payments to shareholders and low investment intensity. However, despite the scenario of stable high trends, the indicators of short-termism presented sharp fluctuations around the dot-com bubble and the financial crisis.

The analysis highlights that among the Member States considered, **Slovakia, Belgium, Portugal and the Netherlands appear to be more short-term oriented**, by registering between 2016 and 2018 higher levels of pay-outs to net income compared to their peers. Moreover, the first two countries were the ones who showed the highest growth since 1996. On the opposite, Poland and Hungary are the countries with the lowest ratio of total pay-outs.

As for sectors, the **Food industry appears to be the most short-term oriented sector**, by allocating the largest share of earnings to pay-outs, followed by **the Oil and Gas sector and the Garment sector**. The Garment presented the highest growth of this indicator during the last decades. In terms of business investment expressed as CAPEX relative to total revenue, the Telecommunications and Power and Utilities Sectors are today the ones which seem to be more oriented towards long term objectives, while Construction, Garment and Food industries allocate the lowest share of resources to CAPEX, thus being more short term oriented. However, we need to be careful when analysing this indicator by industry as the differences may be due to technological differences or sector specific capital intensity issues. In the period 1996-2016 "car manufacture" and "construction" were the sectors that registered a more effective decrease in CAPEX as percentage of total revenues (-7,9 and -5.6 p.p., respectively) while "transport services" grew by approximately 5p.p..

The following sections present a detailed analysis of each indicator as well as results per country and per industry. Where possible, a focus on trends of similar indicators in the US has been included to adequately scale the relevance of short-termism in the EU.

### 3.1.1.4 Evolution of pay-outs

**Shareholders pay-outs increased between 1992 and 2018.** This is clear when observing the upward trend of total pay-outs as percentage of revenues between 1992 and 2018. This indicator, which includes dividends as well as repurchase of common and preferred stocks, increased at a CAGR of 7.4% throughout the period, climbing from less than 1% of revenues in 1992 to more than 4% in 2018.

However, **the growth of the shareholders' pay-outs between 1992 and 2018 was not linear.** One can identify five distinct phases (Figure 1):

- A first phase between 1992 and 2001, corresponding to a significant upward trend that anticipated the dotcom bubble. In this period, the indicator rose from less than 1% to 3% of total revenues;
- A second phase, from 2001 to 2003, in which the pay-outs suffered the impact of the crisis going from 3.1% to 2.5% of the revenues;
- A third phase, between 2003 to 2007, where the ratio registered a steep climb to 5%;
- A fourth phase, from 2007 to 2010, when the impact of the global financial crisis was felt in the decline of the ratio from 5% to less than 3%;
- A fifth phase, since 2010, when the indicator rose again to 4%, though it was not able to recover the previous peak;
- The financial crisis of 2007-2009 marks an inflexion. Total pay-outs as a percentage of revenue increased 4.5 percentage points between 1992 and 2007 and declined approximately 1.8 percentage points between 2007 and 2010. Afterwards, there is a moderate increase in the ratio, but unable to meet the levels of 2007.

Within total pay-outs, **the evolution of dividends is smoother than share buybacks**. The latter, which in the figure below corresponds to the difference between total pay-outs and total dividends, shows sharper increases in periods of crisis, 2001 and 2007. This evidence suggests that the drivers of share buybacks are different from the ones explaining the evolution of dividends. Its evolution highlights the intensified share repurchase activity after regulatory changes in late 1990's and early 2000's,<sup>35</sup> and it also appears to be related not only to the regulatory changes that facilitated repurchases, but also to the development of stock price cycles.

This finding supports the explanations commonly referred to as reasons why a firm decides to repurchase its shares:

- The price support hypothesis, according to which firms execute share repurchase programs to boost or sustain share price;<sup>36</sup>
- The free cash flow hypothesis, which states that, due to deterioration of growth prospects, repurchases serve to distribute cash flow in excess, preventing potential over-investment;<sup>37</sup>
- The signalling hypothesis, which states that firms, by repurchasing shares, send signals about future profits to investors when markets are incomplete.<sup>38</sup>

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<sup>35</sup> Until the late 1990s share repurchases were either prohibited or very difficult to implement due to legal restrictions in most of the European countries. The main exception was the United Kingdom, where the major legislation change that facilitates repurchases occurred in 1981. In Italy, Germany and France these changes occurred in 1998.

<sup>36</sup> Harrison, L., Swanson, E.P. (2016), 'Is price support a motive for increasing share repurchases?', *Journal of Corporate Finance*, Vol. 38, pp. 77-91.

<sup>37</sup> Grullon, G., Roni M. (2004), 'The information content of share repurchase programs', *The Journal of Finance*, Vol. 59, No. 2, pp. 651-680.

<sup>38</sup> Massa, M., Zahid R., Vermaelen, T. (2007), 'Mimicking repurchases', *Journal of Financial Economics*, Vol. 84 No. 3, pp. 624-666.

**Figure 1 - Evolution of total pay-outs vs net income (as percentage of revenues) | Listed companies**



Source: S&P Capital IQ, Amadeus and EY

**Total pay-outs as percentage of revenues have varied, on average, in line with net income between 1992 and 2018.** However, two main differences are visible. Firstly, they have shown less volatility in periods of crisis (see 2000-2002 and 2007-2009), situations when total pay-outs often match or even exceed net income. These lower levels of volatility of total pay-outs when compared to net income can be explained by the time frame of each indicator. While net income is referring to the performance of the firm in a specific year, the decision of rewarding shareholders can take into consideration several years, comprehending the past results and the future growth prospects. Secondly, another difference corresponds to the period between 2010 and 2015, when the slight upward trend of pay-outs is accompanied by a reduction of net income. As can be seen in the following paragraphs, this situation can be explained by a higher percentage of companies registering negative net income.

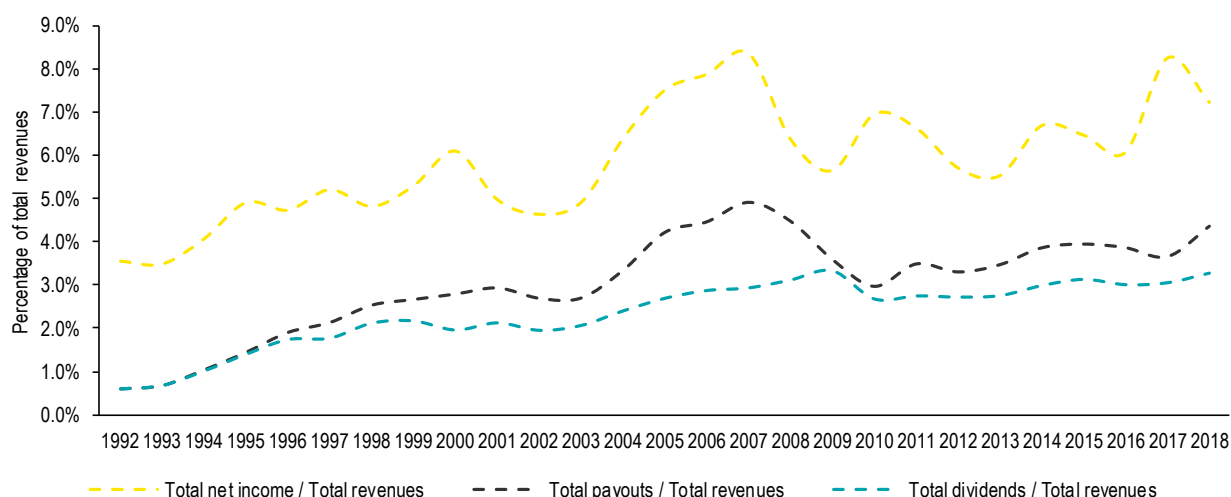
As a matter of fact, it is important to note that the analysis of the relationship between pay-outs and net income can be substantially biased by the presence of companies with negative net income. For example, in periods of crisis, the rise of the ratio total pay-outs/net income, everything else equal, can be explained by a larger share of companies with negative net income, as these observations will only reduce the total amount of net income (and will not lower the amount of pay-outs).

Considering just observations in which net income was positive, net income as a percentage of revenues is relatively less volatile, as expected, particularly in periods of crisis (see 2000-2002 and 2007-2009 in Figure 2).

More importantly, the relation between cash generated and cash distributed (visually depicted as the spacing between the black and the yellow lines in Figure 2 below) remains stable throughout the analysed period, as the ratio of pay-outs to net income never surpasses 64%, except in 2008 (70%) (see Figure 3).



Figure 2 - Evolution of total pay-outs vs net income | Listed companies with positive net income<sup>39</sup>

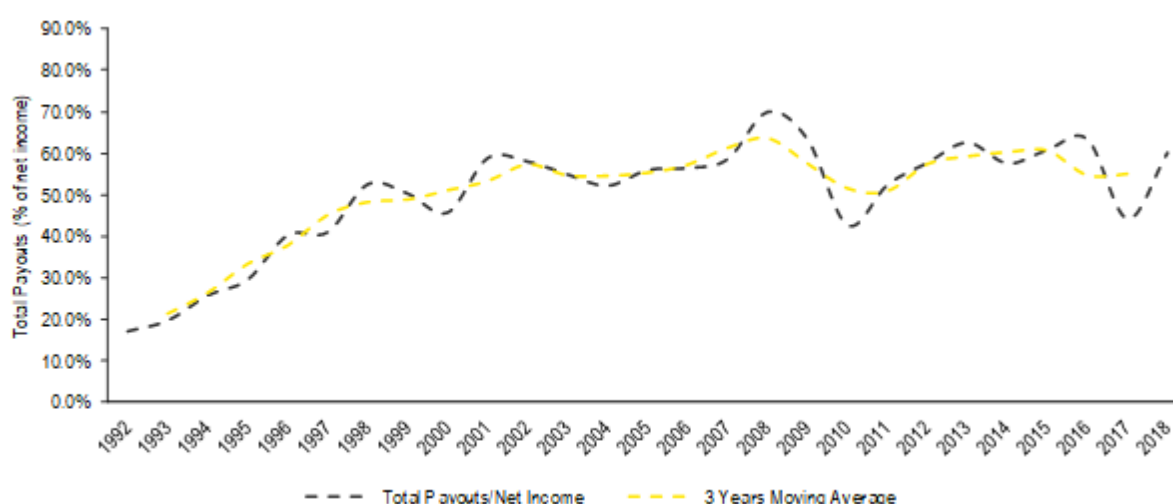


Source: S&P Capital IQ, Amadeus and EY

The evolution of the levels of short-termism is reflected by the analysis of the evolution of the ratio between total pay-outs and net income, which can be interpreted as the percentage of earnings paid to shareholders in dividends and buybacks. Considering companies with a net income greater than zero, it is possible to identify two distinct trends (Figure 3):

- A sharp and long upward trend until the dot-com bubble, in the early 2000's. The total pay-outs to net income ratio increased from around 17% in 1992 to 59% in 2001.
- Afterwards, there are two full cycles, with the periods of growth, 2002-08 and 2010-16, followed by contractions of the identical dimension, in 2008-2010 and 2017, respectively.

Figure 3 - Evolution of the ratio total pay-outs to net income | Listed companies with positive net income<sup>40</sup>



Source: S&P Capital IQ, Amadeus and EY

<sup>39</sup> The figure comprises only observations with positive net income. The sample includes 4154 companies.

<sup>40</sup> The figure comprises only observations with positive net income. The sample includes 4154 companies.

Box 1 – Focus on trends in pay-outs in the US

Differently from Europe, in the US there has been a more linear increase of pay-outs distribution by companies in the last decades. According to a study by William Lazonick with data for 236 companies listed in the S&P 500 Index from 1981 to 2016,<sup>41</sup> the ratio of total pay-out to net incomes rose from 76.5% in the period 1986-1995 (already high compared to Europe, where in 1992 the ratio was 22%) to 81.9% in 1996-2005, and finally to 88.6% in 2006-2015.

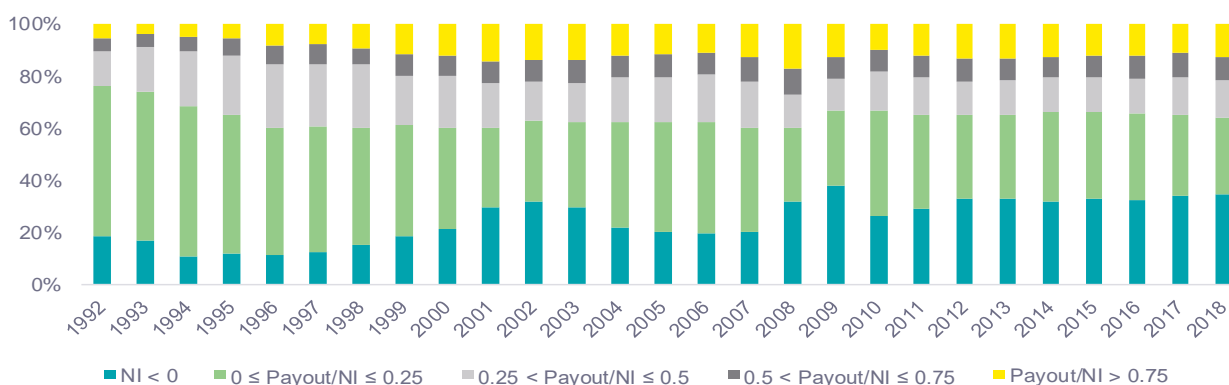
When considering the two components of pay-outs, dividends and buybacks, there has been a gradual decrease of importance of the former and a rise of the latter. Within the same periods indicated above, dividends were 50.7%, 39.0%, and 39.1%, respectively, while buybacks increased from 25.8% to 42.9% and finally to 49,5%.

These results hold for different specifications. When considering companies listed in the stock market throughout the period under analysis, the results are virtually the same. Moreover, when adding listed companies with a negative net income to the sample, the trend is very similar, except for the period comprising the dot-com crisis where an important set of firms reported net income under zero boosted the aggregate level of pay-outs to net income.

These findings can be validated by the analysis of distribution of listed companies by ratio of pay-outs to net income throughout the period. It highlights that companies registering negative net income have seen their importance rise between 1992 and 2010, with sharp upturns around the crisis. Simultaneously, the share of **companies that allocate more than 75% of their net income to pay-outs have also increased**. These two groups together accounted for 24% of listed companies in 1992 and 36% by the end of 2010 (Figure 4). On the other hand, the segment of firms that distribute less than 25% of their net income decreased its percentage among listed companies.

After 2010, one can observe a stabilisation regarding the share of listed companies across all the groups, except a slight increase in the share of companies with negative profits.

Figure 4 - Distribution of listed companies by ratio Pay-outs/Net Income

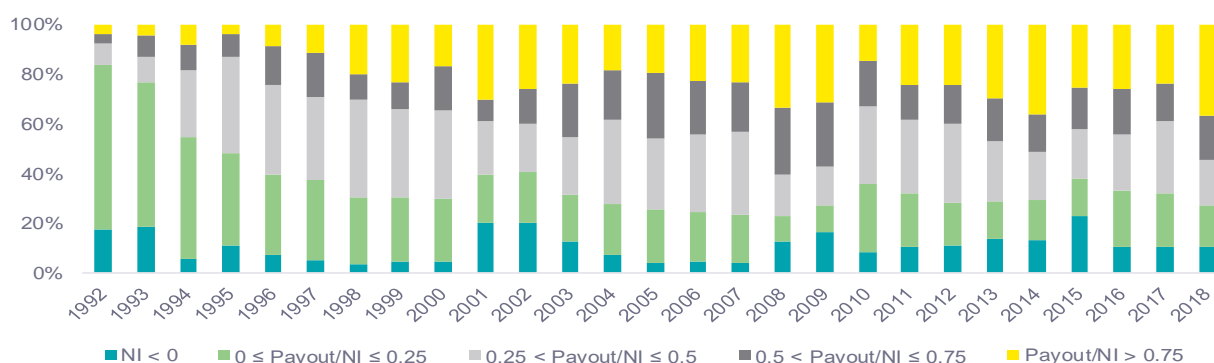


Source: S&P Capital IQ, Amadeus and EY

**The increase in the importance of listed companies with a pay-out ratio of over 75% is even more evident when considering the total revenues of firms in each segment** (and not the number of firms) and taking into account the differences in terms of size among companies. In fact, the share of these companies rose from 4% of the revenues in 1992 to 37% in 2018. That is, the importance of firms that have a total pay-out above 75% of the Net Income have definitively increased, either weighted by the number of firms or by the revenues of those firms. It is also important to note that the composition do not exhibit the same degree of stability after 2010. Moreover, when accounting for total revenues, the rise of companies that fund more their shareholders continues after 2010 (Figure 5).

<sup>41</sup> Lazonick, W. (2016), 'The Value-Extracting CEO: How Executive Stock-Based Pay Undermines Investment in Productive Capabilities', *Institute for New Economic Thinking Working Paper Series No. 54*.

Figure 5 - Share of revenue of listed companies by ratio Pay-outs/Net Income



Source: S&P Capital IQ, Amadeus and EY

To conclude, it is possible to identify **an increase in the levels of short-termism during the nineties and a stabilisation, with some yearly fluctuations, afterwards.** This result is not only supported by the evolution of the pay-outs to net income ratio, but also by the distribution of the number of firms and the aggregated revenue according to different intervals of this ratio.

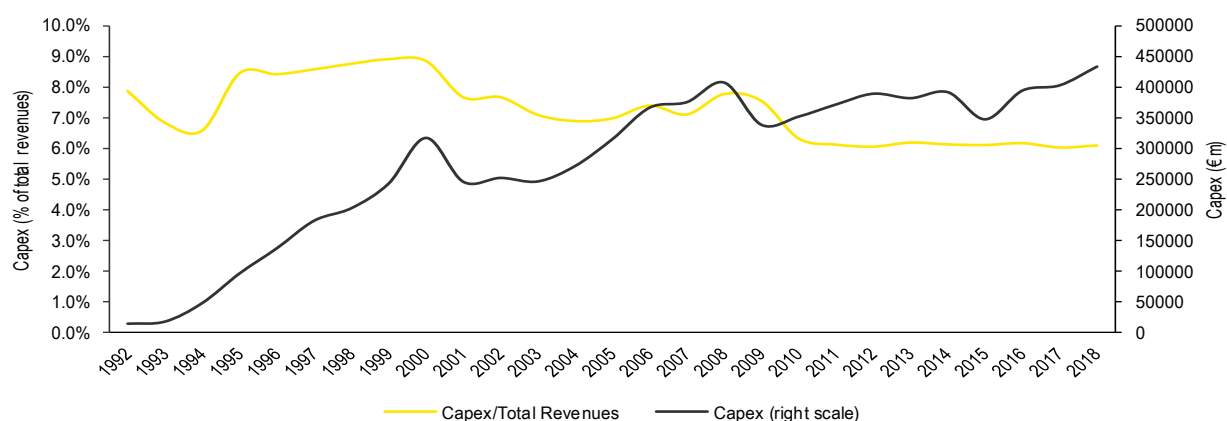
### 3.1.1.5 Evolution of investments

#### Business investment

**The ratio of CAPEX to total revenues has declined** from values between 8% and 9% in the second half of the 1990's to almost 6% in 2018. This slowdown is also corroborated by the evolution of the absolute value of business investment at current prices, proxied by CAPEX, whose growth clearly slowed down. While between 1992 and 2007, CAPEX grew at a CAGR of 24.6%, in the period 2008-2018 it grew at a CAGR of approximately 1.3%, well below the rate previously recorded (Figure 6).

These trends show how the investment intensity has slowed down over the past few years, thus **supporting the short-termism hypothesis.**

Figure 6 - Evolution of business investment | Absolute values at current prices and as % of revenues<sup>42</sup>



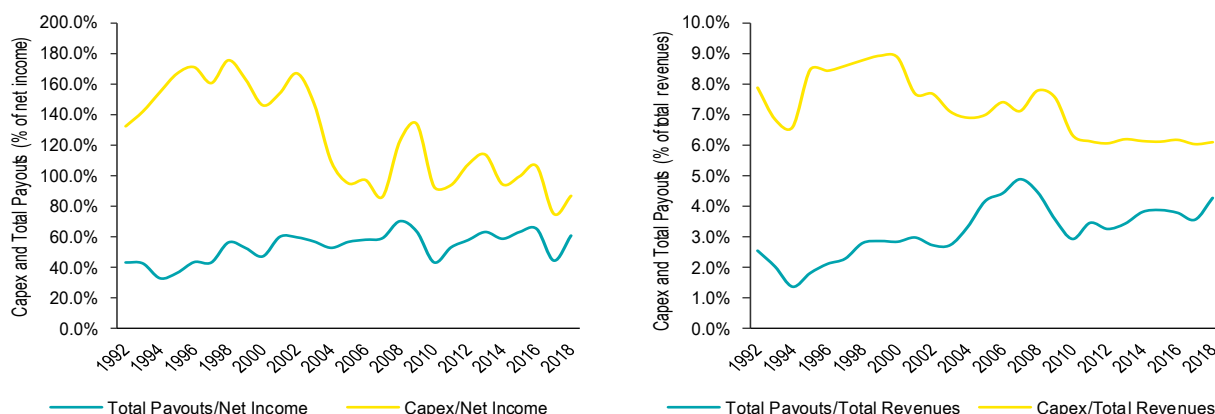
Source: S&P Capital IQ, Amadeus and EY

These findings can be confirmed by the comparison of the trends of business investment and pay-outs as a share of net income. **While the ratio of CAPEX to net income has decreased 45 percentage points, the ratio of total pay-outs to net income has increased by 17 percentage points in the period under analysis.** Although smoother, a similar trend can be

<sup>42</sup> To avoid biased findings due to the limited records in the beginning of the period, the sample comprises only observations with positive capex and net income (3893 companies).

found when taking into consideration the ratios of total pay-outs and CAPEX to revenues (Figure 7).

**Figure 7 - Evolution of business investment and total pay-outs | As % of net income and revenues<sup>43</sup>**



Source: S&P Capital IQ, Amadeus and EY

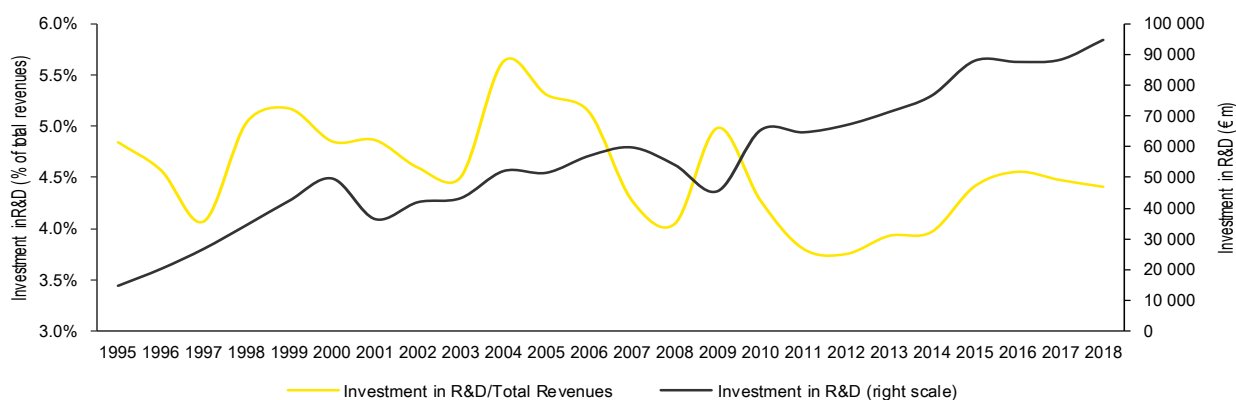
**Box 2 – Focus on trends in the investments in the US**

The growth of investments slowed down also in the US. As described by Enrico Maria Turco in a study<sup>44</sup> “over the last four decades, the investment rate of U.S. firms has been constantly slowing down” as “the annual growth rate of gross capital stock for 1000 S&P non-financial companies was around 32% in the 1980s and declined steadily up to 26% in the 2010s”.

**Investment in R&D**

The European public companies have also underperformed in terms of R&D intensity, supporting the short-termism hypothesis. The ratio of R&D to total revenues has gone from around 4.5%-5% between 1995 and 2009, to 4% and 4.5% afterwards (Figure 8).

**Figure 8 - Evolution of investment in R&D | Absolute values at current prices and as % of revenues<sup>45</sup>**



Source: S&P Capital IQ, Amadeus and EY

The evolution of investments in R&D and total pay-outs as a share of net income (Figure 9) follow a similar pattern to the evolution of business investment (Figure 7). The total pay-outs to net income and to revenues increased, between 1995 and 2018, 22.5 and 3 percentage points

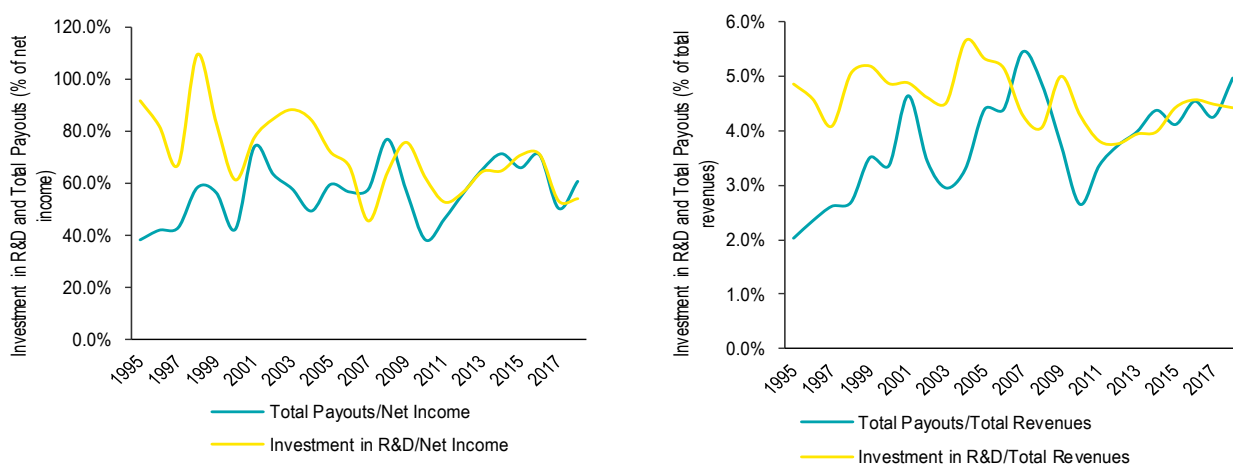
<sup>43</sup> The figure comprises only observations with positive net income and CAPEX. The sample includes 3893 companies.

<sup>44</sup> Turco, E.M. (2018), 'Are stock buybacks crowding out real investment? Empirical evidence from U.S. firms'. Available at [https://www.boeckler.de/pdf/v\\_2018\\_10\\_27\\_turco.pdf](https://www.boeckler.de/pdf/v_2018_10_27_turco.pdf).

<sup>45</sup> The figure comprises only observations with R&D expenditure and net income greater than zero. The sample includes 475 companies.

respectively, while the investment in R&D to net income and to revenues decreased 38 and 0.4 percentage points, respectively. The main difference between the evolution of CAPEX and investment in R&D, as expected, regards the amplitude of oscillation, which is more important in the case of investment in R&D. The results displayed regarding the investments in R&D are in line with the hypothesis of increased short-termism behaviour among listed companies, as one can simultaneously observe a reduction in the level of investment and an increase in the pay-outs to investors per earnings (net income) and per revenue generated.

Figure 9 - Evolution of investments in R&D and total pay-outs | As % of net income and revenues<sup>46</sup>

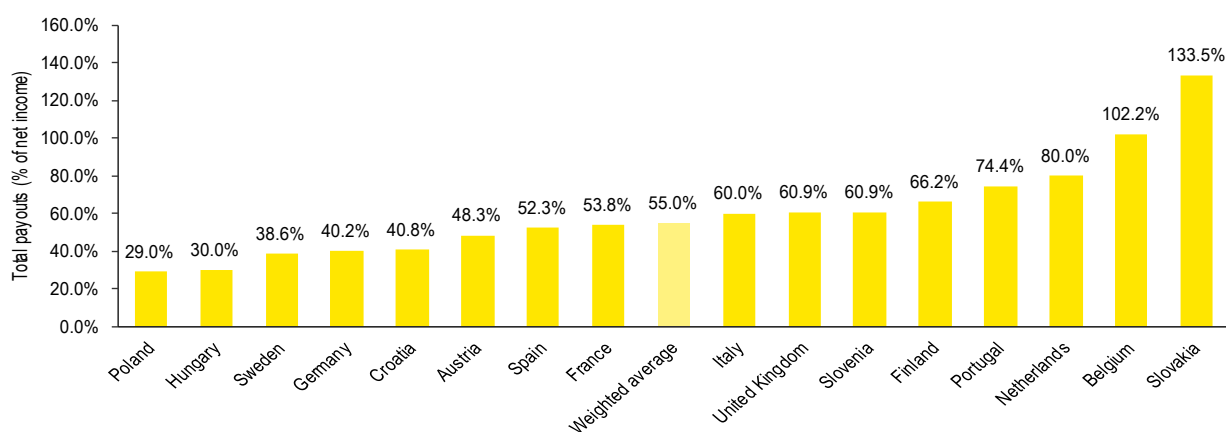


Source: S&P Capital IQ, Amadeus and EY

### 3.1.1.6 Analysis by country

The analysis of total pay-outs as percentage of net income<sup>47</sup> by country in 2016-18 yields **four Member States, among the ones considered, that stand out with relatively larger shares of cash “paid out”, namely Slovakia, Belgium, the Netherlands and Portugal**, on the opposite side, Poland and Hungary stand out with relatively smaller shares (Figure 10). The rest of the Member-States considered in this analysis exhibit more homogeneous behaviours with the ratios ranging from about 40% to 70%.

Figure 10 - Ratio between total pay-outs and net income | Average 2016-2018<sup>48</sup>



Source: S&P Capital IQ, Amadeus and EY

<sup>46</sup> The figures comprise only observations with R&D expenditure and net income greater than zero. The sample includes 475 companies.

<sup>47</sup> The analysis of business investment to net income and total pay-outs to revenues by country show similar results when compared to total pay-outs to net income, consequently only the latter is presented.

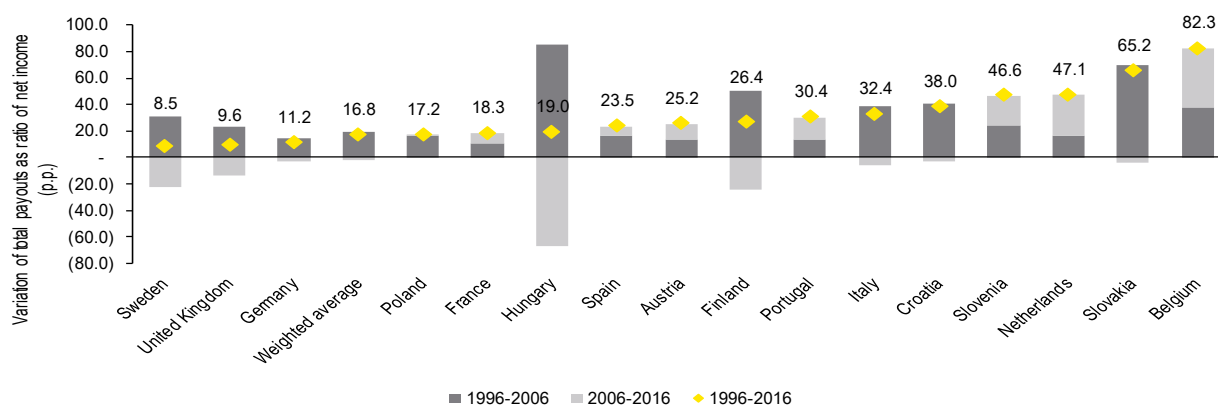
<sup>48</sup> The figure comprises only observations with positive net income. The sample includes 4154 companies.

The analysis of the recent evolution shows that **pay-outs as percentage of net income have increased between 1996 and 2016 across all 16 EU Member States analysed**. However, it is worth noticing that while in the first half of the period this indicator grew in all countries, in 2006-2016 pay-outs as percentage of net income decreased in half the countries analysed (Figure 11).

**The increase in pay-outs as percentage of net income is slowing down.** Between 1996 and 2006, pay-outs as percentage of net income increased, on average across the analysed countries, by approximately 19 p.p., whereas between 2006 and 2016 this variable decreased by 3 p.p.

Portugal, the Netherlands and Belgium are the only cases where the growth of pay-outs as percentage of net income accelerated in 2006-2016, that is, the cases where the growth observed in this period was higher than in 1996-2006.

Figure 11 - Evolution of ratio between total pay-outs and net income<sup>49</sup>

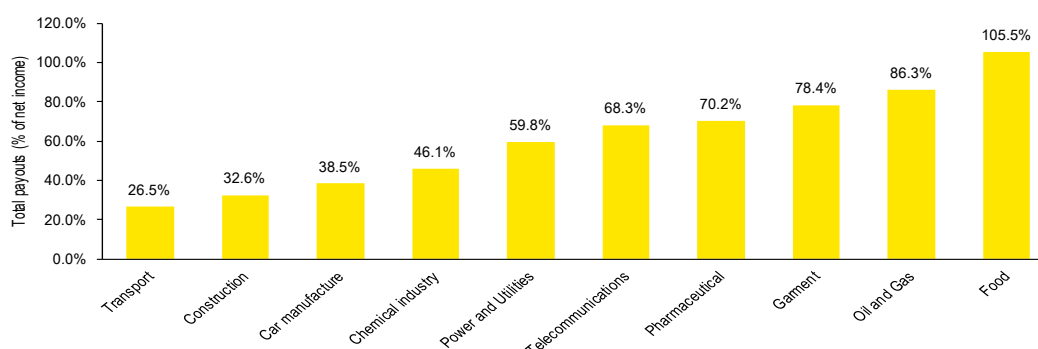


Source: S&P Capital IQ, Amadeus and EY

### 3.1.1.7 Analysis by industry

The analysis of the same indicator by industry<sup>50</sup>, given the classification of the listed companies by NACE rev.2 code, shows that the **"food industries" and "oil and gas" are the ones with the largest share of total pay-outs as percentage of net income**, above 80%, followed by "garment" and the "pharmaceutical industry". On the opposite side, "Transport services", "construction" and "car manufacturing" exhibit the lowest cash "paid out", with ratios under 40% (Figure 12).

Figure 12 - Ratio between total pay-outs and net income | Average 2016-2018<sup>51</sup>



<sup>49</sup> The figure represents the variations between the averages around the years indicated. It comprises only observations with positive net income. The sample includes 4154 companies.

<sup>50</sup> The analysis of business investment to net income and total pay-outs to revenues by industry show similar results when compared to total pay-outs to net income, consequently only the latter is presented.

<sup>51</sup> The figure comprises only observations with positive net income. The sample includes 4154 companies.

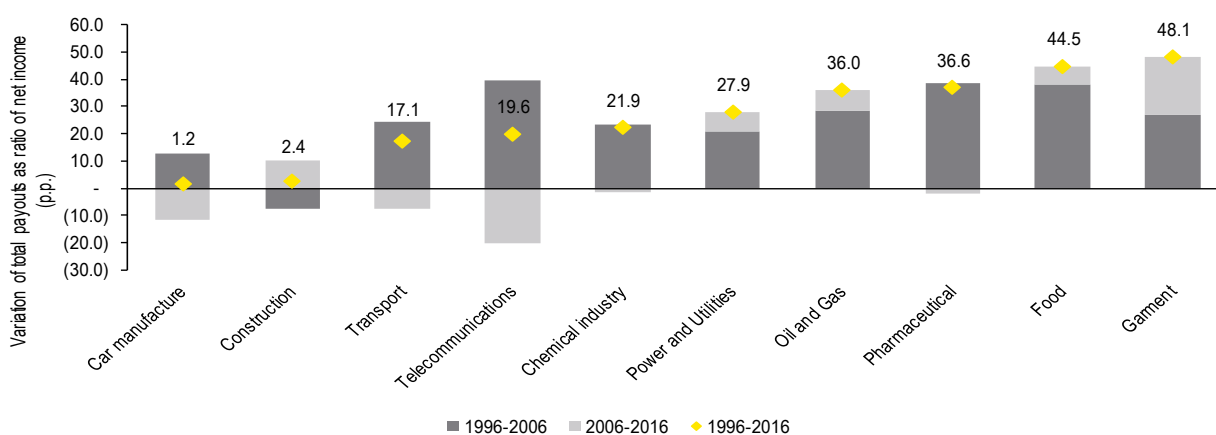
Source: S&P Capital IQ, Amadeus and EY

The analysis of the recent evolution shows that **pay-outs as percentage of net income have also increased across all 10 sectors** analysed since 1996.

Construction was the only sector recording a decrease in total pay-outs as percentage of net income in the turn of the century (period 1996-2006); nevertheless, it resumed growth between 2006-2016 (Figure 13).

The garment sector stands out as the only sector sustaining strong growth over the two periods of analysis, recording an increase of total pay-outs as percentage of net income of approximately 27 p.p. in 1996-2006 and of 21 p.p. in 2006-2016. This evolution exceeded "Telecommunications", "Pharmaceutical" and "food industries", which registered the strongest increase in this ratio between 1996-2006.

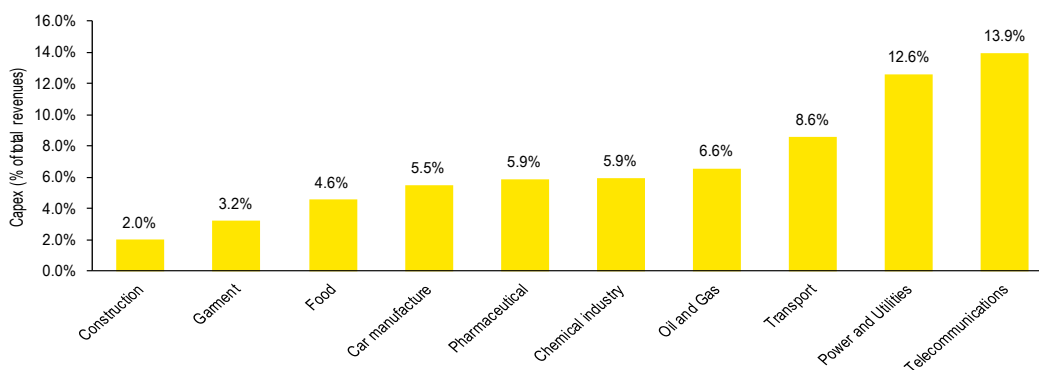
Figure 13 - Evolution of ratio between total pay-outs and net income<sup>52</sup>



Source: S&P Capital IQ, Amadeus and EY

With regard to the business investment, turning the attention to CAPEX as percentage of total revenues by sector, the results yield that, between 2016 and 2018, "power and utilities" and "telecommunications" were the sectors that allocated the most resources to CAPEX, both investing over 10% of total revenues (Figure 14).

Figure 14 - Business investment by industry: CAPEX as percentage of total revenues | Average 2016-2018<sup>53</sup>



Source: S&P Capital IQ, Amadeus and EY

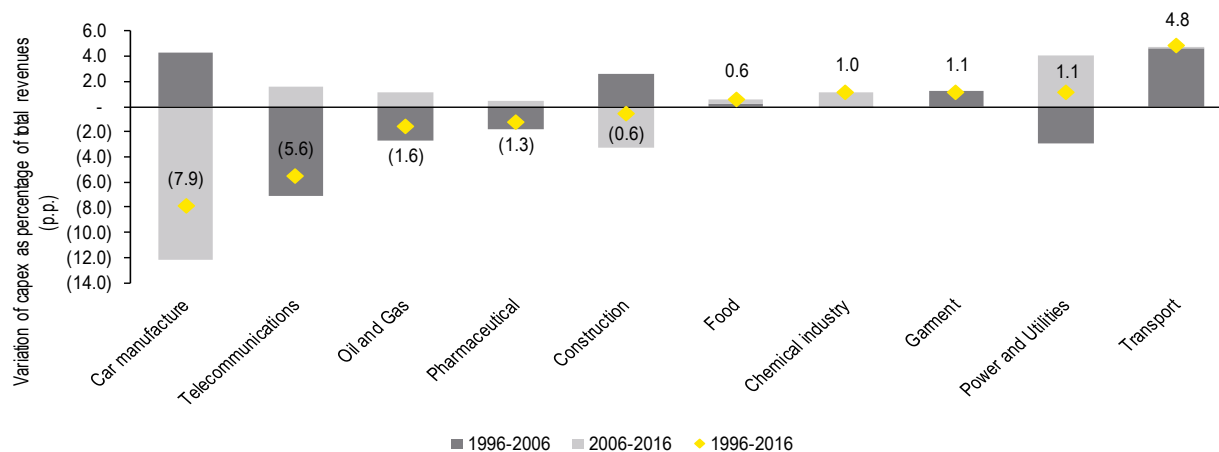
Only half of the sectors analysed have observed an increase in CAPEX as percentage of total revenues over the last 20 years – namely, "food", "chemical industry", "garment", "power and utilities", and "transport" (Figure 15). The first four recorded modest growth, whereas the latest,

<sup>52</sup> The figure represents the variations between the averages around the years indicated. It comprises only observations with positive net income. The sample includes 4154 companies.

<sup>53</sup> The figure comprises only observations with positive net income. The sample includes 4154 companies.

"transport services", grew by approximately 5p.p. since 1996. Note that the sectors in which the CAPEX ratio decreased between 1996 and 2006 resumed growth from 2006 onwards, although modest. Conversely, "car manufacture" and "construction", that recorded an increase in CAPEX as percentage of total revenues in the first half of the analysed period, registered a decrease in investment more recently.

Figure 15 - Evolution of business investment by industry<sup>54</sup>



Source: S&P Capital IQ, Amadeus and EY

### 3.1.2 Main consequences

This section illustrates the long-term consequences of corporate short-termism. These include the impact on the environment in terms of contribution to climate change and biodiversity loss, and other environmental challenges (section 3.1.2.1), the social effects on inequalities and human rights (section 3.1.2.2), the adverse economic effects for companies and the economy at large (section 3.1.2.3), as well as on the attainment of the SDGs (section 3.1.2.4).

Consequences discussed here are mainly based on the review of documents that explore the broader link between short-termism and sustainability. While acknowledging its importance, it is also worth highlighting that short-termism in corporate governance is not the only element that contributes to these consequences and the causal linkage between this phenomenon and long-term sustainability consequences is not completely straightforward or quantifiable.

#### 3.1.2.1 Environmental

Literature connects **short-termism to unsatisfactory response to environmental issues** both at individual<sup>55</sup> (i.e. the psychological tendency of individuals to focus on the short-term and consequently neglect sustainability issues) and organisational level<sup>56</sup> (i.e. the factors leading firms to prioritise short-term profits at the expense of long-term objectives). As highlighted by Slawinski et al.,<sup>57</sup> since climate change mitigation requires significant upfront investments by the companies, directors and executives who are present-focused and have a low tolerance for uncertainty, are unlikely to promote significant organisational changes (such as to the strategy or the main business model) that could lead to absolute emissions reductions. The same study underlines how companies that rely heavily on management practices that emphasise short-

<sup>54</sup> The figure represents the variations between the averages around the years indicated. It includes only observations with positive net income.

<sup>55</sup> Joireman, J., Kamdar, D., Daniels, D., Duell, B (2006), 'Good citizens to the end? It depends: empathy and concern with future consequences moderate the impact of a short-term time horizon on organizational citizenship behaviors', *The Journal of Applied Psychology*, Vol. 91 Issue 6, p. 1307.

<sup>56</sup> Slawinski, N., Bansal, P. (2012), 'A Matter of Time: The Temporal Perspectives of Organizational Responses to Climate Change', *Organization Studies*, Vol. 33, Issue 11, pp. 1537-1563.

<sup>57</sup> Slawinski, N., Pinkse, J. Busch, T., Banerjee, S. B. (2017), 'The Role of Short-Termism and Uncertainty in Organizational Inaction on Climate Change: Multilevel Framework', *Business and Society*, Vol. 56, Issue 2, pp. 253-282.



term financial returns over climate change mitigation (such as discounted cash flow analysis)<sup>58</sup> will be less likely to make significant investments to contribute to absolute Greenhouse Gases (GHG)<sup>59</sup> emissions reductions, especially in light of the uncertainty associated with such investments and their long-term payoff periods.

The link between short-termism and poor sustainability outcomes by the companies has been also highlighted in the field of company law research where **the shareholder primacy in corporate governance has been pointed out as a key driver of short-termism and a powerful barrier against more environmentally sustainable companies.**<sup>60</sup> The Sustainable Companies Project (2010–2014), led by Prof. Beate Sjøfjell of the University of Oslo investigated the barriers to a deeper integration of environmental concerns (in particular climate change mitigation and adaptation) into the decision-making of the companies. Through an extensive comparative legal analysis focused on aspects such as the purpose of the company and the duties of the board, the research found that, despite the space left by company law to integrate environmental externalities in business decisions, boards generally do not choose environmentally friendly, low-carbon options. To the contrary, "the functioning of the board is constrained by the overriding social norm of shareholder primacy, which, supported by management remuneration incentives and other drivers, dictates that board and senior managers are the 'agents' of the shareholders and should maximise returns to shareholders."<sup>61</sup>

Having established the link between shareholder primacy, short-termism and environmental unsustainability, the **environmental consequences of short-termism can be better explained by using the conceptual framework of "planetary boundaries"**. First introduced in 2009,<sup>62</sup> the planetary boundaries framework has so far identified nine planetary boundaries,<sup>63</sup> which define the "safe operating space" for humanity on Earth, i.e. the ecological limits within which humanity can continue developing and thriving for future generations. According to Steffen et al.,<sup>64</sup> **four of the currently identified nine planetary boundaries have been transgressed or are at risk of being transgressed as a result of human production and consumption:** climate change, biodiversity, land system change, and the biogeochemical cycles of phosphorus and nitrogen. Transgressing planetary boundaries entails the risk that the Earth will be driven into a state that is not compatible with human well-being. Notably, two of the four highlighted boundaries, climate change and biodiversity loss, are *core* boundaries, which means that transgressing either of them can be enough in itself to bring the Earth out of its relative stable state. Further, a fifth boundary, novel entities (e.g. microplastics, nanomaterials and various forms of chemical pollution) has not been quantified yet, so the status may be even worse.<sup>65</sup>

Europe faces persistent problems in areas such as **biodiversity loss, resource use, climate change impacts and environmental risks to health and well-being.** The European Environment Agency (EEA) latest 'State of the Environment' report<sup>66</sup> states that Europe faces environmental challenges of unprecedented scale and urgency. The alarming rate of biodiversity

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<sup>58</sup> Discounted cash flow is a method used to estimate the value of an investment based on its future cash flows.

<sup>59</sup> According to the UNEP report, GHGs are "[the] atmospheric gases responsible for causing global warming and climatic change. The major greenhouse gases are carbon dioxide (CO<sub>2</sub>), methane (CH<sub>4</sub>) and nitrous oxide (N<sub>2</sub>O). Less prevalent, but very powerful, GHGs are hydrofluorocarbons (HFCs), perfluorocarbons (PFCs) and sulphur hexafluoride (SF<sub>6</sub>)".

<sup>60</sup> Sjøfjell, B., Johnston, A., Anker-Sørensen, L., Millon, D. (2015), cit.

<sup>61</sup> Sjøfjell, B. (2018), 'Beyond Climate Risk: Integrating Sustainability into the Duties of the Corporate Board', *Deakin Law Review*, Vol. 23, pp 41-62.

<sup>62</sup> The concept of 'planetary boundaries' was first introduced by J. Rockström et al. (2009), 'Planetary Boundaries: Exploring the Safe Operating Space for Humanity', *Ecology and Society*, Vol. 14, Issue 2, and since revised and updated inter alia in Steffen, W. et al. (2015), 'Planetary Boundaries: Guiding Human Development on a Changing Planet', *Science*, 347(6223) 1259855.

<sup>63</sup> The boundaries include ozone depletion, loss of biosphere integrity, chemical pollution, and the release of novel entities, climate change, ocean acidification, freshwater consumption and global hydrological cycle, land system change, nitrogen and phosphorus flows to the biosphere and oceans, and atmospheric aerosol loading.

<sup>64</sup> Steffen, W. et al. (2015), cit.

<sup>65</sup> P. Villarrubia-Gómez, S. E. Cornell, Fabres, J. (2018), 'Marine plastic pollution as a planetary boundary threat – The drifting piece in the sustainability puzzle', *Marine Policy*, Vol. 96, pp. 213–220.

<sup>66</sup> European Environment Agency (2019), 'The European Environment – State and Outlook 2020'.

loss, increasing impacts of climate change and the overconsumption of natural resources as well as environmental risks to health and well-being calls for urgent action.

A 2017 report by the EEA<sup>67</sup> highlights that **climate change is already affecting all regions in Europe, although differently**. The report finds that “[s]outh-eastern and southern Europe are projected to be hotspot regions, having the highest numbers of severely affected sectors and domains. Coastal areas and floodplains in the western parts of Europe are also multi-sectoral hotspots. The Alps and the Iberian Peninsula are additional hotspots for ecosystems and their services. Ecosystems and human activities in the Arctic will be strongly affected owing to the particularly fast increase in air and sea temperatures and the associated melting of land and sea ice.” According to the Intergovernmental Panel on Climate Change (IPCC), observed climate change in Europe has had wide ranging effects throughout the region, including the distribution of animal, fish, and plant species, stagnating wheat yields and forest decline, affecting both human health (from increased heat waves) and animal health (changes in infectious diseases). Climate change will increase the likelihood of systemic failures across European countries caused by extreme climate events affecting multiple sectors, increasing the frequency and intensity of heat waves, particularly in Southern Europe, with mostly adverse implications for health, agriculture, forestry, energy production and use, transport, tourism, labour productivity, and the built environment.<sup>68</sup>

**Another main planetary boundary under threat in the environmental sphere is biodiversity** and according to the literature the EU biosphere boundary has been transgressed and therefore is EU has gone beyond the limits of our planet.<sup>69</sup> The EEA states that the conservation status of more than 60% of species and 77% of habitats, protected within the EU and falling under the umbrella of the EU Habitats Directive, is nowadays in danger potentially having serious consequences for the European society, economy and human health.<sup>70</sup> According to the EEA, “Europe’s biodiversity and ecosystems face cumulative pressures from land use change, natural resource extraction, pollution, climate change and invasive alien species. These have a severe impact on ecosystem services – nature’s benefits to people – as illustrated by the recent alarming loss of insects, especially pollinators. Moreover, according to the Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services (IPBES),<sup>71</sup> in the EU only 7% of marine species and 9% of marine habitat types covered by the Habitats Directive show a favourable conservation status, a total of 73% of the EU’s freshwater habitat types show an unfavourable conservation status, and only 16% of terrestrial habitat assessments in the period 2007–2012 had favourable conservation status. According to IPBES, this is the result of the activity of some economic sectors, such as conventional intensive agriculture, which makes a large use of agrochemicals and reduces natural and semi-natural habitats, and also of infrastructures for hydropower and water abstraction, impacting freshwater biodiversity. According to the International Resource Panel, the production of high-quality food (including luxury products with a large biodiversity and water stress impact, such as coffee or cocoa) and cotton (for the garment industry) puts pressure on water and land resources and increase the utilisation of agrochemicals and fertilisers.<sup>72</sup> Finally, the last assessment of the UN Convention on Biological Diversity<sup>73</sup> stated that biodiversity loss and the degradation of ecosystem services in the EU continued since the last assessment.<sup>74</sup> Clearly, continuing with the

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<sup>67</sup> European Environment Agency (2017), *Climate change, impacts and vulnerability in Europe 2016: An indicator-based report*, Publications Office of the European Union, Luxembourg.

<sup>68</sup> IPCC (2014), ‘Fifth Assessment Report Climate Change 2014: Impacts, Adaptation and Vulnerability’, p. 1270.

<sup>69</sup> Häyhä, T., Cornell, S.E., Hoff, H., Lucas, P., van Vuuren, D., (2018), ‘Operationalizing the concept of a safe operating space at the EU level – first steps and explorations’, Stockholm Resilience Centre Technical Report, prepared in collaboration with Stockholm Environment Institute (SEI) and PBL Netherlands Environmental Assessment Agency’.

<sup>70</sup> European Environment Agency (2019), cit., p. 74.

<sup>71</sup> IPBES (2018), ‘The IPBES regional assessment report on biodiversity and ecosystem services for Europe and Central Asia’.

<sup>72</sup> International Resource Panel (2019), ‘Global Resources Outlook 2019: Natural Resources for the Future We Want’, p. 88.

<sup>73</sup> The UN Convention on Biological Diversity, to which the EU and its Member States are party, was adopted in 1992 and entered into force in 1993. It currently counts 196 Parties, with the notable exception of the United States.

<sup>74</sup> CHM (2019), ‘6th EU Report to CBD’, p. 51.

current, mostly unsustainable production (and consumption) models does not contribute to achieving the Convention's objectives.<sup>75</sup>

At the same time **the world's consumption of raw materials is set to nearly double by 2060** as the global economy expands and living standards rise, placing twice the pressure on the environment that we are seeing today as projected in the Organisation for Economic Co-Operation and Development (OECD) report on 'Global Material Resources Outlook to 2060'.<sup>76</sup> According again to the International Resource Panel, the trend of material use will continue growing to 190 billion tons and over 18 tons per capita by 2060, causing GHG emissions to increase by 43% from 2015 to 2060, industrial water withdrawal to increase by up to 100% from 2010 levels, and the area of agricultural land to increase by more than 20%, thus reducing forests by over 10% and other habitat by around 20%.

According to the United Nations Environment Programme (UNEP),<sup>77</sup> the EU is the third largest GHG and CO<sub>2</sub> emitter in the world, accounting for 9% and 10% respectively. Also for this reason, the **EU has been at the forefront of international efforts to fight climate change**. In fact, the EU has already reduced its GHG emissions in 2017 by about 17% from 1990 levels, while CO<sub>2</sub> emissions decreased by about 22% compared to 1990 in 2018. The EU put forward **a legally binding climate pledge under the Paris Agreement to reduce GHG emissions by at least 40% by 2030 compared to 1990**. To accelerate the reduction of GHG emissions and reach the target, key legislation has been adopted by the end of 2018, including national coal phase-out plans, increasing renewable energy and energy efficiency, and legally binding annual emission limits for each Member State in the transportation, buildings, agriculture and waste management sectors.<sup>78</sup> Moreover, the EU has strived during recent decades to position itself as a leader in environmental policy and promote the concept of sustainable development on the global scene,<sup>79</sup> developing environmental legislation in a wide range of fields, from recycling and waste management to biosafety and eco-labelling,<sup>80</sup> and adhering to a number of international conventions.<sup>81</sup> More recently, the European Commission launched the European Green Deal (see also section 4.3.2), a roadmap for making the EU's economy sustainable, followed by the first European Climate Law, proposed by the European Commission on 4 March 2020 to enshrine the 2050 climate-neutrality target into law, and by the submission of the EU long-term strategy to the UN Framework Convention on Climate Change.

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<sup>75</sup> The Convention has three objectives: the conservation of biodiversity, the sustainable use of biological resources, and the equitable sharing of benefits arising from utilisation of genetic resources

<sup>76</sup> OECD (2019), 'Global Material Resources Outlook to 2060'.

<sup>77</sup> UNEP (2018), *The Emission Gap Report 2018*, Global Carbon Project.

<sup>78</sup> The revision of the EU Emissions Trading System (ETS) for 2021–2030 was adopted in March 2018, encompassing: (1) reducing the cap at an annual rate of 2.2% from 2021 onwards; (2) doubling the Market Stability Reserve feeding rate between 2019 and 2023 to reduce surplus of allowances; and (3) invalidating allowances in the Market Stability Reserve exceeding the number of allowances auctioned in the previous year from 2023 onwards. The provisionally agreed Effort Sharing Regulation applying to GHG emissions from sectors not covered by EU ETS (transport, buildings, agriculture and waste management) was adopted in May 2018. The overall targeted reduction in GHG emissions from these sectors is 30% by 2030, relative to 2005, which is to be achieved by legally binding annual emission limits for each Member State for the 2021–2030 period. The EU has also adopted a regulation to integrate GHG emissions and removals from LULUCF into the 2030 climate and energy framework as well as amendments to the Energy Efficiency Directive and the Energy Performance of Buildings Directive. The Governance of the Energy Union Regulation, which sets out the trajectory and interim targets for achieving the recently agreed 2030 goals of 32% renewable energy and 32.5% energy savings and requirements for regular progress reports, was also adopted in 2018.

<sup>79</sup> Afionis, S., Dupont, C., Sokolowski, M.M., Kalantzakos, S., Martinuzzi, A., Sedlacko, M. (2017), 'EU Environmental Policy', Routledge.

<sup>80</sup> Examples of such legislation are the Environmental Liability Directive, the Seveso Directive, the Directive on the protection of the environment through criminal law, the Regulation concerning the export and import of hazardous chemicals, the Regulation concerning Persistent Organic Pollutants (POP), the Regulation on shipments of waste the Industrial Emission Directive, the Water Framework Directive, the Waste Directive, the National Emission Ceiling Directive, and the Habitats Directive.

<sup>81</sup> Such as the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and Their Disposal, the Convention on Biological Diversity, the Stockholm Convention on Persistent Organic Pollutants, and the Rotterdam Convention on the Prior Informed Consent Procedure for Certain Hazardous Chemicals and Pesticides in International Trade.

**Exposure to chemical pollution negatively affect human health and the environment** and the projected increase in chemical production and continued emissions of persistent and hazardous chemicals suggests that the total chemical burden on health and the environment is unlikely to decrease according to the EEA.<sup>82</sup> European chemical policies have contributed to improved air and surface water quality and reduced related harm to the environment and people's health but significant knowledge gaps remain regarding the impacts of chemicals on health and the environment.

**It is unclear whether the EU is on track to hit its Paris Agreement target.** According to a 2019 report analysing countries' commitments to reduce emissions,<sup>83</sup> these combined measures and policies by the EU are expected to result in GHG emission reductions of 58% by 2030, exceeding the emission reduction commitment in the EU pledge (40%). However, this has been challenged by *The European environment – State and Outlook 2020*<sup>84</sup> report published by the EEA in December 2019. According to the report, recent projections by Member States indicate that the EU is not on track towards its 2030 climate and energy targets. The report notes that recent trends have not been encouraging, with primary energy consumption rising since 2014 and growth of renewables slowing down since 2015. Thus, the report argues EU is on track to reduce emissions by only 30% by 2030 over 1990 levels, as against its Paris Agreement target of 40%. The EEA outlook concludes that Europe will not achieve its 2030 goals without urgent action during the next 10 years to address the alarming rate of biodiversity loss, increasing impacts of climate change and the overconsumption of natural resources.

### 3.1.2.2 Social

There is a substantial body of literature (though mainly focusing on the US context) linking shareholder primacy in corporate governance, the "financialisation"<sup>85</sup> of the global economy, and increasing social inequalities.<sup>86</sup> **From a social perspective, short-termism exacerbates inequalities.** In a context where share ownership is concentrated in the richest households (such as in the US), achieving higher share prices and larger dividend pay-out – the main objective of corporate executives focused on the short-term – is beneficial to a just small fraction of a country's population (the share owners) and contributes to deepen the existing socio-economic cleavages (Box 3).

#### Box 3 – Share ownership concentration among richest households in the US

As reported in a 2015 report from the Roosevelt Institute, most Americans own little or no stock and therefore do not benefit from higher share prices or larger pay-outs. The bottom 50% of households (with incomes of \$50,000 or below) own just 9% of shares. Stock ownership is significantly concentrated, with the richest 4% of households (with incomes of \$250,000 or more) owning a majority of all shares. Rather than having a democratising effect, **the concentration of income from capital is one of the primary drivers of inequality**.<sup>87</sup>

<sup>82</sup> European Environment Agency (2019), cit.

<sup>83</sup> FEU-US (2019), *The Truth Behind the Climate Pledges*. Available at <https://feu-us.org/behind-the-climate-pledges/>.

<sup>84</sup> EEA (2019), *The European Environment – State and Outlook 2020*. Available at <https://www.eea.europa.eu/soer-2020/intro>.

<sup>85</sup> Following the definition given by Epstein, "financialization means the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies". In Epstein, G. A. (ed.), (2005), *Financialization and the world economy*, Edward Elgar Publishing, ch. 1.

<sup>86</sup> For instance, see the following literature (mainly from the US): Jacoby, S. M. (2008), 'Finance and labour: Perspectives on risk, inequality and democracy', *Comparative Labour Law and Policy Journal*, Vol. 30, pp. 17-61; Jacoby, S. M. (2011), 'Labour and finance in the United States', in Williams, C. A., Zumbansen, P. (eds.), *The embedded firm: Corporate governance, labour, and finance capitalism*, pp. 277-317, Cambridge University Press, Cambridge; Lazonick, W. (2013), 'The Financialization of the U.S. Corporation: What Has Been Lost, and How It Can Be Regained', *Seattle University Law Review*, Vol. 36, pp. 857-909. Orhangazi, Ö. (2008), 'Financialisation and capital accumulation in the non-financial corporate sector: 1973-2003', *Cambridge Journal of Economics*, Vol. 32 Issue 6, pp. 863-886; Piketty, T., Saez, E. (2014), 'Inequality in the long run', *Science*, New York, Vol. 344, Issue 6186, pp. 838-843; Reich, R. B. (2016), *Saving capitalism: For the many, not the few*, Icon Books, London.

<sup>87</sup> Mason, J. W. (2015), 'Short-termism. Question and consequences', Roosevelt Institute, pp. 6-28.

The same is true for the shareholding of global corporations, as shown by a study on 299 global corporations, where the largest 30 shareholders (out of more than 2,100 share controllers) owned around 51.4% of the assets.<sup>88</sup> The concentrated distribution of share ownership means that the shareholder primacy is in reality the primacy of a wealthy minority on a global scale. As pointed out by Ireland, "[i]f one broadens and globalises the picture - in order to take account of the fact that a significant proportion of the interest and dividends accruing to financial property is derived from the labour of people elsewhere in the world, among the great majority of whom financial property ownership is virtually non-existent - this elite begins to look smaller still".<sup>89</sup>

**Growing inequalities also result from executive compensation schemes heavily weighted towards stock-related components.** Share-based remuneration has increasingly oriented executive compensation to the stock market, thereby unhitching management pay from the norms and dynamics applicable to the rest of the workforce.<sup>90</sup> According to European Policy Institute data on US largest public firms,<sup>91</sup> the Chief Executive Officer (CEO)-to-worker compensation ratio grew from 20-to-1 in 1965 to 270-to-1 in 2018, peaking at 368-to-1 in 2000. The CEO compensation has grown 940% since 1978, the typical worker compensation has increased only 12% over the same time span. In Europe, a recent study finds that the highest CEO-to-average employee pay ratio are registered in France (113-to-1) and the UK (105-to-1), which are also the countries where companies offer CEO pays with the highest stock-based pay ratios on average.<sup>92</sup> The myopic search for short-term profits created pressure to depress non-executive wages, transforming employees into independent contractors to avoid paying benefits or having responsibility for pensions, and outsourcing work to contracting firms that compete to pay lower and lower wages.<sup>93</sup> This shows how the short-term value creation for shareholders was prioritised at the expense of better employee compensation.

Going beyond income inequality, another significant issue affecting the relation between companies and the general public is the **human rights policies of companies across global supply and value chains**. A large number of contributions in the literature has highlighted the presence of serious violations of labour and other human rights by multinational corporations in developing countries,<sup>94</sup> highlighting the linkage between weak workers protection, profit maximisation and executives' remuneration. One recent study jointly carried out by a number of NGOs described the entire process of production for apparel firms, showing little human rights protection and strong price pressures from the company on the suppliers in third countries,<sup>95</sup> such as the fast growing textile industry in Ethiopia, where some workers are allegedly paid less than 0.15\$ per hour.<sup>96</sup> Another example involves the production of mobile phones and electronic devices,<sup>97</sup> with several cases of misconduct and labour exploitation in countries such as China, Vietnam, India and more. More in general, global statistics of the International Labour Organization (ILO) highlight several issues in term of achieving decent working conditions:

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<sup>88</sup> Murray, G., Scott, J. (2009), *Financial Elites and Transnational Business – Who Rules the World?*, Edward Elgar Publishing, Cheltenham, UK.

<sup>89</sup> Ireland, P. (2005), 'Shareholder primacy and the distribution of wealth', *The Modern Law Review*, Vol. 68, Issue 1, pp. 49-81.

<sup>90</sup> ETUC and ETUI (2012), *Benchmarking Working Europe 2012*. Available at <https://www.etui.org/Publications2/Books/Benchmarking-Working-Europe-2012>.

<sup>91</sup> Report available at <https://www.epi.org/publication/ceo-compensation-2018/>.

<sup>92</sup> Kotnik, P., Sakić, M.E., Guduraš, D. (2018), 'Executive compensation in Europe: Realized gains from stock-based pay', *INET Working Papers*, Working Paper no. 78.

<sup>93</sup> Davis, G. F. (2009), *Managed by the Markets: How Finance Re-Shaped America*, Oxford University Press, New York; Weil, D. (2017), *Fissured Workplace: Why Work Became So Bad for so Many and What Can Be Done to Improve It*, Harvard University Press.

<sup>94</sup> Giuliani E., Macchi C. (2014), 'Multinational corporations' economic and human rights impacts on developing countries: A review and research agenda', *Cambridge Journal of Economics*, Vol. 38 No. 2, pp. 479-517.

<sup>95</sup> PublicEye report available at [stories.publiceye.ch/respect-by-zara/](https://stories.publiceye.ch/respect-by-zara/).

<sup>96</sup> Worker Rights Consortium report on Ethiopia available at [https://www.business-humanrights.org/sites/default/files/documents/Ethiopia\\_isa\\_North\\_Star\\_FINAL\\_0.pdf](https://www.business-humanrights.org/sites/default/files/documents/Ethiopia_isa_North_Star_FINAL_0.pdf).

<sup>97</sup> Hankyoreh report available at [http://english.hani.co.kr/arti/english\\_edition/e\\_international/898949.html](http://english.hani.co.kr/arti/english_edition/e_international/898949.html); China Labour Watch report available at [www.chinalaborwatch.org/upfile/2019\\_09\\_06/Zhengzhou%20Foxconn%20English%2009.06.pdf](http://www.chinalaborwatch.org/upfile/2019_09_06/Zhengzhou%20Foxconn%20English%2009.06.pdf).

around the globe there are around 25 million victims of forced labour,<sup>98</sup> 152 million victims of child labour,<sup>99</sup> 2.78 million deaths for work-related diseases per year and 374 million non-fatal work-related injuries per year.<sup>100</sup> In order to tackle this specific matter international organisations (such as the ILO) developed several conventions to protect workers, but their enforcement is still debatable, especially with reference to the labour markets of developing countries.<sup>101</sup>

Moreover, the pursuit of increasing short-term profits diverts investments from long-term value creation through employee training.<sup>102</sup> For instance, data on 1017 UK companies show that some proxies of short-termism are significantly correlated with the volume of training undertaken.<sup>103</sup> Training of employees is not only an indicator of a long-term focus, but also a driver of sustainability on its own. Skills development can be indeed considered as a key component of a response to environmental challenges, as it can promote innovation, investment and competitiveness, which in turn feed back into social development, thus creating a virtuous cycle.<sup>104</sup> Short-termism is associated also with an increasing pressure to degrade working conditions for employees<sup>105</sup> by increasingly introducing precarious contract conditions, and to announce layoffs as a signal to the market, rather than as a real economic necessity.<sup>106</sup>

### 3.1.2.3 Economic

**Short-termism has serious adverse economic effects on companies, their shareholders and their stakeholders, and undermines the macroeconomy.** As discussed in section 3.2, the strength of the social norm of shareholder primacy in corporate governance theory and practice, combined with growing pressures from institutional and activist investors increasingly focused on the short-term market value of the shares, places intense pressure on corporate boards to prioritise the market valuation of the company and focus on short-term financial performance, driving down all other costs, at the expense of better employee compensation and stronger investments that are important for long-term productivity.<sup>107</sup> As already described in section 3.1.1, there are cutbacks in companies' CAPEX in recent decades, as well as in R&D. A survey conducted in 2004 by the US National Bureau of Economic Research<sup>108</sup> reported that 78% of 401 financial executives surveyed stated that they would sacrifice economic value to reach short-term financial forecasts. More recently, when asked how much of their companies' quarterly earnings or revenue targets could be put at risk to pursue an investment with a positive net present value that would boost profits by 10% over the following three years, a majority of more than 1,000 C-level executives and directors surveyed by McKinsey & Company and Canada Pension Plan Investment Board<sup>109</sup> responded that their companies would not be willing to accept significantly lower quarterly earnings for this kind of investment, and nearly half said short-term pressures reduce their companies' willingness to pursue investments with less certain returns.

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<sup>98</sup> ILO and Walk Free Foundation (2017), 'Global estimates of modern slavery: forced labour and forced marriage', p. 5.

<sup>99</sup> ILO (2017), 'Global estimated of child labour: Results and trends, 2012-2016', p. 5.

<sup>100</sup> Workplace Safety and Health Institute (2017), 'Global Estimates of Occupational Accidents and Work-related Illnesses 2017', p. 11.

<sup>101</sup> Salminen, J., Rajavuori, M. (2019), 'Transnational sustainability laws and the regulation of global value chains: Comparison and a framework for analysis', *Maastricht Journal of European and Comparative Law*.

<sup>102</sup> Stein, J.C. (2003), 'Agency, Information and Corporate Investment', in Constantinides G.M., Harris M., Stulz R.M. (eds), 'Handbook of the Economics of Finance', pp. 111-165.

<sup>103</sup> Felstead, A. (2018), 'Tracing the connections: short-termism, training and recession', *The International Journal of Human Resources Management*, Vol. 29 No. 4, pp. 664-682.

<sup>104</sup> ILO (2018), 'World Employment and Social Outlook 2018: Greening with jobs', ILO flagship report, p. 130.

<sup>105</sup> Lazonick, W. (2013), cit., pp. 857-909; Reich, R. B. (2016), cit.

<sup>106</sup> Reich, R. B. (2016), cit.

<sup>107</sup> For a US-based study, see Mason, J. W. (2015), 'Disgorge the Cash: The Disconnect Between Corporate Borrowing and Investment', The Roosevelt Institute.

<sup>108</sup> Graham, J.R., Harvey, C.R., Rajgopal, S. (2004), 'The Economic Implications of Corporate Financial Reporting', NBER Working Paper 10550.

<sup>109</sup> FCLT (2014), 'Short-termism: Insights from Business Leaders. Finding from a global survey of business leaders commissioned by McKinsey & Company and CPP Investment Board'.

As a result, **companies risk to become less productive and innovative in the long term, with adverse consequences on the sustainability of the company as well as for the local and global economy as a whole.**<sup>110</sup> These adverse consequences on the economy could be further exacerbated by the effects of climate change, environmental degradation and rising inequalities, as described below. Moreover, due to short-term shareholder value maximisation, companies are borrowing money to finance pay-outs for shareholders instead of investing it, which might also **explain why monetary policy showed little effectiveness in boosting employment and economic output in the last economic crisis.**<sup>111</sup>

Shareholder primacy led some boards of directors to believe that they have an obligation to reduce their corporations' tax liabilities to an extent that led to **tax avoidance**, as exemplified by the Luxleaks and Panama Papers scandals.<sup>112</sup> These practices externalise risk by reducing the corporate tax quote and thereby indirectly increasing the tax bill paid by citizens and local corporations. Tax avoidance reduces the tax income of governments, and in turn their capacity to invest in infrastructure, education, and R&D, to the benefit of the society and economy as a whole.

Moreover, some studies underline the **convergence between environmental, social and economic impacts**, which poses a significant challenge for providing progress at development without posing our existence at risk.<sup>113</sup> At micro-economic level, it is recognised that **transgressing planetary boundaries will create specific risks for businesses**, including supply chain disruption, increased scarcity of raw materials, cost increases, and potentially new and stricter regulatory compliance.<sup>114</sup> A 2018 report<sup>115</sup> on the economic costs of climate change in Europe prepared in the context of the CO-designing the Assessment of Climate CHange costs (COACCH) project states that climate change impacts such as floods, high temperatures and water availability will affect business and industry, although risks will vary with sub-sector and location, impacting sites and operations in different ways. Risks will extend along supply chains, as the impacts in non-EU countries will affect the production and transport of raw materials and intermediate goods. Climate change is also expected to affect also the demand side, causing changes in the demand for goods, services and trade. The combination of these impacts may affect business costs, profitability, competitiveness, employment and sector economic performance. At macro-economic level, according to the conclusions of the Joint Research Centre PESETA project,<sup>116</sup> if no further action is taken and global temperature increases by 3.5°C, welfare losses of EU households could amount to at least €190 billion, a net welfare loss of 1.8% of its current Gross Domestic Product (GDP), with high impacts especially in the southern regions. As concerns biodiversity, the continuing loss of biological diversity is estimated to cost the global economy up to €14 trillion by 2050, which is equivalent to 7% of the projected global GDP in 2050.<sup>117</sup>

Finally, short-termism hinders the capacity of companies to face the consequences of environmental degradation and climate change and the related adverse economic impact. In fact, short-termism not only causes companies to neglect their own adverse sustainability impacts (as described in the sections above), but it also prevents them from becoming resilient vis-à-vis changed environmental circumstances. Furthermore, short-termism can prevent

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<sup>110</sup> On the macroeconomic consequences of short-termism, see Terry, S.J. (2017), cit.

<sup>111</sup> Mason, J. W. (2015), cit.

<sup>112</sup> Veldman, J., Gregor, F., Morrow, P. (2016), cit.

<sup>113</sup> Sjøfjell, B. (2018), cit., pp. 41-62.

<sup>114</sup> University of Cambridge Institute for Sustainability Leadership (CISL) (2019), 'Linking planetary boundaries to business: The first White Paper in Kering's series on Planetary Boundaries for Business', Cambridge Institute for Sustainability Leadership, Cambridge, UK.

<sup>115</sup> COACCH (2018), 'The Economic Cost of Climate Change in Europe: Synthesis Report on State of Knowledge and Key Research Gaps', policy brief by the COACCH project.

<sup>116</sup> Joint Research Center PESETA project (Projection of Economic impacts of climate change in Sectors of the European Union based on bottom-up Analysis, part I and II) provides a multi-sectoral assessment of the physical and economic impacts of climate change in Europe for the 2071-2100 time horizon.

<sup>117</sup> Braat, L. et al. (2008), 'The Cost of Policy Inaction (COPI): The case of not meeting the 2010 biodiversity target', Alterra Wageningen University and Research.

companies from identifying and exploiting opportunities offered by the need for a transition to a sustainable economy. Efforts to mitigate and adapt to the effects of climate change may produce benefits through resource efficiency, cost savings, the development of new low-emission products and services, and access to new markets. Studies demonstrate that companies integrating sustainability considerations perform better.<sup>118</sup> Thus, short-term oriented companies will not only contribute to unsustainability, but will not adapt either their business models and strategies and will not carry out the investments necessary to make them resilient, sustainable and viable on the long-term. According to the last World Economic Forum Report on Global Risks<sup>119</sup> today's most urgent business risks, e.g. failure of climate-change mitigation and adaptation, extreme weather events, natural disasters and cyber-attacks, are directly linked to sustainability issues. As stated by the WBCSD and the Committee of Sponsoring Organizations of the Treadway Commission (COSO),<sup>120</sup> such evolution in the risk landscape means that sustainability risks "*that were once considered "black swans" are now far common - and can manifest more quickly and significantly*". These risks, and the related impacts, need to be systematically identified and strategically managed on both company and operational product development level in order for a company to be long-term sustainable and competitive. Numerous examples have shown how **sustainability issues can affect companies to an existential level, since a lack or incorrect identification of such risks** (or the lack of integration with the evaluation of business risks) **may undermine a companies' ability to create value for shareholders** in the long term.

As a recent example of this, **the COVID-19 pandemic and the economic crisis that ensued showed that companies focusing on the short term**, for instance with lower investments in CSR, **have been less resilient to the unexpected shock**, with worse stock market performances,<sup>121</sup> and subsequent need for State aid to navigate through the crisis. In the opposite direction, a recent study by WBCSD signalled how companies in Europe which demonstrate taking ESG factors into account, beat the STOXX Europe 600 benchmark by a margin of 4.3%, for year to date ending on 30 April 2020.<sup>122</sup> This finding is consistent with the view that sustainability favours the creation of trust in company stakeholders, making workers, suppliers, and customers more prone to support companies in times of pressure. Thus, the pandemic has exposed the vulnerabilities of short-termism and shareholder primacy, showing that financial performance is dependent on and deeply intertwined with human and social capital, ecosystems, and natural resources, and that sustainability is necessary to make business models less vulnerable to systemic risks, and more resilient to market shocks in the future.<sup>123</sup>

### 3.1.2.4 Consequences on the achievement of the SDGs

The business world also has a critical role to play in the achievement of the **UN SDGs**. As described in the previous sections, corporate short-termism is among the factors that hinder the achievement of environmental, social and economic sustainability. Without companies abandoning the business-as-usual and proactively embracing and promoting the sustainability transition, it will be hard to achieve such ambitious sustainability goals in the near future. The 2019 Europe Sustainable Development Report by the Sustainable Development Solutions Network and the Institute for European Environmental Policy finds that, although EU countries lead globally on the SDGs, **no Member State has achieved or is on track to achieve the SDGs by 2030**. The EU and its Member States obtain their best results on SDG 1 (No Poverty),

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<sup>118</sup> Friede, G., Busch, T., Bassen, A. (2015), 'ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies', *Journal of Sustainable Finance & Investment*, Vol. 5, Issue 4, p. 210-233, available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2699610](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2699610).

<sup>119</sup> World Economic Forum (2019), 'The Global Risks Report', 14th Edition, World Economic Forum, Geneva.

<sup>120</sup> WBCSD/COSO (2018), 'Applying Enterprise Risk Management to Environmental, Social and Governance-related Risks'.

<sup>121</sup> Ding, W., Levine, R., Lin, C., Xie, W. (2020), 'Corporate Immunity to the COVID-19 Pandemic', NBER Working Paper No. 27055, p. 25, available at <https://www.nber.org/papers/w27055.pdf>.

<sup>122</sup> WBCSD (2020), 'Increasing risk management & resilience through ESG investing', available at <https://www.wbcd.org/Overview/News-Insights/WBCSD-insights/Increasing-risk-management-resilience-through-ESG-investing>.

<sup>123</sup> KPMG (2020), 'The COVID-19 recovery calls for bold corporate action on sustainability', available at [https://assets.kpmg/content/dam/kpmg/dk/pdf/dk-2020/06/COVID-Sustainability-Article\\_20200609.pdf](https://assets.kpmg/content/dam/kpmg/dk/pdf/dk-2020/06/COVID-Sustainability-Article_20200609.pdf).



SDG 3 (Good Health and Well-being) and SDG 8 (Decent Work and Economic Growth), while worst results regard SDG 2 (Zero Hunger) and SDGs 12-15 regarding responsible consumption and production, climate and biodiversity. Importantly, progress over the past few years is also too slow to generate meaningful transformations by 2030. This implies that, under the current trends and **all things being equal, the EU and its Member States will not be able to achieve the SDGs by 2030.**

At business level, the 17 SDGs (and the 169 targets that underpin them) provide companies with a complex and inter-connected framework to internalise global needs into business solutions, thereby contributing to moving the world towards a more sustainable and inclusive future. **Successfully internalising the SDG agenda requires companies to abandon short-term profit maximisation and take a longer-term approach** by: considering how their respective business models and operations can impact the SDGs; adapting their business strategies and aligning them with SDGs; setting measurable targets; keeping track of progresses made and reporting transparently on them.

As long as organisations operate in a system that prioritises short-term financial performance on long-term social progress, businesses will struggle to deliver on the SDGs. Annex I.1 illustrates how an excessive focus on short-term financial performance by the companies might adversely affect the many possible ways in which they could contribute to achieving the SDGs.

#### Summary of the main consequences of short-termism

- The focus of companies on short-term financial results limits their environmental sustainability, as climate change mitigation requires significant upfront investments and organisational changes that companies focused on the maximisation of present value might not be willing to make. This might eventually lead to the non-respect of key "planetary boundaries" such as climate change and biodiversity;
- Short-termism is at the origin of increasing inequalities, in so far as it triggers benefits to a small fraction of population (the share owners), and does not effectively contribute to avoiding human rights violations and degrading working conditions along the global supply chain;
- Due to a short-term focus, companies have spent fewer resources on investments and CAPEX innovation, which reduces their long-term profitability and harms the innovative capacity of the economy, which in turn could prevent the transition towards sustainability;
- Corporate short-termism puts at serious risk the attainment of the UN SDGs and the 2015 Paris Agreement on climate change as well as objectives in other relevant conventions such as the Convention on Biological Diversity.

### 3.2 Factors contributing to corporate short-termism

The study identified factors contributing to short termism that refer to the key areas below:

- Directors' duties and company's interest;
- Pressure from investors;
- Sustainability strategy and estimation of sustainability risks and impacts;
- Board remuneration;
- Board composition;
- Stakeholder involvement;
- Enforcement;
- Non-financial reporting and disclosure.

The main factors identified are linked to either regulatory aspects or market practices, and are generally considered by academics and experts as root causes of short termism. To understand their relevance to the EU context, a detailed analysis of the state of play has been undertaken in 12 selected EU Member States in terms of:

- regulatory framework (through the legal review of company legislation, codes and principles) to understand whether factors linked to regulatory aspects apply;
- market practices (through the analysis of stakeholders' responses to the web-survey) to understand to what extent factors linked to practices apply.

The sections below provide a summary analysis and describe the main issues identified. Details with the main findings of the literature review and the state of play in the 12 selected EU Member States are presented in Annex I.7.

Table 4 shows an overview of the key areas and the related factors analysed with indication of the key sources of information used.

**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
<b>Directors' duties and company's interest</b>	Definition and interpretation of directors' duties and "company's interest"	✓	✓	✓
<b>Pressures from investors</b>	Changes in share ownership structures and emergence of activist investors	✓		
	Disclosure of quarterly returns and earning guidance	✓		
<b>Sustainability strategy and estimation of sustainability risks and impacts</b>	Existence of a sustainability strategy and targets	✓	✓	✓
	Estimation of sustainability risks and impacts	✓	✓	✓
<b>Board remuneration</b>	Directors' remuneration linked to financial performance	✓	✓	✓
	Directors' remuneration linked to sustainability metrics	✓	✓	✓
<b>Board composition</b>	Expertise of the board members	✓	✓	✓
	Independence of the board	✓		
<b>Stakeholder involvement</b>	Stakeholder involvement in corporate decision-making	✓	✓	✓
<b>Enforcement</b>	Stakeholder rights to hold the board or its members accountable	✓	✓	✓
<b>Non-financial reporting</b>	Disclosure of non-financial statements	✓	✓	✓

### 3.2.1 Directors' duties and company's interest

From a legal perspective, directors' duties and liabilities are regulated in all EU Member States. The principle that directors' duties are owed primarily to the company (i.e. to the legal entity), and not to the shareholders of that entity, is also accepted in all EU jurisdictions. This is confirmed also by the in-depth analysis of the regulatory frameworks of 12 Member States.

In all jurisdictions, the core duty of the board is to protect and promote the interests of the company. 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"**. This has been increasingly understood as the maximisation of shareholder value in the short term. This social norm has been thought to be a legal provision, even if no jurisdictions prescribe this. Even where the national regulatory frameworks make explicit that shareholder interests do not take priority over the interests of other stakeholders – as in the Netherlands – the literature identified a lack of appropriate guidance for directors on how to effectively balance different interests – shareholder, stakeholder, and other societal interests (such as the environment) – while acting in the best interest of the company. This is mainly due to a **lack of a clear definition of "company interest" in company law frameworks**, as emerged from the legal review in the 12 Member States in scope of the study. The concept of company's interest is often not defined at all, or mainly relate to the interests of shareholders, this leaving room for interpretation by companies. Literature shows that interpretations are highly influenced by the shareholder primacy norm and thus focus on shareholders and their returns. This is also confirmed by the

survey responses, as 91% (50) of the respondents agree with the statement that "company's interest" should encompass the interest of stakeholders and the environment other than the interest of shareholders.

Moreover, the literature highlights **that the identification and mitigation of sustainability factors affecting the long-term life of the company, both internally** (i.e. sustainability risks to the company) **and externally** (i.e. company's contribution to sustainability as a global overarching goal), **are not embedded in the directors' duty of care**. The in-depth legal review shows that, in most of the analysed national regulatory frameworks for corporate governance, there are requirements in place for directors to take vigilance measures aimed at identifying ESG risks to the company and reporting on sustainability impacts of company activities. However, where present, such requirements are linked to the implementation of the Non-Financial Directive (rather than being part of every directors' duty of care) and apply only to certain companies, based on criteria such as the size (large companies) or the listing status (listed companies). In these countries, as well as those where specific requirements are not expressly stated (DE and ES), the need to identify and mitigate sustainability risks and impacts is not embedded in the directors' duty of care and therefore is not extended to all public liability companies, regardless of their size (e.g. SMEs) and listing status.

When looking at the market practices, the results of the web-survey provide evidence – although very limited – that there is an ongoing tendency on the part of company boards to be involved in the identification of sustainability risks and impacts. However, as indicated by the large body of evidence from the literature reviewed, **boards seem to be engaged in the sustainability efforts of their companies still to a limited extent** and, when they are, they show substantially different levels of depth and detail thus making it difficult to compare sustainability performances and take evidence-base decisions.

As pointed out in the literature, the absence of a clear duty to identify and mitigate long-term economic, social and environmental risks and impacts, combined with the shareholder primacy norm and the market pressures on short-term financial performance, leads directors to focus primarily on shareholder value maximisation and short-term financial risks and neglect or underestimate longer-term risks and impacts. As indicated in Annex I.5, the identification of sustainability risks in relation to climate change mitigation and adaptation can be considered as being already part of the duty of care in some non-EU jurisdictions (i.e. Australia, Canada).

**Driver 1: Directors' duties and company's interest are interpreted narrowly and tend to favour the short-term maximisation of shareholders' value**

- *Issue 1.1:* The formulations of directors' 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
- *Issue 1.2:* The identification and mitigation of sustainability risks and impacts is rarely included in the board duties

### 3.2.2 Pressure from investors

As far as investors are concerned, the growing importance of institutional investors correlates with a shortening of investor engagement in companies, in terms of shorter tenure of shares and increased frequency of portfolio turnovers, as described by economic data and findings surmised from the literature review. These developments, combined with the increased role played by activist investors – like activist hedge funds – having an explicit short-term orientation, determined an overall dynamic in which **investors with a short-term focus exert pressure on boards to focus on short-term shareholder value maximisation and distribution**, rather than on long-term value creation. The attempts to increase the stewardship of investors over companies' long-term value creation presents some problems as well, as most of a company's shareholders are minority shareholders with limited capacity to voice their views, and many of them focus primarily on the market value of their shares.

Moreover, the **disclosure of quarterly returns** and **earnings guidance** are regarded in the literature as key drivers behind the focus on short-term financial performance of listed companies. These practices **create pressures on executives to meet and exceed short-term quarterly earnings' expectations and maximise short-term financial returns to shareholders**, at the expense of longer-term investments and innovation opportunities. Even though none of those practices is mandated under EU law, the literature and the regulatory review reports that both are in use among listed companies – sometimes to meet specific stock exchange regulations and requirements under national law – although precise figures are not available. The relevance of quarterly returns and earnings guidance as a driver of corporate short-termism is confirmed also by survey results, where most respondents (58.9%) considered these practices to lead board members to focus on short-term company goals to a high or very high extent.

**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 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
- *Issue 2.2:* The disclosure of quarterly returns and earnings guidance tend to reinforce board members focus on the short-term financial performance

### 3.2.3 Sustainability strategy, sustainability targets and estimation of sustainability risks and impacts

Embedding sustainability aspects in business strategy, or setting a sustainability strategy,<sup>124</sup> as well as setting measurable targets, seems to be a key step for companies to reduce sustainability-related risks and negative impacts, maximise opportunities, and move their business beyond short-term focus and create value in the long term. However, as shown by the legal review, with a few exceptions, national regulatory frameworks do not enshrine an obligation for companies to adopt and disclose a sustainability strategy. This implies that **the adoption of a sustainability strategy, including the identification of science-based ESG targets** and their alignment with “global” goals (e.g. the SDGs), is in most cases **left to the voluntary initiative and discretion of the companies thus generating a fragmented picture**.

Evidence collected from the literature and the survey seem to indicate that, even if companies are increasingly aware of the importance of setting a sustainability strategy and many of them have already developed one,<sup>125</sup> **sustainability strategies do not always entail science-based targets aligned with high-level objectives** (such as the SDGs) and, most importantly, are **not systematically monitored through dedicated KPIs** allowing to keep track of companies' contributions towards said goals.<sup>126</sup> In the current state of play, there is a risk that sustainability strategies become a corporate tool to improve company's reputation and communicate corporate sustainability commitments that are not effectively monitored or even followed by concrete actions.

This situation is further complicated by the fact that, as highlighted by the literature, **companies might find it difficult to find a solid business case for sustainability**. As emerged from the sectoral analysis, in certain sectors there is a perceived **trade-off between pursuing environmental and social targets** (e.g. GHG emissions reduction), on one side, and

<sup>124</sup> In practice, companies looking for improving their sustainability might follow two different approaches: they might either integrate sustainability aspects systematically into their business strategy, or develop a separate sustainability strategy that goes in parallel with the “traditional” business strategy.

<sup>125</sup> According to the survey answers, 85.7% of companies declared to have a sustainability strategy, while in the literature the percentages are smaller, for instance the study by BCG and the MIT Sloan Management Review ‘Corporate Sustainability at a Crossroads: Progress Toward Our Common Future in Uncertain Times’ reports that only 60% of the interviewed companies have some kind of sustainability strategy.

<sup>126</sup> An example of a sustainability strategy closely monitored by specific KPIs is the “Science Based Targets”, a joint initiative of CDP, the UN Global Compact (UNG), the World Resources Institute (WRI) and WWF, whose goal is to enable leading companies setting ambitious and meaningful corporate GHG reduction targets. To date, 850 companies are taking actions. Nevertheless, this initiative only focuses on GHG emissions.

**economic and business objective**, on the other, which negatively affect the ability of companies to focus on a long-term perspective. This is particularly relevant for some sectors, as the implementation of a long-term sustainability strategy, allowing for the complete and effective integration and management of sustainability risk and impacts, seem to entail the need of structural changes in the sector itself (e.g. *power and utilities, transport, construction and automotive sectors*).

As concerns the **identification of sustainability risks and impacts**, the sectoral analysis found that there are **different levels of maturity across the 10 sectors considered**, with the *food* and *oil and gas* sectors relatively more advanced in terms of the identification and the management of their sustainability risks and impacts. The level of maturity seems to depend also on the specific sustainability topic considered. Based on feedback collected through interviews with companies, NGOs and business organisations, across all sectors there is a prevalent focus on climate change (both in terms of risks/opportunities and in terms of impacts) and on people health and safety. Therefore, it is easier to find awareness and high-level commitment on these aspects, compared to other ones.

Moreover, it seems that, across all sectors considered, there is a **lower level of maturity in the identification and management of sustainability risks as compared to sustainability impacts**. In fact, while there are broadly recognised standards and guidelines on the measurement and monitoring of sustainability impacts (most notably the GRI Standards), which provide a complete framework on KPIs to assess companies' impacts for reporting purposes, currently there are no commonly recognised frameworks/standards for sustainability risks and their management (including quantitative KPIs). This finding from the literature review has been confirmed through interviews with representatives from four business organisations and six NGOs, who have not indicated cross-sectorial and/or sector-specific KPIs to measure sustainability risks. This issue is further aggravated by the fact that, as underlined by the literature review, the integration of sustainability risks within companies' ERM is still at an early stage.

Finally, while there is a **general cross-sectorial recognition of the need to extend the analysis of risks and impacts to the whole value chain**, evidence still shows diversified approaches from company to company and among sectors. According to evidence collected for the sectoral analysis, limited attention has been put by companies to the identification and management of risks and impacts related to the entire value chain, thus leading to a **lack of a complete overview of upstream and downstream activities**. The integration of the risks and impacts deriving from upstream and downstream activities is quite difficult, as it requires close monitoring of the stakeholders involved through audit and due diligence. In absence of an obligation to monitor the supply chain sustainability, and of specific guidelines for the integration of sustainability aspects related to the value chain into the companies' processes, each company manages the issue independently and differently according to its specific need and competencies. However, some sectors are moving towards greater attention to value chain sustainability, addressing and considering all interactions and stakeholders along the value chain<sup>127</sup> (e.g. *food, car manufacture, garment sectors*).

**Driver 3: Companies lack a strategic perspective over sustainability and current practices fail to effectively identify and manage relevant sustainability risks and impacts**

- *Issue 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 KPIs
- *Issue 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

### 3.2.4 Board remuneration

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<sup>127</sup> Information based on the desk sectoral analysis and three interviews with Business associations (Food, Car manufacturer and Garment sectors). Sector-specific information on sustainability risks (environmental, social and economic) is detailed in Annex I.3.

The current structure of executive pay is also identified in part of the literature as a key driver behind short-termism.

A substantial strand of literature argues that **share-based remuneration of executives reinforces**, rather than works against, **the capital market pressure for maximisation of returns to shareholders in the short term**. Share-based remuneration schemes create incentives for executives to focus on shareholder value maximisation and manage corporate resource in a way aimed to increase share price, benefiting themselves and the shareholders, at the expense of investments that are necessary for the long-term sustainability of the company. This is also the position of most of respondents (17) to the web-survey, who believe that share options tend to provide strong incentives for the focus on short-term share price and shareholder value, diverting decision-making from long-term sustainability. In terms of figures, available data indicate that share-based executive pay schemes are largely diffused in Europe (though limited, survey results are consistent with these data), although the level of share-based compensation in Europe is not as high as in the US. At the same time, however, part of the literature and six survey respondents remark how share options are an instrument to align the interests of the executives with those of shareholders, which means that, if share-based compensation schemes have a long-term view, (e.g. long vesting periods, linkage to ESG performance metrics, etc.), they can support (and not undermine) corporate sustainability.

With regard to the latter point, the literature also suggests that a positive link exists between executive compensation schemes that includes non-financial, ESG metrics and the environmental and social performance of a company. Despite that no granular figures are available for EU companies, **available data indicate that linking sustainability performance to remuneration metrics is currently still an emerging trend in the market**. This means that, even though non-financial KPIs are monitored and reported on by large listed companies (as mandated by EU law), such KPIs are in general not connected to remuneration schemes, and a disconnect exist in practice between executive remuneration frameworks and corporate sustainability performance. The in-depth legal review highlighted how this practice is currently left to discretion of individual companies, as none of the legal frameworks reviewed include legal provisions or self-regulatory measures that expressly link board remuneration to sustainability metrics.

**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 exacerbate executives' focus on short-term shareholder value maximisation
- *Issue 4.2:* The integration of ESG metrics into board remuneration structures is still a limited practice

### 3.2.5 Board composition

As highlighted by the findings of the literature review, board composition is key to promote a shift towards greater business sustainability and long-term focus. A diversified board with a wide range of relevant skills and experience is important to challenge the business-as-usual, avoid group think, and raise questions in terms of the long-term sustainability and value creation.

Data from the literature suggest that **in most companies the board lacks competence and expertise in sustainability matters and is still largely dominated by men**. Concerning sustainability expertise, although there is lack of granular data, the literature indicates that companies where the board includes at least one member with ESG, ethics or sustainability experience, or where there is a board-level committee or advisory body with ESG-related responsibilities, are a minority. Though limited, the evidence from the survey is line with these findings, as it suggests that the presence of board members with competence in sustainability matters is rather limited. Moreover, as found by the literature review and the in-depth legal review of the 12 selected Member States, national regulatory frameworks do not include explicit legal provisions concerning the competencies and expertise of board members, while mandatory requirements on gender balance on board are present only in a few EU jurisdictions. It should be highlighted that companies might be well-aware of the importance of having a diversified and well-balanced board and might take the necessary actions to establish one even in absence of

regulatory obligations. Nonetheless, the fact that the boards of most companies seem to lack diversity in terms of gender and competencies raises questions about their ability to have a holistic understanding of stakeholder expectation, take a long-term perspective, abandon the business-as-usual, and move their business towards a more sustainable path. As highlighted above, in November 2012 the European Commission proposed legislation to increase the number of women on corporate boards by 40% in publicly listed companies. Since the legislative proposal on gender balance on corporate boards is already under consideration, this study will not consider any proposal in this regard, and will focus on measures to further the consideration of sustainability (in term of competence, knowledge, expertise) as a relevant criterion to be taken into account in the board composition process.

**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*

### 3.2.6 Stakeholder involvement

As highlighted by the literature, the prominence of shareholder primacy in corporate governance and the pressure it generates to pursue short-term profit maximisation leads **board members not to take sufficient account of the long-term interests of stakeholders other than shareholders** (such as employees, creditors, suppliers, customers and the society at large as well as the environment).

This can have negative consequences on the long-term success of a company, as it might undermine its social license to operate. As a matter of regulatory frameworks, it is argued in the literature that, to some extent, a duty for directors to take the interests of all stakeholders into account is recognised, in some form or another, in all EU jurisdictions. The in-depth legal review of the 12 Member States found instances of legal requirements that ensure the protection of shareholders and employees' interests in corporate decision-making, while other stakeholders relevant to a company's sustainability (e.g. local communities) are not explicitly covered, indicating that an asymmetry persists among stakeholder groups. Although limited, survey results also suggest a clear division between stakeholder categories as concerns the degree to which current national regulatory frameworks provide an adequate level of protection for stakeholder interests in corporate groups: 86.7% of the respondents representing companies, business associations, and investors believe the current level of protection is adequate, while 85.7% of the respondents representing trade unions, NGOs, and experts and academics believe the opposite. In sum, **the current regulatory frameworks seem to lack the clarity and strength needed to ensure that directors go beyond shareholder centrality** and concretely consider the interests of all stakeholders (including the environment).

A greater involvement of all stakeholders can help companies to counterbalance pressure from financial markets and short-term investors and give "voice" – if not representation – to subjects with a strong interest in the long-term sustainability of the company. However, there is evidence in the literature that **stakeholder involvement in corporate decision-making is rather limited**, especially when it takes place through voluntary company initiatives. In this regard, the survey provide evidence, though limited, that the establishment of stakeholder engagement fora such as advisory bodies or consultation meetings is not yet a widespread market practice. Survey results also indicate that employees are currently the stakeholder category (other than shareholders) that is most involved in company decision-making. As highlighted in the literature, employees make illiquid, non-diversifiable investments in the companies for which they work, and for this reason they have a longer-term perspective than many shareholders. While it is recognised that in many EU countries there are legal requirements for employee representation at board level (DE, FI, FR, HU, SI, SE, just in our sample for the in-depth legal review), existing literature underlines that significant differences exist among national settings, as employee representation depends on various parameters in different national contexts (e.g. type of company, board structure, the way employee directors are nominated and appointed etc.). Moreover, there is there is a minority of EU countries where employees are not entitled to board-level representation.

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

- *Issue 6.1:* Actual stakeholder engagement and involvement in corporate decision making is a limited market practice

### 3.2.7 Enforcement

The in-depth legal review found that, with few exceptions, national regulatory frameworks include provisions and substantive rules concerning the civil and criminal liability of board members towards the company, the shareholders, and other stakeholders (most notably creditors). As concerns the latter, in the Member States covered by the legal review, board members are generally liable towards stakeholders when the latter suffered a damage as a result of directors' decision (either lawful or in breach of law), even though the specific conditions to be met to start a legal action are slightly different in each national framework.

To be effective, directors' duties and liabilities need to be enforced. In this regard, the literature highlights that, while personal claims do not raise particular problems,<sup>128</sup> the **enforcement of company's claims against directors for an alleged violation of the duty of care is problematic**. In most EU jurisdiction, the only actors empowered to instigate legal proceedings against the directors on behalf of the company are the board of directors, the supervisory board (in two-tier systems), and/or the shareholders in the general meeting. As a consequence, enforcement of the company's claims against its directors faces two major problems: conflict of interest (obvious in the case of one-tier board structure, where the board brings the company's claim against its own member), and collective action (in case of derivative actions, the shareholders who bring the legal action bear all costs, while benefits from the claimant's efforts accrue also to passive shareholders). As reported in the literature, due to these obstacles, **enforcement levels are currently low in all Member States**.

In the current context, stakeholders of the company (other than shareholders) lack legal standing to enforce directors' duty of care, even when they have a legitimate interest in the long-term sustainability of the company. This means that **stakeholders** such as employees, local communities, etc. **lack enforcement mechanisms to effectively ensure the protection of their legitimate interests in corporate activities**, and therefore to exercise substantial influence over the board and board members and keep them accountable. It could be observed that in some EU Member States (namely France and the Netherlands) recent legislative developments in the area of corporate due diligence have introduced "new" enforcement mechanisms accessible to company's stakeholders. However, enforcement is linked to (alleged breach of) specific due diligence obligations arising from these pieces of legislation, rather than to the directors' duty to act in the (long-term) interest of the company.

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

- *Issue 7.1:* Enforcement of directors' duties is largely limited to the board of directors, the supervisory board and the shareholders, with no rights for other stakeholders (or a regulatory authority) to instigate legal proceedings on behalf of the company
- *Issue 7.2:* Current enforcement levels of directors' duties are low in all Member States

### 3.2.8 Non-financial reporting and disclosure

Companies' non-financial reporting, mandated under the EU Non-Financial Directive, is intended to play a key role in reorienting financial capitals towards sustainability investments and make companies accountable for identifying and addressing the ESG as well as economic risks and impacts associated with their activities, including in their supply chains, where relevant.

<sup>128</sup> Personal claims are actions brought by shareholders or third parties in their own name for the infringement of individual rights owed directly to them. Enforcement of such rights generally does not pose problems. By definition, personal claims are characterised by a loss suffered by the claimant (shareholder or third party) personally and not shared with other shareholders (or third parties). In addition, they arise from duties owed directly to them and not to the company, as the duty of care. See Gerner-Beuerle, C., Paech, P., Schuster, E.P. (2013), cit., p. 184.



However, the literature highlights how **sustainability reporting so far failed to provide meaningful, comprehensive and comparable non-financial information**, mainly due to the lack of specificity of the EU Non-Financial Directive with regard to what information and KPIs companies should disclose, and to the flexibility left to companies in terms of reporting standards to be used which, in turn, limited data consistency and comparability. Moreover, the lack of mandatory external verification raises questions on the relevance and reliability of information disclosed. In line with the literature, the in-depth legal review also indicated that significant differences (e.g. in terms of companies in scope, integrated reporting, external verification, etc.) shape obligations at country level, as a result of the discretion left for Member States in national transposition. As a result, the sustainability information disclosed by most companies does not allow investors and other actors to understand and compare companies' impacts and by extension their development, performance and position. Due to these issues, it is argued in the literature that **non-financial reporting requirements have proven insufficient to overcome pressures to focus on short-term financial performance and to influence companies and their investors to prioritise sustainability**.

As reported above, the Commission launched an inception impact assessment and a public consultation (still open) in view of a possible revision of the Non-Financial Reporting Directive. While recognising that developments in the area of sustainability disclosure and reporting is closely related to business sustainability and more sustainable corporate governance, this study will not consider any proposal regarding a revision of the Non-Financial Reporting Directive, as a parallel initiative specifically dedicated to it is already ongoing.

## 4 PROBLEM DEFINITION AND OPTIONS

Building on the previous findings, this chapter defines the problem to be addressed and its drivers (section 4.1), discusses the necessity of an EU intervention to address the identified problem (section 4.2), lays down the general and specific objectives for such EU action (section 4.3), and at the end presents a list of potential options that can be adopted to address the problem and its causes (section 4.4).

### 4.1 The problem

#### 4.1.1 Problem definition

As highlighted in section 3.1, over the past three decades there has been a **trend for EU listed companies to focus on the short-term benefit of shareholders** rather than on the long-term interests of the company (*core problem*). Data indicate an upward trend in shareholder pay-outs, also showing that dividends continue being the largest form of pay-outs, although buybacks show sharper increases over the period – especially during the financial crisis (see sections 3.1.1.4 and 3.1.1.5). Moreover, the ratio of CAPEX and R&D investment to revenues has been declining since the beginning of the 21<sup>st</sup> century, with more amplified oscillations in the case of R&D investment. In sum, while it is possible to identify a steep upward trend in short-termism in the Nineties, over the last two decades the indicators that proxy short-termism seem to have stabilised around high levels of pay-outs and low investment intensity.

The orientation of EU businesses to short-termism is a complex and multifaceted problem driven by various factors, not all of them related to company law (e.g. undue short-term pressures on companies stemming from the financial sectors, which are also the subject of separate studies,<sup>129</sup> and the widespread diffusion of the shareholder primacy norm). However, this study focuses on company law and corporate governance aspects and shows how, to some extent, corporate short-termism finds its root causes in regulatory frameworks and market practices that work together to promote a focus on short-term financial return rather than long-term sustainable value creation.

As described in detail in section 3.2, issues related to corporate governance might be grouped around seven key *drivers*:

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;
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.

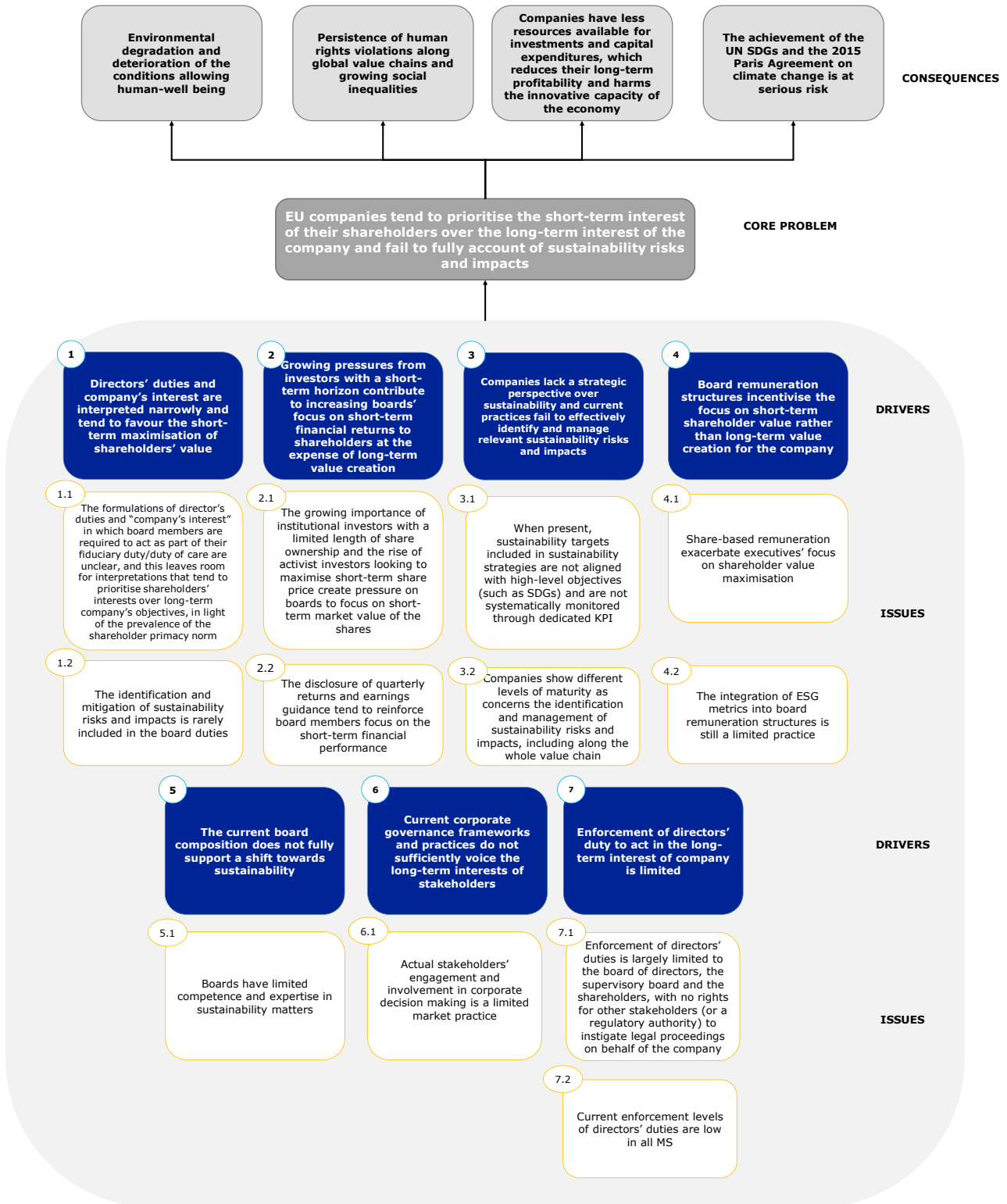
Each driver and the related *issues* are illustrated in the **problem tree** below (Figure 16) which provides visual summary of the core problem, its consequences, the problem's drivers and their underlying issues. The problem tree builds on the evidence collected during the study. As highlighted in section 2.1, limited data from the survey have been – at least partly –

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<sup>129</sup> See reports delivered in December 2019 by the three European Supervisory Authorities: ESMA (2019), cit. EBA (2019), *EBA Report on Undue Short-Term Pressure from the Financial Sector on Corporations*. European Insurance and Occupational Pensions Authority (EIOPA) (2019), *Potential Undue Short-Term Pressure from Financial Markets on Corporates: Investigation on European Insurance and Occupational Pension Sectors*, EIOPA-BOS-19-537.

compensated by the large availability of information and data from the literature review and by the findings of the legal review.

Figure 16 – Problem tree



#### 4.1.2 Who is affected and how?

The **identified drivers affect different categories of stakeholders**, either directly involved in the governance of companies, or concerned by the impacts of companies' operations. This section points at the most relevant issues that negatively affect stakeholder activities.

##### **Driver 1 – Directors' duties and company's interest are interpreted narrowly and tend to favour the maximisation of shareholders' value**

Driver 1 leads directors to focus on short-term financial results under the pressure imposed on them by financial markets, activist shareholders, etc. The categories most affected by Driver 1 are employees and society at large (which includes the local communities where the company operates, suppliers and workers along the supply chain, etc.) as directors tend to prioritise the interest of shareholders over that of all other stakeholders impacted by or interested in the company long-term prosperity. Moreover, the employees and the society are strongly affected by the narrow interpretation of directors' duties as owned primarily to the shareholders, leading to the long-term interest and sustainability risks and impacts of the company being neglected, with negative environmental, social and economic consequences suffered by the mentioned categories.

The narrow interpretation of the "company's interest" undermines the capacity of the company to produce long-term value and be sustainable in the long term. This affects the value created for the shareholders in the long term (especially those that do not have a short-term focus, such as pension funds). Moreover, it affects directors' performance, as it inhibits members of the board from integrating sustainability into corporate decision-making and thus taking business decisions that pay-off in the long-run. Misinterpretations on who is the ultimate beneficiary of the duties leads directors to overlook sustainability risks and impacts that might occur in the medium/long-term and leave them exposed to the risk of legal actions for a breach of their duties.

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.

##### **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**

Boards are directly affected to a high extent as the disclosure of quarterly returns and earnings guidance pressures them to focus on short-term financial results rather than long-term value creation for the company.

In the long term, the shareholders (at least those with a long-term interest in the company), the employees and society at large can be adversely affected. Corporate boards are pressured to manage companies in ways that improve the short-term market valuation of the firm, mostly by raising the proportion of corporate profits spent on dividends and share buybacks and by engaging in M&A transactions. This comes at the expense of alternative choices for resource allocation that might pay-off in the long-run and contribute to keeping the company productive, innovative and attractive in the long term, with possible positive consequences at company level (in terms of shareholder value and possibly employee satisfaction) and at macroeconomic level.

##### **Driver 3 – Companies lack a strategic perspective over sustainability and current practices fail to effectively identify and manage relevant sustainability risks and impacts**

The lack of a sustainability strategy, including the assessment of sustainability risks and impacts, directly affects to a large extent the board and shareholders, as the companies may lack adequate guidance needed to achieve long-term objectives and mitigate the risks.

Society is also negatively affected to a large extent. The lack of sustainability strategies encompassing measurable targets and KPIs aligned with global goals makes it impossible to

understand to what extent businesses are really contributing towards their attainment, and complicates the design of effective policy interventions aimed at achieving those goals.

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

The incentives to the board to consider the short-term financial results of the company are directly detrimental to the long-term interests of employees and the society, as well as to the long-term policy objectives that public authorities pursue through their regulatory activity.

Shareholders are also strongly affected by the negative effect of this driver on the long-term success of the company.

Executive remuneration schemes that fail to include sustainability metrics adversely affect the long-term decision-making process of corporate boards, as directors are not incentivised to take business decisions that contribute to sustainability.

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

The board is directly affected by this driver to a large extent. Limited sustainability-related skills adversely affect board capacity to take sustainable, long-term decisions, and the absence of diversified points of view increases the risk of group thinking.

The other categories are indirectly affected due to the lower capacity of the board to guarantee long-term performance for the company and to take into account sustainability-related factors.

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

This driver directly affects those stakeholders that are not involved in corporate decision-making, such as employees and other societal actors (for instance, NGOs and the trade unions), preventing them from having their interest expressed or considered at the higher level of companies decision-making.

Other categories, i.e. the board, shareholders and public authorities, are indirectly affected by the negative effect of this driver on the long-term success of the company.

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

The most affected categories are employees and the society at large, that are directly affected by the absence of enforcement mechanisms available for them, even when they have a legitimate interest in the sustainability of the company.

Also, shareholders are directly affected by the low enforcement levels of the breach of the duty of care by directors, but to a lower extent, as they have more instruments to make a personal claim against directors.

The board and public authorities are neither directly nor indirectly affected.

## 4.2 Why should the EU act?

### *Legal basis*

**EU action in the area of company law and corporate governance has been characterised by a strong focus on the internal market.** Building an effective and efficient company law and corporate governance framework can shape a positive EU-wide business environment in the internal market. The purpose of EU rules in this area is thus to enable businesses to be set up anywhere in the EU enjoying the freedom of movement of persons, services and capital, to provide protection for shareholders and other parties with a particular

interest in companies, to make businesses more competitive, and to encourage businesses to cooperate across borders.<sup>130</sup>

**EU competence in the area of company law and corporate governance is based on:**<sup>131</sup>

- **Article 50(2) (g)** of the Treaty on the Functioning of the European Union (TFEU), which provides for the EU competence to take coordination measures concerning the protection of interests of companies' members and other stakeholders, with a view to making such protection equivalent throughout the EU. In accordance with this article, the EU has competence to harmonise national company laws (exclusively by means of directives) to attain the internal market freedom of establishment of the companies;
- **Article 114 of the TFEU**, which provides for the EU general competence for the approximation of the provisions of law, regulation or administrative action in Member States which are aimed at the establishment and functioning of the internal market.

Over the years, these two articles have been interpreted by the EU and the Member States so as to give the EU broad competence to harmonise legal and economic conditions for doing business across the EU and reduce obstacles to a level playing field, while contributing to the achievement of other key EU objectives.<sup>132</sup> On the basis of Article 50, the EU has adopted several legal acts in the area of company law and corporate governance, including the Shareholder Rights Directive, the Accounting Directive, and the Non-Financial Reporting Directive.

More generally, **sustainability – human, social, economic, environmental – is an overarching objective of the EU** and meant to be the guiding principle for the EU's policies and activities within Europe and in its relations with the rest of the world.<sup>133</sup> The transition to a more sustainable economic system (which includes also more sustainable corporate governance) has strong legal basis in the EU's overarching goals set out in its Treaties, with duties to protect the environment,<sup>134</sup> human rights and human dignity,<sup>135</sup> within the EU and in the EU's relations with the wider world.

Against this background, it seems that **the existing legal basis allows the EU to intervene in the field of company law and corporate governance in order to curb short-termism**, promote greater attention to and accountability for companies' sustainable value creation, support the respect of EU commitments related to the Paris Agreement and the UN SDGs, and ultimately contribute towards the overarching EU objective of sustainability in EU and the wider world.

Finally, given their internal market focus, it is worth highlighting that EU competences for company law and corporate governance are shared competences and, as such, are subject to the principle of subsidiarity.

### ***The necessity of EU action***

An **EU policy intervention is required** to lengthen the time horizon in corporate decision-making and promote a corporate governance that is more conducive to sustainability, as illustrate below:

- **Shareholder primacy and short-term pressures will likely continue influencing corporate decision-making.** As highlighted in section 3.1.1, trends in proxy indicators

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<sup>130</sup> European Parliament (2019), *Company Law*, Fact Sheets on the European Union. Available at [https://www.europarl.europa.eu/ftu/pdf/en/FTU\\_2.1.11.pdf](https://www.europarl.europa.eu/ftu/pdf/en/FTU_2.1.11.pdf).

<sup>131</sup> Gerner-Beuerle, C., Anderson Schillig, M. (2019), *Corporate Company Law*, Oxford, Oxford University Press, p. 87.

<sup>132</sup> ECCJ (2017), 'The EU competence and duty to regulate corporate responsibility to respect Human Rights through mandatory Human Rights Due Diligence', ECCJ Briefing, November 2017, p. 2.

<sup>133</sup> Article 3(3) and 3(5) of the Treaty on the European Union (TEU).

<sup>134</sup> Articles 11 and 191 to 193 of the TFEU are the foundation of the EU's environment policy. Article 11 requires that environmental protection must be integrated into the Union's policies and activities, in particular with a view to promoting sustainable development.

<sup>135</sup> According to Article 2 of the TEU, "the Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights." The Treaties make abundantly clear that the EU has a duty to promote respect for human rights, within its powers and competences, when it adopts and implements EU legislation as well as in its relations to the wider world (Articles 2, 3(5) and 21 of the TEU).

show that short-termism has affected and is affecting the behaviour of EU listed companies. **If the status quo is maintained, relentless short-term pressures from the financial markets will not disappear.** To the contrary, combined with the shareholder primacy norm and with corporate governance issues (e.g. concerning corporate strategies and reporting, board remuneration, etc.), directors and executives of most companies will continue feeling the pressure to maximise shareholder value and distribute earnings through dividends and buybacks, at the same time sacrificing investments (in R&D, CAPEX, employee development, etc.) that are much needed for a transition to sustainable value creation. This means that the majority of businesses would continue following the business-as-usual that largely ignores sustainability risks and impacts and undermines long-term sustainability goals. While it is worth acknowledging that regulatory provisions (e.g. EU Non-Financial Reporting Directive) and voluntary initiatives (e.g. Science Based Targets initiative) aimed at promoting greater corporate sustainability have already been developed, these measures appear to be too patchy and lack strength to effectively counter the effects that the entrenched shareholder primacy norm and the short-term pressures of financial markets have on corporate governance.

- **The consequences of unsustainability are serious and have EU-wide (and global) implications.** Short-term time horizons that fail to capture the full extent of long-term sustainability risks and impacts could amount to devastating environmental, social and economic consequences for companies, shareholders, investors, and society at large. As highlighted in section 3.1.2, **the ultimate consequences of keeping the status quo unaltered** (e.g. climate change, biodiversity loss, raising inequalities, weakening of the innovative capacity of the economy, etc.) **are serious and have implications for the EU and its Member States.** The economic costs of inaction are extremely high and have an unprecedented scale, as it is clear by looking at climate change and biodiversity loss, which are both core planetary boundaries that have been transgressed. Even though impacts will be differently distributed, there is no Member State that is protected from the consequences of unsustainability.
- **The achievement of the goals of the Paris Agreement on climate change and the UN SDGs is unlikely, given the status quo.** The attainment of these important global goals does not depend exclusively on companies and on the way they are managed, as it requires profound social and economic changes (e.g. the way energy is used and produced, the way food is produced and consumed, the way people moves around, etc.), not only at EU but at global level. Nonetheless, it is also broadly recognised that companies' sustainability efforts are key to the achievement of these goals. If no action is taken to put EU economy and society on a more sustainable path, including by intervening in the area of company law and corporate governance, **the EU will not be able to meet its global sustainability commitments.** Although some Member States are making more progress than others, no EU country is currently on track to achieve the SDGs by 2030, with the greatest challenges being on SDGs related to climate, biodiversity, and circular economy. All things being equal, the EU and its Member States will not be able to achieve the SDGs by 2030.<sup>136</sup> Similarly, according to the EEA, EU is not on track to achieve its Paris Agreement target of a 40% reduction in emissions over 1990 levels by 2030 and will not be able to achieve it unless urgent action is taken during the next 10 years. Action to meet the Paris Agreement target and the SDGs needs to be scaled up dramatically and urgently. Timewise, EU action seems even more necessary to overcome the collective action problem Member States and companies are faced with.
- **Only EU action can ensure a level playing field for European companies.** A number of international corporate governance principles and good practices exist and promote long-termism and greater attention to sustainability, and companies are increasingly aware of

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<sup>136</sup> The mismatch between the (large) efforts required at all levels to meet global sustainability goals and the (small) time still available to meet them is evident also in social matters. For instance, as highlighted in section 3.1.2.2, there is a clear need for the EU and its Member States to reach achievements in the area of decent work (e.g. SDG #8, and in particular: Target #8.5: achieve decent work for all by 2030; Target #8.7: eradication of forced labour, and elimination of child labour by 2025; Target #8.8: protect labour rights and promote safe and secure working environments for all workers).

the need to take sustainability seriously. At the same time, however, corporate governance frameworks in Europe varies significantly between Member States, depending upon the interaction between company law, listing rules and corporate governance codes with a “comply or explain” approach. While a certain degree of flexibility within the national frameworks is necessary to accommodate different company needs and should be preserved, an **EU action seems the only capable to achieve a higher level of corporate responsibility for long-term sustainable value creation and to set a common minimum ground for dealing with sustainability** while avoiding market distortions. Data on the achievement of the Paris Agreement and the SDGs indicate that current corporate governance frameworks and practices do not support transition to sustainability enough. Only an EU initiative might ensure that companies operating in different EU Member States are equally “protected” against the pressure to maximise financial returns and equally responsible for pursuing sustainable value within planetary boundaries, both in EU and throughout global supply chains. No action would not address current market distortions, whereby a minority of companies – the business “leaders” that follow or are transitioning towards sustainable business practices, adhere to international principles and good practices, mostly on voluntary basis, and bear the costs of this process – have to compete against companies that are unwilling to take serious sustainability commitments and free-ride on other companies’ efforts – the “laggards”. EU action would address current market distortions and bring about a more level playing field for EU companies to compete fairly in the single market. It would create more space for business leaders to be even more innovative and ambitious and accelerate the pace of change towards sustainable value creation. This could not be achieved through uncoordinated national efforts.

In sum, an EU action is needed to create the conditions to protect company directors and management against the pressure to maximise financial return and support business shift towards sustainable corporate governance, in view of contributing to achieving the targets of the Paris Agreement and the SDGs and to avoiding the environmental, social and economic consequences of unsustainability.

### ***EU added value***

**An EU intervention would ultimately create added value by contributing to the proper functioning of the internal market.** An EU action aimed at promoting sustainable corporate governance would create added value compared to what could be achieved Member States and individual companies. As mentioned above, only an EU intervention can bring to a more level playing field for EU companies from different EU Member States by creating common minimum rules for more sustainable corporate governance. While it is recognised that initiatives to combat corporate short-termism and promote sustainability can be (and have been) taken at national and company level, only an EU initiative could ensure that boards of directors enjoy equal levels of protection against short-term pressures and are subject to equal responsibilities related to sustainability. Moreover, considering today’s global value chains, EU action seems more effective than national interventions or company voluntary initiatives to make sure that companies take responsibility for identifying and addressing the sustainability risks and impacts connected to their business model, operations and supply chains also beyond the geographical boundaries of the Member States where they are located.

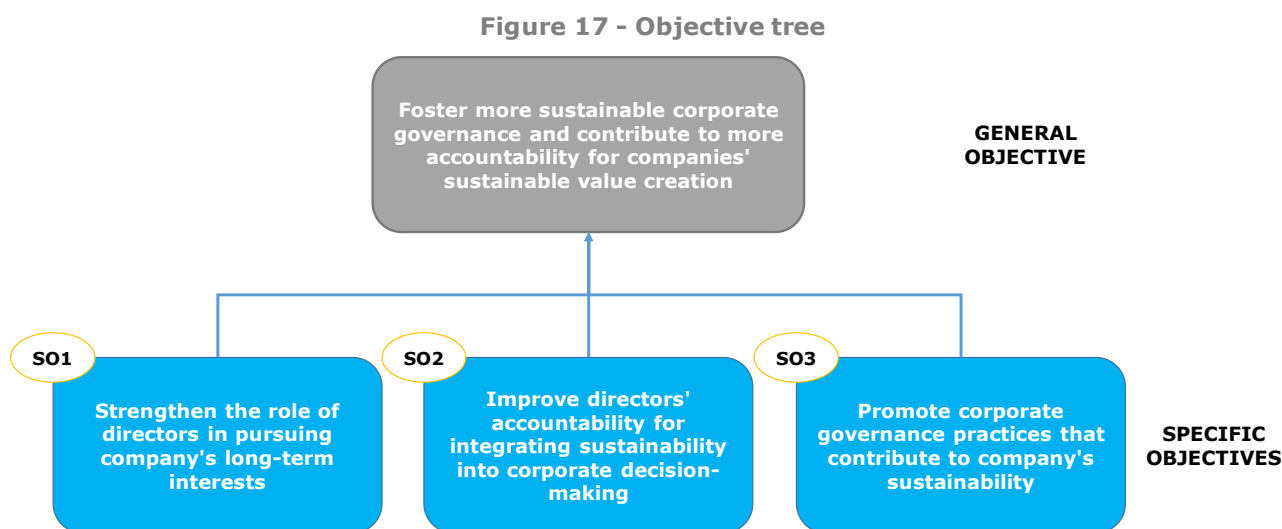
By removing barriers to corporate sustainability, reinforcing positive trends, and spreading good corporate governance practices, an EU initiative could set EU-wide conditions for laggards to abandon the business-as-usual and integrate sustainability into their business, and for leaders to “change the gear” and further accelerate in their transition towards sustainable business models.

Given the current level of fragmentation of corporate governance frameworks across EU jurisdictions, and in light of the short timeframe available to make a change, it seems very difficult that a similar harmonisation effort could be achieved through the uncoordinated action of the Member States, or through the voluntary business initiatives.



### 4.3 Objectives of a potential EU intervention

The objectives of an EU initiative in the area of company law and corporate governance to foster more sustainable corporate governance are summarised in the **objective tree** below (Figure 17), which differentiates between one general objective and three specific objectives. Objectives are described in section 4.3.1, while section 4.3.2 assesses their consistency with other EU policy objectives.



#### 4.3.1 General and specific policy objectives

A possible future EU action in the area of company law and corporate governance should pursue the **general objective** (GO) of **fostering more sustainable corporate governance and contributing to more accountability for companies' sustainable value creation**. In doing so, the EU intervention should seek to reach a balance between, the need to attenuate short-term pressures on company directors and to promote the integration of sustainability into corporate decision-making on the one hand, and the need for enough flexibility to take into account the different national regulatory frameworks on the other hand.

To achieve this general objective, the future EU intervention should pursue the following three **specific objectives** (SO), which are the immediate objectives of EU action:

- **Strengthening the role of directors in pursuing the long-term interests of companies (SO1)**: the EU intervention should dispel current misconceptions and errors in relation to the purpose of the company and the duties of directors, which lead directors to prioritise short-term financial performance over the long-term interest of the company;
- **Improving directors' accountability for integrating sustainability into corporate decision-making (SO2)**: the EU intervention should bring about a higher level of responsibility for sustainable value creation by making directors more accountable for the sustainability of their business conduct;
- **Promoting corporate governance practices that contribute to company sustainability (SO3)**: the EU intervention should address corporate governance practices that favour short-termism and hinder the integration of sustainability into company decision-making (e.g. in the area of corporate reporting, board remuneration, board composition, stakeholder involvement).

Specific objectives are defined in connection with the above-mentioned core problem and are directly related to its drivers and specific underlying issues as described in section 3.2.

Table 5 summarises the correspondence between the identified problem drivers and the objectives of the EU intervention.

Table 5 – Correspondence between problem drivers and objectives

PROBLEM DRIVERS		SO1	SO2	SO3	GO
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	✓	✓		✓
5	Board remuneration structures incentivise the focus on short-term shareholder value rather than long-term value creation for the company			✓	✓
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		✓		✓

### 4.3.2 Consistency with other EU policy objectives

The **general** and **specific objectives** of a possible EU initiative **are consistent with current and future EU policy developments**.

First, as mentioned in section 4.2, an EU action aimed at attenuating short-termism and strengthening company's responsibilities to attain sustainability goals would be **supportive of EU and Member States commitments on delivering on the UN SDGs and the Paris Agreement on climate change** (as well as other global conventions and EU environmental legislation that companies are already required to comply with).

Second, the need for urgent action to attenuate short-termism and promote sustainable corporate governance is clearly identified in the **Action Plan on Financing Sustainable Growth**,<sup>137</sup> put forward by the European Commission in 2018. The Action Plan recognises that, despite the efforts made by several European companies, pressures from capital markets lead company directors and executives to fail to consider long-term sustainability risks and opportunities and be overly focused on short-term financial performance. Action 10 of the Action Plan is therefore aimed at "*fostering sustainable corporate governance and attenuating short-termism in capital markets*". The present study implements Action 10, together with other studies aimed at investigating complementary aspects of short-termism,<sup>138</sup> which shows European Commission's commitment to explore this complex problem from different angles and find an integrated response.

Third, the attenuation of short-termism and **the promotion of sustainable corporate governance are in line with the policy priorities put forward by the new von der Leyen Commission**. The priority given to sustainability and the necessity of integrating it into corporate decision-making are reflected into the political guidelines<sup>139</sup> of the new Commission, which confirmed existing EU commitments and emphasised the need to change the current production and consumption models to build a climate-neutral continent on a strong and resilient social market economy. In a passage of her speech in front of the European Parliament Plenary Session,<sup>140</sup> President von der Leyen highlighted the need to rediscover EU competitive

<sup>137</sup> European Commission (2018), 'Action Plan: Financing Sustainable Growth', COM(2018) 97 final, Brussels.

<sup>138</sup> A study on due diligence requirements through the supply chain, and a study on potential sources of undue short-termism on corporations from the financial sector.

<sup>139</sup> Von der Leyen, U. (2019), *A Union that strives for more. Political guidelines for the next European Commission*. Available at [https://ec.europa.eu/commission/sites/beta-political/files/political-guidelines-next-commission\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/political-guidelines-next-commission_en.pdf).

<sup>140</sup> Von der Leyen, U. (2019), *Speech in the European Parliament Plenary Session*. Available at

sustainability as a foundation of the European social market economy, a European culture for companies that is not built “solely on shareholder value and next bonuses” but, on the opposite, is built to last, to pass down generations, to provide a fair living for employees, and to innovate. As concerns the social implications of corporate short-termism, such an EU initiative would be in line with the priorities enshrined in the Commission Communication “**A Strong Social Europe for Just Transitions**” of 14 January 2020.<sup>141</sup> In this document, the Commission expressed its commitment to ensure social justice (“social fairness and prosperity are the cornerstones for building a resilient society with the highest standards of well-being in the world”), fight inequalities (“need to act now so that our children and grandchildren will all have the possibility to benefit from a fair, green and prosperous future, and to ensure inter-generational fairness”), step up training, ensure access to good quality learning and upskilling opportunities for all, ensure fair working conditions (including fair minimum wage, high standards for health and safety, and stronger social dialogue at company level), and to use its political and economic influence to foster social fairness in the rest of the world (including the protection of labour and zero-tolerance approach to child labour in its trade policy).

Against this background, on December 2019 the new Commission adopted a **European Green Deal**<sup>142</sup> that aims to help Europe to strive for more by being the first climate neutral continent by 2050. The Green Deal announces the first binding European “Climate Law” to enshrine the 2050 climate neutrality target in EU legislation. In addition, the Green Deal also includes strategies and actions on adaptation to climate change, supplying clean, affordable and secure energy, biodiversity, zero pollution, a circular economy and sustainable food production. These overarching objectives will be addressed through financial and real-economy<sup>143</sup> policy, across the public and private sectors. With regard to financial reforms, the Green Deal anticipates two main policy initiatives that will be put forward by the new Commission, namely a Sustainable Europe Investment Plan<sup>144</sup> to support the transition to sustainability, and a **renewed sustainable finance strategy** aimed at reorienting private financial and capital flows towards green investments. With reference to the actions to be taken as part of renewed sustainable finance strategy, the Commission notes explicitly that “[s]ustainability 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.” An EU initiative aimed at fostering sustainable corporate governance would therefore contribute to the objective of the renewed sustainable finance strategy.

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[https://ec.europa.eu/info/sites/info/files/president-elect-speech-original\\_en.pdf](https://ec.europa.eu/info/sites/info/files/president-elect-speech-original_en.pdf).

<sup>141</sup> European Commission (2020), ‘A Strong Social Europe for a Just Transition’, COM(2020) 14 final, Brussels.

<sup>142</sup> European Commission (2019), ‘The European Green Deal’, COM(2019) 640 final, Brussels.

<sup>143</sup> Economic and industry-related reforms include rapid decarbonization of energy systems, innovation in sustainable industry, large-scale renovation of existing buildings, development of cleaner public and private transport, and progress towards sustainable food systems.

<sup>144</sup> European Commission (2020), ‘Sustainable Europe Investment Plan - European Green Deal Investment Plan’, Objectives of a potential EU intervention COM(2020) 21 final, Brussels.

#### 4.4 Inventory of options

For each driver, the study identified one or more high-level options linked to the issues underlying the driver. This has been done by drawing, among others, on literature, feedback from stakeholders, the analysis of corporate governance frameworks in some third countries, and the analysis of good practices.

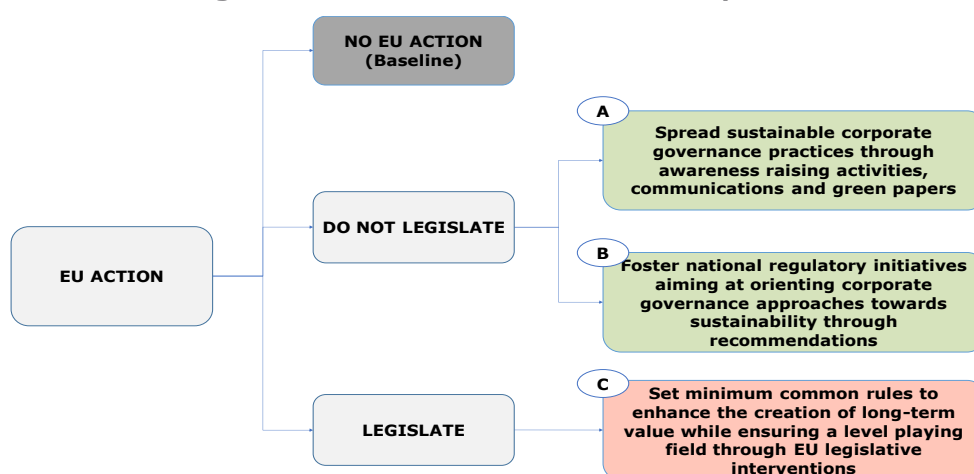
High-level options were then operationalised into realistic measures ranging from non-legislative measures/soft measures (including encouraging the spread of new principles or the transparency on sustainable corporate governance practices by means of communications or recommendations by the European Commission), to legislative measures/hard measures (including amending existing legislation and proposing new binding rules). The effort to identify the list of measures has been based on the analysis of existing legislation, the work undertaken by the European Commission and by academics on the matter, and the elements provided by the analysis of the problem.

Depending on their nature, measures were grouped into three options characterised by an increasing level of regulatory intervention compared to the baseline which identifies a status quo scenario in which no policy intervention occurs, and it is assumed that the current legislative framework remains in force. The options identified are the following:

- **Baseline** (the EU does not take further action to promote more sustainable corporate governance, and leaves room for national regulatory measures by the Member States and voluntary initiatives by the companies in the context of the current EU legislative framework);
- **Option A** (*non-legislative/soft*) – Spread sustainable corporate governance practices through awareness raising activities, communications and green papers;
- **Option B** (*non-legislative/soft*) – Foster national regulatory initiatives aiming at orienting corporate governance approaches towards sustainability through recommendations;
- **Option C** (*legislative/hard*) – Set minimum common rules to enhance the creation of long-term value while ensuring a level playing field through EU legislative interventions.

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

Figure 18 - Overview of the identified options



Options and the related measures (coded with M) are indicated in the following sections according to the specific driver they relate to.

**4.4.1 Driver 1 – Directors' duties and company's interest are interpreted narrowly and tend to favour the short-term maximisation of shareholders' value**

Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A1	Option B1	Option C1
<p><u>Issue 1.1:</u> The formulations of directors' 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</p>	<p>Clarify the fiduciary duty of corporate directors: when acting in the interests of the company, directors should properly balance the following interests, alongside the interest of shareholders:</p> <ul style="list-style-type: none"> <li>- Long -term interests of the company (beyond 5-10 years)</li> <li>- Interests of employees</li> <li>- Interest of customers</li> <li>- Interest of local and global environment</li> <li>- Interest of society at large.<sup>145</sup></li> </ul>	<p><b>M1.1: Commission-led/funded awareness-raising campaign</b> aimed at:</p> <ol style="list-style-type: none"> <li>1. Clarifying that, when acting in the interests of the company, <b>directors should properly balance the following interests, alongside the interest of shareholders:</b> long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global environment; interest of society at large</li> <li>2. Promoting the principle that <b>identifying and mitigating sustainability risks and impacts</b>, both internal and external, is</li> </ol>	<p><b>M1.2: Commission recommendation that provides a uniform interpretation of directors' duties and company's interest</b> to the Member States and recommends them to:</p> <ol style="list-style-type: none"> <li>1. Clarify in their respective national frameworks that, when acting in the interests of the company, <b>directors should properly balance the following interests, alongside the interest of shareholders:</b> long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global</li> </ol>	<p><b>M1.3:</b> Commission proposal for a <b>new EU directive providing an EU-wide formulation of directors' duties and company's interest</b>, requiring directors to:</p> <ol style="list-style-type: none"> <li>1. <b>Properly balance the following interests, alongside the interest of shareholders</b>, when acting in the interest of the company: long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global environment; interest of society at large</li> <li>2. <b>Identify and mitigate sustainability risks and impacts</b>, both internal and external, connected to the</li> </ol>
<p><u>Issue 1.2:</u> The identification and mitigation of sustainability risks and impacts is rarely</p>	<p>Introduce in the law an explicit duty for the directors to identify and mitigate the economic, social, and environmental</p>			

<sup>145</sup> See recommendations on governance and leadership in High-Level Expert Group on Sustainable Finance (2018), cit. p. 40. As concerns clarifying the company interests, see also: Jeffwitz, C. (2018), cit.; and Article 169 of the French law on Business Growth and Transformation (the so-called "PACTE Law"), which amended Article 1833 of the French Civil Code by adding a second paragraph stating that corporations must be managed in their own "corporate interests" by taking into consideration the "social and environmental issues" related to their operations. Considering third countries, in the US the Accountable Capitalism Act, proposed in the Congress, calls for directors to balance the pecuniary interests of shareholders with the best interests of persons that are materially affected by the conduct of the company. In addition, 5 survey respondents provide suggestions in line with the need to clarify that the primary interest of the company is to survive in the long run, not to maximise shareholder value. 3 survey respondents make reference to the amendment introduced by the French PACTE law.

## Study on directors' duties and sustainable corporate governance

Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A1	Option B1	Option C1
included in the board duties	factors and impacts both internal (i.e. risks to the company) and external (impacts on stakeholders) <sup>146</sup>	part of directors' duty of care	environment; interest of society at large 2. Introduce in their respective national frameworks an <b>explicit directors' duty to identify and mitigate sustainability risks and impacts</b> , both internal and external, connected to the company's business operations and value chain	company's business operations and value chain

### 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
<u>Issue 2.1</u> : 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	<b>M2.1: Commission green paper</b> to stimulate public debate on how to <b>foster long-term shareholder engagement and longer shareholding periods</b>	<b>M2.3: Commission recommendation</b> for Member States to amend their national regulatory frameworks and provide for mechanisms to <b>incentivise longer shareholding periods</b>	<b>M2.4: Commission proposal to amend the Shareholder Rights Directive II</b> to introduce binding rules requiring Member States to <b>introduce mechanisms to incentivise longer shareholding periods</b>

<sup>146</sup> See Jeffwitz, C. (2018), cit. Sjøfjell, B., Mähönen, J., Taylor, M. et al (2019), Supporting the Transition to Sustainability: SMART Reform Proposals. On the need to clarify directors' duties and board obligations, see also the *Statement on Corporate Governance for Sustainability* signed by over 60 academics from all over the world (no weblink available). Article 169 of the French PACTE Law, which adjusted Articles L. 225-35 and L. 225-64 of the French Commercial Code that corporate and management boards take into consideration "social and environmental issues" as part of their respective managerial assignments.

## Study on directors' duties and sustainable corporate governance

Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A1	Option B2	Option C2
	<ul style="list-style-type: none"> <li>- Making returns on shares conditional upon the basis of the time the shares are held (i.e. create time-weighted dividends with increasing payments made to investors that remained for the long-term)</li> <li>- Decreasing or exempting capital gains tax on the basis of long-term shareholdings<sup>147</sup></li> </ul>			
<p><u>Issue 2.2</u>: The disclosure of quarterly returns and earnings guidance tend to reinforce board members focus on the short-term financial performance</p>	<p>Ban the practice of forecasting and publishing earnings on quarterly basis<sup>148</sup></p>	<p><b>M2.2: Commission led/funded campaign to discourage listed companies to publish earnings guidance</b> and returns on a quarterly basis</p>	<p><b>M2.2: Commission led/funded campaign to discourage listed companies to publish earnings guidance</b> and returns on a quarterly basis<sup>149</sup></p>	<p><b>M2.5: Commission proposal to amend the Transparency Directive to prohibit both earning guidance and quarterly reporting</b> for listed companies</p>

<sup>147</sup> See Veldman, J., Gregor, F., Morrow, P. (2016), cit., p. 57. See also the ESMA recommendation that "The Commission, in close cooperation with ESMA, should assess the impact of national legislation that has recently introduced additional incentives (such as increased voting or dividend rights) to promote shareholders' long-term perspective and consider whether EU-harmonised incentives would be necessary", in ESMA (2019), cit., p. 70.

<sup>148</sup> See the 2018 joint call by Warren Buffett (veteran investor) and Jamie Dimon (JPMorgan Chase chief executive), backed by 200 CEOs (<https://www.wsj.com/articles/short-termism-is-harming-the-economy-1528336801>). They echoed a similar 2016 proposal from BlackRock CEO Larry Fink.

<sup>149</sup> In case of issue 2.2, a non-binding Commission recommendation to the Member States would not be a suitable measure. For this reason, in order to address this issue, M2.2 is considered both under option A2 and B2.

#### 4.4.3 Driver 3 – Companies lack a strategic perspective over sustainability and current practices fail to effectively identify and manage relevant sustainability risks and impacts

Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A1	Option B3	Option C3
<p><u>Issue 3.1</u>: 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 KPIs</p> <p><u>Issue 3.2</u>: Companies show different levels of maturity as concerns the identification and management of sustainability risks and impacts, including along the whole value chain</p>	<p>Require boards of directors to consider and integrate sustainability aspects (risks, opportunities, impacts) into the business strategy, including by means of appropriate due diligence to identify and mitigate external harm throughout the company supply chain, and of measurable sustainability targets aligned with overarching goals (such as the SDGs or the Paris Agreement on climate change)<sup>150</sup></p>	<p><b>M3.1: Commission guidance document for boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy, to identify and set as part of the business strategy measurable, specific, time-bound, and science-based sustainability targets aligned with overarching goals (such as the SDGs and the goals of the Paris Agreement on climate change), and to disclose appropriate information.</b> The guidance document would be accompanied by a dissemination <b>campaign</b>.</p>	<p><b>M3.2: Commission recommendation for Member States to introduce in their respective national frameworks:</b></p> <ol style="list-style-type: none"> <li>1. A requirement for boards to <b>integrate sustainability aspects (risks, opportunities, impacts) into the business strategy</b></li> <li>2. A requirement for boards to <b>identify and set as part of the business strategy measurable, specific, time-bound, and science-based sustainability targets aligned with overarching goals (such as the SDGs and the goals of the Paris Agreement on climate change) and to disclose appropriate information.</b></li> </ol>	<p><b>M3.3: Commission proposal for a new EU directive requiring corporate boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy, to identify and set as part of the business strategy measurable, specific, time-bound, and science-based sustainability targets aligned with overarching goals (such as the SDGs and the goals of the Paris Agreement on climate change), and to disclose appropriate information.</b></p> <p>This measure would complement and contribute to the implementation of the duty referred to in <b>M1.3</b> (new EU</p>

<sup>150</sup> See Action 10 of the Commission Action Plan on Financing Sustainable Growth (assessment of 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”). See also recommendations on governance and leadership in High-Level Expert Group on Sustainable Finance (2018), cit., p. 41 (“Require the company management to develop a climate strategy, aligned with climate goals, and to describe the company’s approach to the SDGs”). Moreover, see the *Statement on Corporate Governance for Sustainability*. On the adoption of science-based targets, see the Science Based Targets initiative carried out jointly by the CDP, the UN Global Compact, the World Resources Institute (WRI) and the WWF (<https://sciencebasedtargets.org/companies-taking-action/>). See also the recommendation by EBA that “[i]nstitutions should be required in Directive 2013/36/EU [...] to adopt long-term strategies that account for ESG considerations and climate-related risks, and clearly identify targets, taking into account both current risks and those that can plausibly arise in the future” in EBA (2019), cit. Similarly, the EIOPA recommended that “insurers need to consider the near and medium-term impacts of their investment policies. EIOPA’s work focuses particularly on the sustainability risks; however, it can be extended to any long-term consideration and risks” (in EIOPA (2019), cit.). In addition, 6 survey respondents suggest directors to develop a sustainability strategy, including due diligence procedures in order to identify and address adverse human rights and environmental risks and impacts linked to the company’s global operations.



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Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A1	Option B3	Option C3
		<p>This measure would complement and contribute to the implementation of the duty referred to in <b>M1.1</b> (Commission-led/funded awareness-raising campaign aimed at promoting the principle that identifying and mitigating sustainability risks and impacts, both internal and external, is part of directors' duty of care)</p>	<p>Agreement on climate change), 3. A requirement to <b>disclose</b> appropriate information.</p> <p>This measure would complement and contribute to the implementation of the duty referred to in <b>M1.2</b> (Commission recommendation to Member States to introduce in their respective national frameworks an explicit directors' duty to identify and mitigate sustainability risks and impacts, both internal and external, connected to the company's business operations and value chain)</p>	<p>directive requiring directors to identify and mitigate sustainability risks and impacts, both internal and external, connected to the company's business operations and value chain)</p>

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

Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A4	Option B4	Option C4
<p><u>Issue 4.1</u>: Share-based remuneration exacerbate executives' focus on shareholder value maximisation</p>	<p>Limit corporate executives ability to sell shares they receive as pay by extending the vesting period of shares<sup>151</sup></p>	<p><b>M4.1: Commission led/funded campaign</b> aimed at companies to encourage them <b>link board remuneration to long-term,</b></p>	<p><b>M4.2: Commission recommendation</b> for Member States to introduce in their respective national frameworks:</p>	<p><b>M4.3: Commission proposal to amend the Shareholder Rights Directive II to align executive remuneration policy with the long-term</b></p>

<sup>151</sup> See the Accountable Capitalism Act proposed by US Senator Elizabeth Warren (<https://www.warren.senate.gov/imo/media/doc/Accountable%20Capitalism%20Act%200ne> -

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Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A4	Option B4	Option C4
<u>Issue 4.2</u> : The integration of ESG metrics into board remuneration structures is still a limited practice	Require companies to integrate ESG metrics into directors' pay schemes <sup>152</sup>	<b>sustainable value creation</b> for the company	<ol style="list-style-type: none"> <li>1. A provision to <b>restrict executives' ability to sell shares they receive as pay</b></li> <li>2. A provision to make compulsory the inclusion of <b>non-financial, ESG metrics</b>, linked to a company's sustainability targets, <b>in executive pay scheme</b></li> </ol>	<b>and sustainability goals</b> , in particular by: <ol style="list-style-type: none"> <li>1. Regulating executives' ability to sell the shares they receive as pay</li> <li>2. Making compulsory the inclusion of non-financial, ESG metrics, linked to a company's sustainability targets, in executive pay scheme</li> </ol>

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

Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A5	Option B5	Option C5
<u>Issue 5.1</u> : Boards have limited competence and expertise in sustainability matters	Ensure that the board encompasses members with expertise and competencies on sustainability matters <sup>153</sup>	<b>M5.1:</b> Commission information campaign in collaboration with relevant stakeholders (in particular business associations) to <b>promote the consideration</b>	<b>M5.2:</b> Commission recommendation for Member States to introduce in their respective national frameworks a provision to <b>ensure that sustainability-</b>	<b>M5.3:</b> Commission proposal for a <b>new EU directive laying down rules on board composition</b> of listed companies, including a requirement for companies to

Pager.pdf). See also EIOPA recommendation to encourage the application of the principles stated in the Solvency II Delegated Regulation, such as deferral of a substantial portion of variable remuneration to no less than three years, in EIOPA (2019), cit. In addition, 2 survey respondents suggest to include shareholding requirements for executives (e.g. longer vesting schedules)

<sup>152</sup> See recommendations on governance and leadership in High-Level Expert Group on Sustainable Finance (2018), cit., p. 41 ("Ensure that remuneration policies and individual executive employment contracts are consistent with the long term, including sustainability goals"). See also PRI (2012), Integrating ESG issues into executive pay. See also the *Statement on Corporate Governance for Sustainability*. See also EIOPA recommendation to encourage the application of the principles stated in the Solvency II Delegated Regulation, such as the balanced consideration of financial and non-financial criteria (e.g. ESG factors) when assessing an individual's performance, in EIOPA (2019), cit. In addition, 4 survey respondents suggest that companies set long-term sustainability KPIs in their strategies, which should be linked substantially to directors' remuneration.

<sup>153</sup> See recommendations on governance and leadership in High-Level Expert Group on Sustainable Finance (2018), cit., p. 41 ("Ensure that in the board nomination process, competence in relevant sustainability matters is systematically considered"). See also Accountancy Europe (2019), cit. On the creation of a new role in the board, the Chief Value

Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A5	Option B5	Option C5
		of sustainability-related expertise in the board nomination process of companies (including by creating a new board role, the Chief Value Officer)	related expertise is systematically considered in the board nomination process of companies	consider sustainability criteria in the board nomination process

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

Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A6	Option B6	Option C6
Issue 6.1: Actual stakeholder engagement and involvement in corporate decision making is a limited market practice	Ensure company's stakeholders are involved in defining and supervising the implementation of the company's processes aimed at identifying, preventing and mitigating company sustainability risks and impacts <sup>154</sup>	<b>M6.1:</b> Establishment of a <b>Commission Advisory Group on Sustainable Corporate Governance</b> to identify good practices on stakeholder engagement and involvement. Practices identified could be eventually disseminated	<b>M6.2: Commission recommendation for Member States</b> to introduce in their respective national frameworks a requirement for companies <b>to engage with and involve both internal and external stakeholders</b> in identifying, preventing and mitigating sustainability risks	<b>M6.3:</b> Commission proposal for <b>new EU binding rules requiring corporate boards to establish mechanisms for engaging with and involving internal and external stakeholders</b> in identifying, preventing and mitigating sustainability risks and impacts

Officer, which would entail a broader perspective on value creation and fully integrate ESG factors with financial performance, see King, M., Atkins, J. (2016), Chief Value Officer: Accountants Can Save the Planet, Greenleaf Publishing. In addition, 3 survey respondents suggest to select board members with specific expertise on sustainability-related issues, on the impact of transgression of planetary boundaries on the companies' risk profile, and on non-financial reporting. 2 survey respondents suggest to take sustainability into consideration in the nomination process of the board.

<sup>154</sup> See Accountancy Europe (2019), cit. Meaningful stakeholder engagement (to identify actual or potential adverse impacts, devise prevention and mitigation responses to risks, identify forms of remedy for adverse impacts caused or contributed to by the enterprise and when designing processes to enable remediation, etc.) is also recognised in the OECD Due Diligence Guidance for Responsible Business Conduct; article 1 of the French Law on the Corporate Duty of Vigilance (law No. 2017-399 of 27 March 2017), which provides that the company's vigilance plan (i.e. covering items like risk mapping, regular assessment procedures, appropriate actions for mitigating risks or preventing serious breaches, warning and reporting mechanisms, monitoring processes to assess the effectiveness of the measures implemented) shall be drafted in association with the company's stakeholders, and where appropriate, within multiparty initiatives that exist in the subsidiaries or at a territorial level. On the need to develop, disclose and implement a forward-looking sustainability strategy, see also the *Statement on Corporate Governance for Sustainability*. In addition, 6 survey respondents suggest introducing non-executive director

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Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A6	Option B6	Option C6
		through a dedicated <b>campaign</b> .	and impacts as part of their business strategy.  This measure could be implemented in synergy with <b>M3.2</b> (Commission recommendation for the Member States to introduce in their respective national frameworks specific requirements for boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy) as well as with <b>M1.2</b> (Commission recommendation providing a uniform interpretation of directors' duties and company's interest to the Member States and recommending them to introduce in their respective national frameworks an explicit directors' duty to identify and mitigate sustainability risks and impacts, both internal and external, connected to the company's business operations and value chain).	as part of their business strategy.  This measure could be implemented in synergy with <b>M3.3</b> (Commission proposal for a new EU directive requiring corporate boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy), as well as with <b>M1.3</b> (regarding an <b>EU directive providing an EU-wide formulation of directors' duties and company's interest</b> , including a duty of board members to identify risks and mitigate negative human and environmental impact in the value chain).

seat for trade unions and worker involvement, 2 respondents suggest organising annual stakeholder dialogue and 1 respondent suggests setting up an external stakeholders committee.

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

Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A7	Option B7	Option C7
<p><u>Issue 7.1</u>: Enforcement of directors' duties is largely limited to the board of directors, the supervisory board and the shareholders, with no rights for other stakeholders (or a regulatory authority) to instigate legal proceedings on behalf of the company</p>	<p>Allow stakeholders (other than shareholders) to bring suits in courts for alleged violations by directors of the duty of care and loyalty<sup>155</sup></p>	<p>None</p>	<p><b>M7.1: Commission recommendation for Member States to consider measures to strengthen enforcement of directors' duty to act in the interest of the company</b> in their respective national frameworks.</p> <p>This measure would provide for a proper enforcement mechanism for <b>M1.2</b> (Commission recommendation providing a uniform interpretation of directors' duties and company's interest to the Member States and recommending them to introduce in their respective national frameworks an explicit directors' duty to identify and mitigate sustainability risks and impacts, both internal and external, connected to the company's business operations and value chain) and <b>M3.2</b> (Commission recommendation for the Member States to introduce in their respective national frameworks specific requirements for boards to integrate sustainability aspects</p>	<p><b>M7.2: Commission proposal for new EU binding rules to strengthen the enforcement of the directors' duty to act in the interest of the company.</b></p> <p>This measure would provide for a proper enforcement mechanism for <b>M1.3</b> (regarding an EU directive providing an EU-wide formulation of directors' duties and company's interest, including a duty of board members to identify risks and mitigate negative human and environmental impact in the value chain) and <b>M3.3</b> (Commission proposal for a new EU directive requiring corporate boards to consider and integrate sustainability aspects (risks, opportunities, impacts) into the business strategy), and could therefore be implemented in synergy with them</p>
<p><u>Issue 7.2</u>: Current enforcement levels of directors' duties are low in all Member States</p>	<p>Allow stakeholders (other than shareholders) to launch a legal action against directors in case of damages resulting from the mis-execution or failure of the company's measures to identify, prevent and mitigate sustainability risks and impacts.<sup>156</sup></p> <p>Empower a national regulatory body to bring proceedings against the executive directors where non-implementation has caused serious harm to</p>			

<sup>155</sup> See Greenfield, K. (2008), The Failure of Corporate Law: Fundamental Flaws and Progressive Possibilities, University of Chicago Press, p. 251.

<sup>156</sup> See the French Law on the Corporate Duty of Vigilance, which provides that parent companies may be held liable in civil proceedings for any damage resulting from non-compliance, i.e. failing to prevent human rights violations through the effective implementation of a well-designed vigilance plan.

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Issue	High-level options	Options		
		Non-legislative/Soft		Legislative/Hard
		Option A7	Option B7	Option C7
	third parties or unlawful harm to the environment. <sup>157</sup>		(risks, opportunities, impacts) into the business strategy), and could therefore be implemented in synergy with them	

<sup>157</sup> See the *Statement on Corporate Governance for Sustainability*. In Australia, the Australian Securities and Investments Commission has power to bring proceedings in the public interest against directors for breach of disclosure regulations and breach of duty. See Welsh, M. (2014), cit. In addition, 3 survey respondents suggest giving legal standing to workers and establishing a national regulatory body empowered to bring proceedings against directors.

## 5 ASSESSMENT OF OPTIONS

For each driver, this Chapter presents:

- The **baseline scenario** occurring in case no further EU intervention is undertaken to deal with the identified problems. This scenario will be used to comparatively assess the impacts of other options. Due to the difficulty to quantify the possible environmental, social and economic effects that might be directly linked to each driver, the description of the baseline scenario is mainly qualitative and illustrates what would be the main adverse environmental, social and economic effects that would persist or arise if problems rest unaddressed.
- The **assessment of the options**, including: *i*) an assessment of their **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 (all impacts defined in Section 2.2); *ii*) an **assessment of their effectiveness, efficiency, coherence and proportionality**, as defined in Section 2.2. Each criterion was provided a score (from -3 to + 3) or a judgement (Yes/No) together with a rationale.<sup>158</sup>

### 5.1 Driver 1 – Directors' duties and company's interest are interpreted narrowly and tend to favour the short-term maximisation of shareholders' value

#### 5.1.1 Baseline

In the absence of an EU intervention, the social norm of shareholder primacy would remain unchallenged and continue leading directors to focus on short-term profit maximisation for the company shareholders, rather than on making businesses more sustainable in the long run. It will also continue affecting directors' understanding of the duty of care as a duty to act in the best interest of the shareholders, rather than in the interest of the company itself, leading them to prioritise shareholders' interest over the interests of other relevant company stakeholders. Moreover, the identification of sustainability risks and impacts will continue being substantially perceived as a retrospective exercise resulting from non-financial disclosure obligations, rather than an integral part of directors' duty of care.

It can be imagined that the recent and future policy initiatives at EU level (such as the renewed sustainable finance strategy, and other initiatives that are part of the European Green Deal) will stress the importance of sustainability in many aspects of the European economy and society, and will contribute to progressively increasing awareness and responsibility in the European business community for more sustainable business conduct. Moreover, the various initiatives, projects and calls concerning the purpose of corporation that have been carried out in recent years (see Box 2 in Annex I.7) – sometimes originating from inside the global business community – can also be expected to raise awareness about the issue of corporate short-termism, and to persuade some business leaders to embrace a longer-term perspective in managing companies.

Nonetheless, given the current level of entrenchment of the shareholder primacy norm, which has been identified in the literature as one of the main barriers to sustainable companies, it is unlikely that, in the near future, directors and executives are going to change their focus and develop a long-term oriented understanding of the interest and purpose of the company in absence of a specific intervention in the area of company law and corporate governance. Without action, the shareholder primacy norm will persist in current regulatory frameworks, and continue being an obstacle to change towards more sustainable, long-term oriented business practices.

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<sup>158</sup> The quality and quantity of information collected allowed the Team to develop a qualitative assessment of the options, based on both stakeholder feedback (referenced where possible), relevant documentary resources, and Team's own assessment. Considering the far-reaching scope of measures under consideration and the relatively small number of stakeholders consulted for the impact assessment, conclusions should be taken cautiously.

The persistence of this problem can be expected to bring about a wide range effects.

From an economic perspective, a persisting focus by directors on short-term shareholder interest might lead EU companies not to make the upfront investments and changes to their business model that are necessary to meet key sustainability challenges, such as the need to reduce reliance on brown energy or to mitigate the impacts of climate change on their business and supply chain. In the long run, sustainability risks that are neither considered nor addressed in good time can threaten the survival of businesses and can have large negative consequences at the moment they materialise, impacting a broad range of company stakeholders such as workers, shareholders, suppliers, and creditors. It should also be remarked that the persisting focus on short-term returns will remain as a barrier that prevents companies from fully capturing the potential value from sustainability (e.g. reducing resource use, waste and emissions associated with operations; achieving higher prices, market shares, new markets and customers by leveraging on sustainability; improving employee motivation related to sustainability, which might be particular important for future generations, etc.). At macro-level, in the long term, a trend of decrease in CAPEX and investments in R&D as share of total revenues by companies (see section 3.1.1.5) in favour of profit distribution to shareholders might harm the level of productivity and the innovative capacity of the economy as a whole. A recent US-focused research on the macroeconomic impact of short-termism estimates that, by increasing R&D volatility, short-termism contributes to lower growth for the economy by 0.1% annually and output by 6% over 100 years.<sup>159</sup>

From a social perspective, the persistence of directors' focus on shareholder value maximisation might turn out as detrimental for other company stakeholders. Pressures to maximise shareholders' value might lead companies to cut on other costs, including labour costs, a problem that exacerbates in times of economic downturn. Other possible negative social effects for employees might regard the lack or limited investments in policies and programmes aimed at workforce training, reward and retention, or at promoting workplace health and safety. Moreover, if companies continue overly focusing on maximising short-term financial returns, there is a serious risk that also human rights issues in third countries (such as child labour, unsafe or unhealthy working conditions, pay below living wage, violations of fundamental freedoms, etc.) along the (global) supply chains of European companies will not be addressed properly. At macro-level, a persisting focus on shareholder value maximisation and corporate pay-outs might aggravate social inequalities by skewing corporate value towards smaller groups of actors (the company shareholders and the directors), increasing social vulnerability.

From an environmental perspective, as highlighted above, directors' excessive focus on shareholder value maximisation can prevent companies' from taking the necessary actions to become more environmentally sustainable in the future (e.g. emission reduction, reduced use of plastics, sustainable sourcing, etc.), with negative consequences on the environment and in particular the two "core" planetary boundaries of climate change and biodiversity loss. Although customers' demands and peer pressure might lead directors to pay greater attention to environmental sustainability, without clarifying that businesses should create sustainable value within planetary boundaries, the problem of "green-washing" and substantial unsustainability of certain practices or business models will persist.

### 5.1.2 Assessment of option A1

**A1**

*Commission -led/funded awareness-raising campaign (M1.1) aimed at:*

- *Clarifying that, when acting in the interests of the company, directors should properly balance the following interests, alongside the interest of shareholders: long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global environment; interest of society at large*
- *Promoting the principle that identifying and mitigating sustainability risks and impacts, both internal and external, is part of directors' duty of care*

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<sup>159</sup> Terry, S.J. (2017), cit.



### 5.1.2.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	Small
Impacts on companies	0
Economic impacts	+0.5
Social impacts	+0.5
Environmental impacts	+0.5
Impacts on fundamental rights	+0.5
Impacts on public administrations	-0.5

#### Expected degree of change in the national regulatory frameworks

Option A1 would bring **small changes in national regulatory frameworks**.

The Commission awareness-raising campaign would contribute to raising awareness in the business community about current misconceptions of company's interest and directors' duties.

Directors' duties and liabilities are defined by the law in all 12 Member States in scope. Legal provisions in this regard apply to all companies, regardless of their type (listed, non-listed), size, or sector of operation. However, the existing definitions do not include explicit reference to directors' duties and liabilities linked to long-term sustainability risks and impacts. In addition, the national regulatory frameworks in the 12 Member States tend to link the concept of directors' duties and company's interest with short-term objectives. Even if other long-term interests can be put in the Company's Article of Association, the interpretation of the national regulatory frameworks linked with short-term objectives remains prevalent.

Within this contest, an awareness-raising campaign would likely not lead to substantial modifications of the current regulatory frameworks and such modifications could be slow.

#### Impacts on companies

Option A1 would have **no relevant impact on companies**.

The awareness-raising campaign would not create direct compliance costs on companies, as it would not introduce any additional formal requirements or obligations.

Several investors (7) and companies (6) interviewed prefer such a soft measure to harder measures, as companies need an adjustment period to fully implement changes in line with the formulation of directors' duties and company's interest promoted by the campaign (e.g. review of internal risk management process). However, other stakeholders consulted believe that a Commission awareness campaign would be too weak to create any impact considering how deeply shareholder primacy is entrenched in corporate governance culture.

The chances of success of this option will depend on the effectiveness of the campaign in conveying its message and willingness of directors to change their approach despite the persistence of the shareholder primacy drive and the pressure from financial markets to meet short-term earnings targets.<sup>160</sup> Thus, this option is not expected to lead to a widespread adoption of measures that effectively drive change in all companies, but it can contribute to changing behaviours. Companies that adopt these principles may gain a competitive advantage if customers recognise and value the improvements, leading to a moderate increase in turnover that can offset the costs of the change. An increase in the market share of companies that adopt these behaviours could also eventually occur.

#### Economic impacts

Option A1 would have a **very limited positive economic impact**.

<sup>160</sup> According to 2 interviewees, large companies are gradually integrating sustainability in their decisions and SMEs, as most have a strong majority shareholder ("the owner"), tend to consider the long-term value in the decisions in the form of providing long term income to the shareholder, although not always explicitly. In listed companies or companies led by private equity, the decisions are more short term oriented and only legislation could stop short-termism.

A Commission campaign can be a starting point to achieve a more balanced decision-making process with limited costs and some marginal benefits. However, the results would depend on the level of adoption by companies. The literature review suggests the social norm of shareholder primacy is deeply entrenched and works as a main barrier to sustainable companies. Therefore, boards may not voluntarily follow the campaign and adopt a decision-making approach in which shareholders' interests are balanced with others' interests.

Thus, depending on the awareness-raising campaign, any changes in strategies to maximise sustainability might increase adaptation costs. In the short run, first movers might have a competitive advantage as a result of brand recognition and a subsequent increase in turnover. In the long term, positive impacts on investment (CAPEX, R&D and training) could be expected, reinforcing competitiveness (inside and outside borders).

Considering its voluntary nature, this option would have a limited economic impact. However, benefits are expected to outweigh costs.

### Social impacts

Option A1 would have a **very small positive social impact**.

The Commission aware-raising campaign might have an indirect positive impact on company's stakeholders (including employees, consumers and communities impacted by company's operations and in the value chain). The campaign might weaken the shareholder primacy drive, and persuade directors of European companies to consider the interest of the stakeholders and the likely sustainability impacts of any decision taken in the interest of the company.

However, the extent of the positive impact of option A1 at social level would depend on the success of the campaign in promoting among directors a new understanding of directors' duties and company's interest, emphasising accountability towards all stakeholders and for company's sustainability risks and impacts. Eventually, the chances of success will depend on the willingness of directors to change their approach in spite of the persistence of the shareholder primacy drive and the pressure from financial markets to meet short-term earnings targets, and this is difficult to anticipate. Considering the different approaches to company's interest that currently exist across EU jurisdictions, the strength of the social norm of shareholder primacy, and the fact that some leading companies already have a stakeholder and long-term oriented approach, option A1 can be expected to result into minor positive changes. At the same time, it would not have negative social impact. Therefore, overall, option A1 would have a positive, though very small social impact, as also confirmed by representatives from 4 NGOs and 2 trade unions interviewed.

### Environmental impacts

Option A1 would have a **very small positive environmental impact**.

The Commission awareness-raising campaign would not have any direct impact at environmental level. Indirectly, this measure might have beneficial effects by raising awareness about the need to identify and, if necessary, address relevant environmental risks and negative impacts (including on climate, natural capital, circular economy and resource efficiency) as part of directors' duty to act in the long-term interest of the company.

However, the possible behavioural changes inducted by this campaign would be very difficult to anticipate, and expectations on its effectiveness in terms of environmental impacts should be small, especially considering that over the past few years several calls and initiatives have been launched on the matter of redefining directors' duties and the purpose of the corporation more broadly (see Box 2 in Annex I.7), and that the campaign alone would likely not affect the longstanding pressures on directors to focus on meeting earnings targets and maximising shareholder value in the short term. First, the awareness-raising campaign is more likely to produce its positive persuasive effects on large companies (which are more sensitive for their reputation, more scrutinised by the media, and susceptible to confrontation for adverse

sustainability impacts) than on SMEs,<sup>161</sup> at least in the short term. Second, even if the campaign is successful in reaching out to a large number of companies, it might still take time before it brings visible results in terms of changing directors' focus in practice, while acting on environmental issues is urgent.<sup>162</sup> As highlighted in two interviews with representatives from NGOs, option A1 might result in a loss of time and resources in terms of possible social and environmental impacts. Therefore, it is assessed that option A1 would not have environmental impacts.

### Impacts on fundamental rights

Option A1 would have a **very small positive impact on fundamental rights**.

The Commission awareness-raising campaign would not have any foreseeable negative impact on fundamental rights. On the opposite, indirectly it might result in beneficial effects, as greater responsibility on the part of directors for sustainability aspects might lead to more effective initiatives to identify and mitigate negative impacts on fundamental rights (including the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour).

At the same time, any beneficial effect of option A1 will depend on the extent to which the awareness-raising campaign will be successful in persuading directors to consider more closely the externalities on the communities and the environment, including in third countries, arising from business own operations and their (global) value chains. As behavioural changes inducted by the campaign are very difficult to anticipate, especially in light of the strength of the shareholder primacy drive, these possible positive developments are expected to be very small. Therefore, it is assessed that option A1 would not have likely impacts on fundamental rights.

Option A1 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option A1 would have **very small negative impacts on public administrations**.

The option will not have significant budgetary consequences for Member States public authorities, while it will have minor implications at EU level. These implications are the costs related to the awareness-raising campaign, but the actual amount will depend on the tools adopted for the campaign. It is not possible to provide cost estimates in that regard, as the actual amount will depend on the audience engagement strategy and tools adopted for the campaign, with online contents assumed to be less expensive than live events, especially considering the large number of companies to be targeted.

#### 5.1.2.1 Assessment by criteria

Criteria	Rate
Effectiveness	+1
Efficiency	0
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option A1 would be **effective to a small extent** in strengthening the role of directors in pursuing company's long-term interests.

<sup>161</sup> As highlighted in a 2018 report by GRI, SMEs "are unlikely to have in-house sustainability knowledge and expertise, which means they may have to rely on external consultants – an often-costly enterprise. A limited number of SMEs' interviewed for the research shared their fear that transparency may hurt their business, which shows that they are not familiar with the business case for sustainability and reporting". See GRI (2018), *Empowering small and medium enterprises. Recommendations for policy makers to enable sustainability corporate reporting for SMEs*, p. 8. Available at [https://www.globalreporting.org/resource/library/Empowering\\_small\\_business\\_Policy\\_recommendations.pdf](https://www.globalreporting.org/resource/library/Empowering_small_business_Policy_recommendations.pdf).

<sup>162</sup> According to the UN IPCC Special Report released in 2018, to keep global temperatures from rising more than 1.5 degrees Celsius - a goal of the Paris climate agreement – anthropogenic carbon dioxide emissions would need to be cut to net zero by around 2050. To reach that goal, CO2 emissions would have to start dropping "well before 2030" and be on a path to fall by about 45% by around 2030 (12 years away at that time).

On the one hand, option A1 would contribute to raising awareness in the European business community that acting on the interest of the company requires directors to take into consideration and properly balance not only the interests of the shareholders, but also the long-term interest of the company (beyond 5-10 years), the interests of other company stakeholders (such as employees and customers), and the interests of the environment and the wider society in which the company operates. This initiative might promote a renewed understanding of directors' duties and company's interest, encompassing the long-term success of the company and the management of sustainability risks and impacts, while entailing limited costs at the EU level. Moreover, option A1 would not require any regulatory change, neither at EU nor at national level, which would make it easier to implement. Option A1 could be an "easy start" to raise awareness in companies (especially SMEs), without creating costs at company level.<sup>163</sup> Of course, the effectiveness of this option is likely to increase with the number of companies reached by the awareness campaign, both large and SMEs. Moreover, considering the existence of different national legal traditions and regulatory frameworks and the lack of a unified EU legal framework, an EU-level campaign might be useful to stimulate debate among practitioners from different countries and lay the ground for developing a more harmonised conception of directors' duties and company's interest, which could eventually be followed by stronger policy initiatives.<sup>164</sup>

Even though a campaign could be effective in raising awareness about a renewed and common conception of directors' duties and company's interest, option A1 will be voluntary in nature and will not produce any binding effect, leaving Member States room to decide whether to modify some rules and/or companies to adjust their market practices. Considering that a number of calls and initiatives on the definition of directors' duties and the purpose of the corporation more broadly have already been launched over the past few years (see Box 5), an awareness-raising campaign might not be sufficient to weaken the long-standing social norm of shareholder primacy as well as the pressures from shareholders and investors on directors to focus on meeting earnings targets and maximising shareholder value in the short term. As highlighted by one NGO respondent to the survey, "*It is relatively easy to clarify the notion of company's interest to include the long-term success of the company [...]. The problem is whether this conception of the company's interest is given sufficient weighting in light of the surrounding legal and regulatory architecture (e.g. time horizons of reporting requirements, lack of regulatory oversight or enforcement of directors' duties and short-term market pressures from investors)*". Moreover, even if the campaign is successful in reaching out to a large number of companies and promoting a more long-term and stakeholder-inclusive understanding of directors' duties and company's interest, it might still take time before the campaign produces tangible effects on the ground, and lengthen time horizon in corporate decision-making and increase directors' focus on sustainability risks, impacts and opportunities. In light of the considerations made above option A1 would be effective only to a small extent in strengthening directors' duties regarding sustainability and their responsibility to identify and address sustainability risks and impacts.

### Efficiency

#### **Costs**

Option A1 is expected to **increase costs to a very small extent**.

The awareness-raising campaign would not entail the introduction of substantive obligations or requirements for companies to comply with. Therefore, it would not bring direct compliance costs, although companies that decide to follow the formulation of directors' duties and company's interest promoted by the campaign might bring some implementation costs (for instance, a company might decide to set up a sustainability committee at board level to better monitor and manage sustainability risks and impacts), which however cannot be directly ascribed to the campaign (as implementation is voluntary). In the short run, following the campaign

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<sup>163</sup> Interviews with representatives from 2 companies.

<sup>164</sup> Interviews with representatives from 4 corporate governance committees.

might create in a competitive advantage for first movers, resulting in reputational gains, increased brand recognition and possibly translated into an increase in turnover.

As regards public administrations, the realisation of the campaign would have direct budgetary implications at EU level. Even though the amount of costs will depend on implementation choices (e.g. communication channels used, number of live events, involvement of partners, etc.) and cannot be quantified, it will be comparable in scale to similar initiatives already carried out by the Commission in the past (in other policy fields) and is not expected to be remarkable (considering that it will be targeted mainly to corporate directors).

### **Benefits**

Option A1 it is expected to have **very limited benefits**.

Similar to costs, also possible benefits would be mostly indirect,<sup>165</sup> and their extent would heavily depend on the number of companies that will choose to modify their practices as suggested by the Commission awareness raising campaign.

At economic level, increased board responsibility for company's sustainability, both in own operations and value chains, might contribute to intensifying investments at company level (e.g. in CAPEX for industrial modernisation and energy efficacy, in R&D for developing low-emissions products and services, etc.), with positive aggregate effects for the innovation potential and the long-term sustainable growth of EU economies. By highlighting the importance of identifying and mitigating sustainability risks and impacts as part of the duty to act in the long-term interest of the company, option A1 might have also some indirect beneficial effects at social, environmental and fundamental rights level by stepping up directors' attention to sustainability risks and negative externalities.

### **Coherence**

Option A1 would be **coherent with other main EU policy objectives and initiatives**.

The awareness-raising campaign would be aimed at weakening the shareholder primacy drive in corporate governance and promote a more balanced and uniform understanding of these concepts across different EU jurisdictions. In doing so, the campaign would be in line with one of the declared goals of the forthcoming renewed sustainable finance strategy,<sup>166</sup> i.e. contributing to further embedding further sustainability into the corporate governance frameworks and strengthening companies' focus on their long-term development and sustainability aspects. In addition, this would clearly concur to achieving the long-term objective of achieving climate neutrality by 2050<sup>167</sup> and implementing the SDGs.<sup>168</sup>

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<sup>165</sup> According to the Better Regulation Toolbox TOOL #48, indirect benefits include wider macroeconomic benefits (including GDP improvements, productivity enhancements, greater employment rates, improved job quality, etc.) and other non-monetisable benefits, such as protection of fundamental rights, social cohesion, reduced gender discrimination, international and national stability, etc.

<sup>166</sup> As announced in the Communication on the European Green Deal (COM(2019) 640 final) and confirmed in the Communication on the Sustainable Europe Investment Plan (COM(2020) 21 final), the Commission will present a renewed sustainable finance strategy in the third quarter of 2020 that will focus on a number of actions, including strengthening the foundations for sustainable investment. Acting in that regard includes also developing a more sustainable corporate governance, as "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". See European Commission (2019), 'The European Green Deal', Brussels, COM(2019) 640 final, p. 17.

<sup>167</sup> As summarised in COM(2020) 21 final, "The European Green Deal is the European Union's response to the climate and environmental-related challenges that are this generation's defining task. It is a new growth strategy that aims to transform the EU into a fair and prosperous society, with a modern, resource-efficient and competitive economy where there are no net emissions of greenhouse gases in 2050, where the environment and health of citizens are protected, and where economic growth is decoupled from resource use." Presented in March 2020, the Commission proposal for proposal for the first European Climate Law aims to write into law the goal set out in the European Green Deal – for Europe's economy and society to become climate-neutral by 2050. This objective is in line with the EU's commitment to global climate action under the Paris Agreement (to keep the global temperature increase to well below 2°C and pursue efforts to keep it to 1.5°C).

<sup>168</sup> As expressed in COM(2019) 640 final, the Green Deal is an integral part of this Commission's strategy to implement

Moreover, it could be reasonably expected that the campaign would be consistent with possible EU initiatives taken on the basis of recently released study on due diligence requirements through the supply chain,<sup>169</sup> which examines options for regulating due diligence in companies' own operations and through their supply chains for negative human rights and environmental impacts, including relating to climate change. In particular, the campaign foreseen under option A might underline how a more balanced and comprehensive understanding of company's interest and directors' duties as concerns the identification and mitigation of sustainability risks and impacts might serve as a foundation for due diligence requirements at corporate-level.

### Proportionality

Option A1 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

Option A1 could contribute to promoting a more harmonised, long-term and sustainability-oriented understanding of directors' duties and company's interest among European companies, including SMEs, while leaving the highest degree of flexibility to boards on the time and modalities to put this renewed formulation into practice. By operating at "educational" level, this option could start a process of progressive "eradication" of the social norm of shareholder primacy and promote a "cultural convergence" of European directors towards a more sustainability, long-term oriented and stakeholder inclusive approach to discharging their duties to the company under the business judgment rule. It is not expected to create disproportionate costs/burdens for companies and public administrations.

### 5.1.3 Assessment of option B1

<b>B1</b>	<p><i>Commission recommendation (M1.2) that provides a uniform interpretation of directors' duties and company's interest to the Member States and recommends them to:</i></p> <ul style="list-style-type: none"> <li>▪ <i>Clarify in their respective national frameworks that, when acting in the interests of the company, directors should properly balance the following interests, alongside the interest of shareholders: long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global environment; interest of society at large</i></li> <li>▪ <i>Introduce in their respective national frameworks an explicit directors' duty to identify and mitigate sustainability risks and impacts, both internal and external, connected to the company's business operations and value chain</i></li> </ul>
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#### 5.1.3.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	Moderate
Impacts on companies	-0.5
Economic impacts	+0.5
Social impacts	+1
Environmental impacts	+1
Impacts on fundamental rights	+0.5
Impacts on public administrations	0

### Expected degree of change in the national regulatory frameworks

Option B1 would bring **moderate changes in the national regulatory frameworks**.

The Commission recommendation could have direct impact on national regulatory frameworks.

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the United Nation's 2030 Agenda and the SDGs, and the Commission is committed to putting the SDGs at the heart of the EU's policymaking and action.

<sup>169</sup> British Institute of International and Comparative Law, Civic Consulting and LSE (2020), *Study on due diligence requirements through the supply chain – Final Report*. Available at [https://www.business-humanrights.org/sites/default/files/documents/DS0120017ENN.en\\_.pdf](https://www.business-humanrights.org/sites/default/files/documents/DS0120017ENN.en_.pdf).

On the one hand, as the definition of directors' duties and liabilities in the 12 Member States in scope (IT, BE, DE, ES, SE, FR, FI, NL, HU, PL, PT and SI), does not include explicit reference to directors' duties and liabilities linked to long-term sustainability risks and impacts, this option would allow jurists (including judges) across Member States to consider an alternative definition of directors' duties and liabilities which is more oriented towards the long-term.

On the other hand, the identification and mitigation of sustainability risks and impacts is already included for listed companies by i) the Directive on the disclosure of non-financial information, which requires to companies' boards the implementation of specific measures to identify and mitigate sustainability risks; ii) by international reporting standards which are widely used by companies, such as GRI Sustainability Reporting Guidelines; and by iii) Corporate Governance Codes already recommending the board and the company to ensure adequate internal controls and risk management procedures.

In addition, as the current main interpretation of the national regulatory frameworks links directors' duties and company's interest to short-term objectives, a Commission recommendation would provide Member States with the necessary flexibility to adapt recommended modifications to their national regulatory frameworks and start either legislative reforms or revisions of the national corporate governance codes.

### Impacts on companies

Option B1 would have a **very small negative impact on companies**.

The Commission recommendation could have some limited impact on companies, depending on the level of adoption of the recommendation at national level.

The introduction of new requirements by the Member States that adopt the recommendation could determine an increase in costs of compliance for companies based in those countries (e.g. arising from time spent by board members and employees in reviewing internal risk management and monitoring frameworks, collecting and processing information to support board decisions, etc.). These costs might be higher than in option A1, but this will depend on how demanding the requirements associated with the recommendations are. The fact that each Member State would have some freedom of adjustment, namely to take into account the business context and the corporate culture of the companies operating in the country, could minimise compliance costs and facilitate a more moderate transition, avoiding a one-size-fits-all approach.

The compliance costs would tend to be higher in the smaller enterprises, which have less flexibility in introducing new tasks on employee's current work without jeopardising the normal functioning of the company and lower in companies already adopting complementary measures (for example non-financial reporting applied to large enterprises). No benefits in the form of short-run cost savings are expected.

### Economic impacts

Option B1 would have a **very small positive impact on the economy**.

The Commission recommendation will leave room for some differences in interpretation and implementation approach in each Member State, which could result in different specifications and requirements from one Member State to the next.

This possible development could adversely affect the competitiveness of European firms within the Internal Market, as it could distort the levels of competition across Member States and also the international trade flows, at least in the short-run. Nonetheless, as corporate boards in an increased number of companies would take a more long-term and stakeholder-oriented approach, positive long-term impacts may arise through more investment (especially on R&D and training) and innovation in the companies. To mitigate competition problems, Commission recommendations should be simple (so that the Member States would not be reluctant to adopt them), in view to start changing behaviours while the legislators of each Member States could take into account the respective corporate culture. Being these risks mitigated, the positive effects on investments could offset the negative effects on costs, competition and trade flows.

### Social impacts

Option B1 would have a **small positive social impact**.

The recommendation could have some direct positive impact, depending on the adoption of the recommendation from Member States. Considering that a number of national corporate governance codes (such as the 2020 Belgian Code on Corporate Governance, the 2016 Dutch Corporate Governance Code, the 2020 French Corporate Governance Code of Listed Corporations, the 2017 German Corporate Governance Code, the 2020 Italian Corporate Governance Code and the 2015 Spanish Good Governance Code of Listed Companies) were already amended to include a modified definition of company interest which integrates the promotion of long-term value creation considering the interest of different stakeholders, some impact is foreseeable. A number of companies might start paying more attention to internal stakeholders, such as employees, and the inequalities in the society might be reduced due to a reduced focus on the remuneration for the owners of shares. Similarly to option A1, also option B1 is considered as not having remarkable social impacts according to representatives from 4 NGOs and 2 trade unions interviewed.

### Environmental impacts

Option B1 would have a **small positive environmental impact**.

The Commission recommendation might push an increased number of EU countries to clarify at national level that directors' duty to act in the long-term interest of the company includes sustainability risks and impacts, including environmental externalities in business own operations and supply chain. As highlighted for the social impact, this measure has the potential to strengthen and spread further across EU ongoing developments linked to the integration of sustainability and long-termism into fiduciary duties of corporate directors, such as in the 2016 Dutch Corporate Governance Code and the 2020 Italian Corporate Governance Code, the 2020 Belgian Code on Corporate Governance, the 2020 French Corporate Governance Code of Listed Corporations, the 2017 German Corporate Governance Code and the 2015 Spanish Good Governance Code of Listed Companies. If the recommendation is implemented by EU countries, an increased number of corporate directors will adopt a more stakeholder, long-term oriented understanding of the company's interest, with possible positive consequences at environmental level resulting from increased attention to prevent and mitigate negative external impacts (including on climate, natural capital, circular economy and resource efficiency). However, the expected positive environmental impact is only limited because the recommendation would be non-binding and the extent of its effective implementation would depend on different variables that are hard to anticipate (e.g. the number of Member States implementing the recommendation, the modality chosen to introduce it into the national regulatory frameworks and its binding force, the compliance approach followed by directors - substantial or tick-box, etc.).

### Impacts on fundamental rights

Option B1 would have a **very small positive impact on fundamental rights**.

Member States would be invited to take the necessary steps to introduce at national level a set of provisions clarifying the duties of directors – i.e. that directors need to take stakeholder interest into account alongside shareholders' interest in promoting the long-term success of the company, and to identify and mitigate sustainability risks and impacts – either in corporate governance codes or through legislation. While such policy intervention is not expected to bring likely negative impacts on fundamental rights, it is hard to foresee if and to what extent it could result into positive impacts (including on the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour in third countries) generated by changes in practice on the part of directors. In fact, as already highlighted for the environmental impacts, many variables difficult to predict are at play (e.g. the number of Member States implementing the recommendation, the modality chosen to introduce it into the national regulatory frameworks and its binding force, the compliance approach followed by directors - substantial or tick-box, etc.). Therefore, it is assessed that option B1 might have only a very small positive impact specifically on fundamental rights.



Option B1 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option B1 would have **no impacts on public administrations**.

Option B1 will not have significant budgetary consequences for Member States public authorities, nor implications at EU level. An administrative burden might be expected at EU level in a situation in which different Member States apply different laws, as EU bodies may need to follow and monitor national initiatives and possibly facilitate some type of information exchange. However, it can be expected that this would be covered by existing operational structures and budgets since this would be a normal process of monitoring policy developments in Member States.

#### 5.1.3.2 Assessment by criteria

Criteria	Rate
Effectiveness	+1
Efficiency	0
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option B1 would be **effective to a small extent** in strengthening the role of directors in pursuing company's long-term interests.

The Commission recommendation might prompt an increased number of EU countries to clarify at national level that directors' duty to act in the long-term interest of the company includes considering and balancing the interests of different company stakeholders (alongside shareholders), as well as identifying and mitigating sustainability risks and impacts, both in company's direct operations and value chain. Option B1 would leave Member States with the flexibility to implement the recommendation in the most suitable way vis-à-vis their respective national legal tradition, existing regulatory framework, corporate culture and business structure. This is the main reason why option B1 has been indicated as effective and useful by 5 representatives from corporate governance committee interviewed.

The effectiveness of the measure in achieving its objective would very much depend on the implementation instrument that will be chosen by the Member States that decide to implement the recommendation domestically. The implementation of the recommendation through national legislation would integrate the proposed formulation into national company law, with binding effects on all public companies subject to statutory law, a solution that would leave minimum room for interpretation and could thus be effective in strengthening directors' responsibilities for sustainable and long-term value creation. If the recommendation is implemented domestically by means of inclusion into the national corporate governance code, the extent of the effectiveness of the measure would be reduced by the limited scope of application of the code (i.e. listed companies), the voluntary and non-enforceable nature of the instrument, and the wider room left for interpretation by corporate boards. As highlighted by a representative of a corporate governance committee, the latter point is remarkable because to be effective the recommendation should not leave too much room for different national interpretations, while remaining flexible. At the same time, implementing the recommendation through the code would be easier, as it would not require starting a reform process, and could be realised with active collaboration by relevant market participants.

Option B1 has the potential to promote a long-term and sustainability-oriented interpretation of directors' duties and company's interest, while respecting differences in national situations. It could also strengthen and spread further across EU ongoing developments linked to the integration of sustainability and long-termism into fiduciary duties of corporate directors through the reform of corporate governance codes. At the same time, its effectiveness is limited by its non-binding nature, which leaves Member States free to decide whether and how to implement it, with the risk of increasing regulatory fragmentation across EU countries rather than promoting a more uniform interpretation. Regulatory differences might eventually reflect on different rules

for companies from different Member States in terms of more (or less) comprehensive responsibilities for long-term value creation and corporate sustainability. Striking the right balance between formulating clear and general principles and leaving some room for interpretation/adaptation to different national contexts will be key in determining the higher or lower effectiveness of the measure.

### Efficiency

#### **Costs**

Option B1 is expected to **increase costs to a very small extent**.

Similarly to option A1, the Commission recommendation would not entail the introduction of substantive obligations or requirements for companies to comply with. The main addressee of the recommendation would be the Member States, which would be invited to take the steps necessary to introduce at national level the suggested formulation. Indirectly, companies based in EU countries where the recommendation is adopted might decide to take the measures necessary to comply with the revised formulation and bear the related compliance costs. Such costs would not be directly ascribable to option B1 and are impossible to quantify ex ante.

As regards public administrations, the adoption of the recommendation would not have budgetary implications, neither at national nor at EU level.

#### **Benefits**

Option B1 is expected to have **limited benefits**.

Similar to costs, also possible benefits would be indirect, and their extent would depend on the number of Member States that will choose to take measures to adopt the recommendation at the national level.

At economic level, the effects of option A1 could be mixed. As it is expected that Member States will adapt the recommendation to their specific national contexts, there is a risk that this option increases disparities across Member States' regulatory frameworks even further, with possible distortive effects on the competition within the Internal Market and competitiveness vis-à-vis third countries (though such possible effects should not be overestimated, as the baseline situation is already fragmented). At the same time, option B1 could have some beneficial long-term effects in terms of resilience and innovation potential of EU economies, as it could stimulate sustainability-oriented CAPEX and R&D investments at company level in the EU countries where recommendations are implemented.

Also option B1 might have some indirect limited beneficial effects at social, environmental and fundamental rights level, but the extent of such effects could be (slightly) larger than for option A1. By virtue of its different political weight, a recommendation can be expected to instigate a wider change compared to an awareness-raising campaign directly addressed to companies.

### Coherence

Option B1 would be **coherent with other main EU policy objectives and initiatives**.

The Commission recommendation would contribute to the goal of the forthcoming renewed sustainable finance strategy (i.e. strengthening companies' focus on their long-term development and sustainability aspects) and, in turn, contribute to broader policy goals in the framework of the European Green Deal (in particular as concerns climate neutrality and implementation of the SDGs).

Finally, as already mentioned for option A1, the recommendation under option B1 might be issued in synergy with possible policy initiatives in the area of corporate duty of due diligence for adverse human rights and environmental impacts.

### Proportionality

Option B1 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

Option B1 would encourage Member States to adapt their national regulatory frameworks in order to incorporate a sustainability, long-term oriented and stakeholder inclusive formulation of directors' duties and company's interest, thus promoting regulatory convergence (and preparing the ground for a more incisive future EU harmonising intervention). Being implemented through a non-binding recommendation, option B1 would provide Member States with a high degree of flexibility to introduce the recommended modifications at national level in line with the existing company law and corporate governance framework and corporate culture. It is not expected to create disproportionate costs/burdens for companies and public administrations.

#### 5.1.4 Assessment of option C1

C1	<p>Commission proposal for a new EU directive (M1.3) providing an EU-wide formulation of directors' duties and company's interest, requiring directors to:</p> <ul style="list-style-type: none"> <li>▪ Properly balance the following interests, alongside the interest of shareholders, when acting in the interest of the company: long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global environment; interest of society at large</li> <li>▪ Identify and mitigate sustainability risks and impacts, both internal and external, connected to the company's business operations and value chain</li> </ul>
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##### 5.1.4.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	Large
Impacts on companies	-0.5
Economic impacts	+1.5
Social impacts	+3
Environmental impacts	+3
Impacts on fundamental rights	+3
Impacts on public administrations	0

#### Expected degree of change in the national regulatory frameworks

Option C1 would bring **significant changes in national regulatory frameworks**.

The EU directive would trigger a harmonised adaptation of laws and measures focusing on the importance of directors' duties and company's interest linked with long-terms objectives, in all national regulatory frameworks.<sup>170</sup> The adoption of a Directive would require national competent authorities whose laws and regulations do not already comply with the proposed content of the option, to launch the transposition of the new requirements into their national laws. Subsequent changes would be significant.

Indeed, the current regulatory framework of all 12 the Member States in scope, does not include explicit reference of directors' duties and liabilities linked to long-term sustainability risks and impacts and the existing definitions do not include explicit requirements for board members to identify and mitigate the economic, social and environmental factors and focus more generally on the duty to act in good faith and in the best interest of the company. In all 12 Member States analysed, directors must fulfil their duties with care. In this regard, directors must perform their roles as loyal representatives, operating in good faith and in the best interest of the company.

In addition, as highlighted under option B1, only listed companies are required to be compliant with requirements related to the identification and mitigation of sustainability risks and impacts and there are still a number of companies that are currently not subject to the same obligations.

<sup>170</sup> Interviews with representatives from 3 corporate governance committees.

### Impacts on companies

Option C1 would have a **small negative impact on companies in the short term, while in the long term it is expected to be positive.**

The new EU directive would raise costs of compliance in the short term for the large majority of European companies, as this option is compulsory and in most cases internal processes, structures and systems would need to be revised to ensure that directors are able to meet their obligations (e.g. review of the internal risk management and monitoring frameworks).

The costs of compliance are expected to be higher for large listed companies (as highlighted by some interviewees, if the scope of the directive would be limited only to listed companies, this could create incentives to delisting and increase burden for listing<sup>171</sup>) and companies led by private equity, as they are typically the ones that are more short term oriented, but also for SMEs, in which the costs to comply with additional requirements and obligations is proportionally higher. On the contrary, the rise in costs would tend to be lower in (mostly large) companies already adopting complementary measures (e.g. reporting of non-financial information pursuant to the Non-Financial Reporting Directive). This option would be applied in all Member States, meaning that the compliance costs would be higher compared to softer options.

In terms of benefits, option C1 might lead directors across EU companies to pay greater attention to sustainability aspects in allocating company's resources compared to the baseline scenario, which could be expected to positively contribute to the productivity, profitability and attractiveness of EU businesses in the long run. This would make companies also more resilient to adverse consequences of changed environmental or social circumstances, or to sudden crises, as in the recent COVID-19 epidemic.<sup>172</sup> Moreover, it would secure a level playing field across EU and also some degree of standardisation in directors' responsibility for sustainability, reducing discrepancies and providing companies with a common reference in that regard. This might save costs compared to what companies are doing in absence of a common standard (as trying to keep up with various recommendations and expectations has costs too). Moreover, introducing harmonised EU rules can also have benefits in making companies more interesting for sustainability-oriented investors, public procurers, consumers, and various potential contractual parties, with positive consequences in terms of turnover increase.

### Economic impacts

Option C1 would have a **moderate positive economic impact, especially in the long term.** In the short term, the introduction of new requirements and the associated increase in compliance costs could have a negative impact on the level of competitiveness of EU businesses vis-à-vis external competitors and, therefore, decrease the exports of final products of European companies. Moreover, firms could have extra incentives to delocalise at least part of their production process to other geographic areas,<sup>173</sup> where these requirements do not apply. Several interviewees<sup>174</sup> considered that the negative impact of option C1 on business environment, competitiveness, and trade flows would be rather small.

In the longer term, however, effects on competitiveness could be positive, as option C1 might help European companies be "first movers" and be at the forefront of the future sustainability transition. This option would have likely positive effects on investment (CAPEX, R&D and training), resulting from an earlier detection of sustainability risks and impacts and from a more balanced decision-making approach between shareholder pay-outs and sustainability investments. By focusing on the development of sustainable products and services, sustainability first movers would have the opportunity to gain brand recognition, gain market share, and build

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<sup>171</sup> Incentive to delisting was referred by 4 interviewees (1 company, 2 investors and 1 corporate governance committee).

<sup>172</sup> Ding, W., Levine, R., Lin, C., Xie, W. (2020), 'Corporate Immunity to the COVID-19 Pandemic', NBER Working Paper No. 27055, p. 25.

<sup>173</sup> This effect was referred by 2 companies and 1 NGO.

<sup>174</sup> Interviews with representatives from 2 companies, 4 investors, 2 NGOs, 3 trade unions, 5 corporate governance committees. Companies, investors and corporate governance committees tend to anticipate more negative effects than other stakeholders (among these only one considers negative impacts on analysed variables).

customer loyalty, ultimately achieving sustainable sales and profitability. As market pioneers, EU companies could make pre-emptive investments in production capabilities by securing access to resources (e.g. suppliers, skilled personnel, etc.), technology (e.g. through patenting), and gain economies of scale vis-à-vis later market entrants. Moreover, by creating an EU level playing field, option C1 would remove current distortions and favour internal competition.

### Social impacts

Option C1 would have a **large positive social impact**.

The EU-wide formulation of directors' duties and company's interest enshrined in a new EU directive would require corporate directors to consider and balance the interests of different company stakeholders (alongside shareholders), and to identify and mitigate sustainability risks and impacts for the long-term success of the company. Under option C1, directors are to abandon an excessive focus on short-term shareholder value maximisation and adopt a view on long-term value creation for the company, for the long-term benefit of all stakeholders, including but not limited to shareholders. This is expected to result into increased attention by the board to the social risks and impacts associated with company's direct operations and in its (global) value chain, eventually leading to adopting more sustainable and long-term oriented policies on employees (for instance increased investments in policies and programmes aimed at workforce training, reward and retention, or at promoting workplace health and safety, improving in this way the working condition of employees within companies). For employees, the impact of option C1 might be particularly positive in those EU countries where board-level representation of workers is either absent<sup>175</sup> or limited to state/municipality-owned companies.<sup>176</sup> Considering other stakeholders, option C1 might contribute to an increased focus on the satisfaction of consumers, with more sustainable and high-quality products for them. Importantly, also stakeholders less able to influence the financial performance, but equally impacted by the company's activities, such as the local and global communities, would receive higher attention. This might lead directors to identify and prevent negative impacts (e.g. on health) and promote positive impacts (such as more decent work conditions and the pay of living wages across supply chains), thus contributing to reducing social vulnerability and inequalities at macro level (in line with global goals such as SDG #1, #3 and #8). In interviews with representatives from 4 NGOs and 1 trade union, option C1 has been indicated as with the largest potential for positive impact at social level.

### Environmental impacts

Option C1 would have a **large positive environmental impact**.

The new EU directive would make it clear that, as part of their duties to act in the long-term interest of the company, directors are under an obligation to take into account the interest of the (local and global) environment and to prevent, identify and mitigate sustainability risks and impacts, including negative externalities at environmental level. Therefore, it is expected that this measure might push corporate directors to increase their attention to the environmental impacts, both in business direct operations and value chain, and possibly to take further measures that could have positive consequences in the environmental area – primarily on climate (e.g. reduction of GHG emissions), but also on natural capital (e.g. reduction of ecological footprint), circular economy and resource efficiency (e.g. reduction in energy consumption; reduction of waste production; reduction of packaging, etc.). By virtue of its wide scope of application to limited liability companies of all sizes and its binding nature, option C1 is expected to have a large positive impact at environmental level. Also for environmental impacts, option C1 has been indicated in interviews with representatives from 5 NGOs as the intervention with the largest potential for positive impact.

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<sup>175</sup> Belgium, Bulgaria, Cyprus, Estonia, Italy, Latvia, Lithuania, Malta, and Romania.

<sup>176</sup> Greece, Ireland, Poland, Portugal and Spain.

### Impacts on fundamental rights

Option C1 would have a **large positive impact on fundamental rights**.

The adoption of a new EU directive would enshrine in company law a common understanding of the duties of directors regarding sustainability and their responsibility to identify and mitigate sustainability risks and impacts, both in own business and along the value chain, when acting in the long-term interest of the company. Under option C, the formulation of directors' duties would explicitly address the issue of sustainability and the interest of stakeholders affected by the operations of the company. As part of their duties to act in the long-term interest of the company and maximise its value, directors would be required to consider the interest of the society at large and to identify and mitigate negative social impacts on stakeholders, either directly affected by companies' own operations or along the value chain. For directors, acting in a way that promotes the long-term interest and success of the company would imply considering and addressing negative externalities, including on violations of fundamental rights that might occur as part of the international business activities of their companies (including as regards the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour in third countries).

In light of the wide scope of application and the binding force of the principles established in the directive, the impact of option C1 on the protection of fundamental rights has the potential to be positive and large, especially if combined with a corporate duty of human rights due diligence (currently foreseen only in France and the Netherlands -as regards child labour).

Option C1 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option C1 would have **no impacts on public administrations**.

The measure will not have significant budgetary consequences for public authorities, nor implications for the EU budget. The new understanding of the duties will be enforced through the existing mechanisms, with a little role for public authorities.

#### 5.1.4.2 Assessment by criteria

Criteria	Rate
Effectiveness	+2.5
Efficiency	+1.5
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option C1 would be **effective to a large extent** in strengthening the role of directors in pursuing company's long-term interests.

The adoption of an EU directive would ensure that a harmonised interpretation of these concepts is integrated into all EU jurisdictions, reducing the current fragmentation across different national regulatory frameworks. By virtue of its binding force and its generalised application across the EU territory, this intervention would apply to corporate directors of all European companies in the Internal Market, thus minimising possible distortive effects and contributing to a more level playing field. This would maximise its effectiveness in achieving the objective of clarifying and strengthening the role and responsibility of the directors for taking into consideration the interests of company stakeholders (alongside shareholders) in promoting the long-term interest of the company, and for identifying and mitigating sustainability risks and impacts as part of their duties. As underlined by an interviewee representing an NGO, option C1 would also be most effective in weakening the social norm of shareholder primacy across EU, as it would clarify that directors' duties are owed to the company itself, not to the shareholders.

The main obstacle to the effectiveness of option C1 is in identifying and clearly articulating a formulation of directors' duties and company's interest that could be widely accepted, without creating confusion for corporate boards on how to perform their duties. With regard to the

formulation considered in this study, some interviews underlined how requiring directors not just to take account of, but to “balance” different interests might be problematic. First, there is a risk that this regulatory change leaves “*board members alone with the task to pick the right stakeholders and base their decisions on the adequate information in the context of the business judgement rule*”<sup>177</sup> (though it should be noted that this issue could be mitigated via rules on stakeholder involvement at company level, as discussed in section 5.6). Second, by putting the long-term interest of the company on par with other interests, rather than on top of them, there is the risk that shareholder interests would remain paramount in board decision-making, considering the current accountability structure whereby stakeholders collectively have the rights to appoint directors by voting at shareholders' meetings.<sup>178</sup> Moreover, the possible principle-agent problems<sup>179</sup> that might arise from requiring directors to balance different interests (including broadly defined ones, such as the interest of society or the interest of the environment) should be closely considered, as reported by one investor interviewed.

Finally, the effectiveness of option C1 could be enhanced by parallel interventions addressing the topics of corporate purpose (i.e. requiring companies to define a purpose, as mentioned by a representatives from an EU-level association) and corporate duty of human rights and environmental due diligence, as mentioned by two NGOs. To maximise the effectiveness of any EU regulatory intervention with regard to the identified objective, synergies with parallel policy initiatives (especially in the area of corporate purpose, corporate duty of due diligence, and non-financial reporting) should be closely considered, including to identify the most appropriate policy instrument. As noted by an interviewee representing an NGO, it could be considered to include provisions regarding directors' duties and company's interest into the forthcoming Commission proposal on corporate duty of human rights due diligence and the Commission proposal to revise the Non-Financial Reporting Directive, rather than in a separate directive.

### Efficiency

#### **Costs**

Option C1 is expected to **increase costs to a small extent**.

Option C1 would introduce substantive requirements for directors of European companies to comply, in particular as concerns the consideration and balancing of shareholder and other stakeholders interests in acting to promote the long-term success of the company, and the identification and mitigation of sustainability risks and impacts. Consequently, option C1 would create some compliance costs for companies, as in most companies internal processes, structures and systems would need to be revised to ensure that directors are able to meet their obligations (it is assumed that boards would not follow a tick-box approach to compliance, as risks might be too high). Compliance costs are expected to be company-specific, with companies that are already at the leading hedge of sustainability being advantaged compared to others (in particular SMEs). As internal processes, structures and systems supporting the compliance with the requirements would already be in place (at least partly) in most companies (i.e. not created from scratch), costs can be expected to be limited to moderate, although they cannot be quantified ex ante.

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<sup>177</sup> Interview with representatives from 1 corporate governance committee.

<sup>178</sup> Interview with representatives from 1 NGO. The interviewee mentioned South African King IV Report on corporate governance as example of balanced formulation: “directors owe their duties to the company and the company alone as the company is a separate legal entity from the moment it is registered until it is deregistered. The company is represented by several interests and these include the interests of shareholders, employees, consumers, the community and the environment. Thus, requiring directors to act in good faith in the interest of ‘the company’ cannot nowadays mean anything other than a blend of all these interests, but first and foremost they must act in the best interest of the company as a separate legal entity. Any interest that may be primary at one particular point in time in the company’s existence may well become secondary at a later stage.” See Institute of Directors Southern Africa (2016), *King IV Report on Corporate Governance 2016*, p. 26.

<sup>179</sup> The principal-agent problem occurs when one person (the agent) is allowed to make decisions on behalf of another person or group of persons (the principal). In this situation, there are issues of moral hazard, information asymmetry, and conflicts of interest.

As regards public administrations, the adoption of the recommendation would not have budgetary implications, neither at national nor at EU level.

### **Benefits**

Option C1 it is expected to have **moderate benefits**.

At economic level, the effects of option C1 would be positive, especially in the long term. On one hand, the generalised and binding application ensured by the new directive would create a more level playing field for companies within the Internal Market, mitigating possible problems for internal competition highlighted under option B1. Moreover, option C1 might help European companies be "first movers" and leaders of the future sustainability transition, with positive effects on international competitiveness and sustainable growth of the EU economy in the long term. On the other hand, the introduction of new requirements could reduce the competitiveness of EU business vis-à-vis non-EU competitors in the short term, while in the long term this option could lead to more sustainable economic growth, as it would encourage long-term, sustainability-oriented CAPEX and R&D investments by EU companies. By making companies more interesting for sustainability-oriented investors, public procurers, consumers, and various potential contractual parties, option C1 could have positive effects in terms of turnover increase.

By virtue of its legal force and generalised application, option C1 would ensure that the identification and mitigation of sustainability risks and impacts becomes an essential component of directors' fiduciary duties towards their companies, and as such could have large benefits at social, environmental, and fundamental rights level (leading corporate boards to closely consider – and better address – working conditions and training programmes for employees, GHG emissions, ecological footprint of their business model, fundamental rights protection for workers in global value chains, etc.). Benefits could be far-reaching (for instance, they might regard also workers and communities in third countries) and diffused (as they would not regard just single constituencies but the environment and society at large).

### **Coherence**

Option C1 would be **coherent with other main EU policy objectives and initiatives**.

Currently, there is no EU-level legislation laying down a uniform formulation of company's interest and directors' duties. The formulation proposed under option C1 would strengthen directors' duties related to sustainability by making explicit that acting in the long-term interest of the company entails balancing the interest of the shareholders with other interests, including the likely (social and economic) consequences of decisions in the longer term (beyond 3-5 years). By explicitly incorporating sustainability into directors' duties, this option would certainly contribute to the goal of the forthcoming renewed sustainable finance strategy (i.e. strengthening companies' focus on their long-term development and sustainability aspects) and to broader sustainability-related policy goals in the framework of the European Green Deal (in particular as concerns climate neutrality and implementation of the SDGs).

The policy initiative under option C1 would also complement, on the corporate side, the clarification of fiduciary duties of investors under EU Regulation on disclosures relating to sustainable investment and sustainability risks,<sup>180</sup> which promotes a better disclosure on the integration of ESG factors into investment decisions and advice by financial market participants.

Finally, as already mentioned for options A1 and B1, also option C1 might be taken in synergy with possible policy initiatives in the area of corporate duty of due diligence for adverse human rights and environmental impacts.

### **Proportionality**

Option C1 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

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<sup>180</sup> Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.



Option C1 would ensure that a harmonised formulation of directors' duties and company's interest is included in the domestic company law and corporate governance frameworks of all Member States, while the choice of the directive as implementation instrument would still leave a certain degree of flexibility, in particular in order to allow the norms to adequately fit into the distinct corporate governance frameworks. Compared with voluntary initiatives implemented by individual companies or at the Member States level, the EU intervention under option C1 would create more leverage and "critical mass" to address the problem identified under Driver 1. Even though option C1 could be relatively costlier than option A1 and option B1 (especially in terms of adaptation costs in the short term), it is not expected to create disproportionate costs/burdens for companies and public administrations.

## 5.2 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

### 5.2.1 Baseline

In the absence of EU intervention, driven by investor short-termism and trading based on momentum and/or share price movement, boards will continue feeling pressure to deliver financial results and to employ strategies to sustain the share prices in the short term. At the same time, it should be considered that EU policy initiatives that have been recently adopted/transposed might have positive effects in promoting long-termism. For instance, the Shareholder Rights Directive II, whose transposition period finished in June 2019, might have a positive effect on holding periods by increasing transparency around portfolio turnover. As noted by ESMA, "[w]hile asset managers must report on portfolio turnover and turnover costs to their institutional investor clients, institutional investors must report how they monitor turnover costs and how they define and monitor a targeted portfolio turnover or turnover range with their asset managers. ESMA is of the view that a focus on costs of turnover and turnover ranges could lead to longer holding periods generally". Similarly, it might be expected that, by requiring professional investors to be transparent as to whether and how they take ESG risks and ESG factors into account, the EU Regulation on disclosures relating to sustainable investment and sustainability risks<sup>181</sup> could prompt these financial market participants to also place greater value on long-term and sustainable investment.

Moreover, disclosure of quarterly returns and earnings guidance – which are both allowed under the current EU and national regulatory frameworks – will continue being allowed in absence of some EU action to address them. In this scenario, these market communication practices will remain a factor that contribute to directors' short-term focus on quarterly financial returns for shareholders, with the economic, social and environmental effects highlighted under Driver 1.

### 5.2.2 Assessment of option A2

<b>A2</b>	<ul style="list-style-type: none"> <li>- Commission green paper to stimulate public debate on how to foster long-term shareholder engagement and longer shareholding periods (M2.1)</li> <li>- Commission led/funded campaign to discourage listed companies to publish earnings guidance and returns on a quarterly basis (M2.2)</li> </ul>
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#### 5.2.2.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	No change
Impacts on companies	0
Economic impacts	0
Social impacts	+0.5

<sup>181</sup> Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

Impact	Rate
Environmental impacts	+0.5
Impacts on fundamental rights	0
Impacts on public administrations	-0.5

### Expected degree of change in the national regulatory frameworks

Option A2 would bring **no changes in the national regulatory frameworks**.

The main aspect covered through the legal analysis of the regulatory frameworks is the disclosure of quarterly returns. In this regard, only in PT and ES there is an obligation to disclose quarterly returns. Specifically, in ES, listed companies, whose stock or securities are admitted to trade on regulated secondary markets or any regulated market domiciled in the EU, must disclose a mid-term management statement on a quarterly basis, and in PT, only certain listed companies which are credit institutions and financial companies, are obligated to file quarterly returns.

In light of the very limited number of Member States where there is an explicit requirement for disclosure, potential changes to the current regulatory frameworks would be minimal. Moreover, considering the non-binding nature of the Commission led/funded campaign to discourage listed companies to publish earnings guidance, it is likely to assume that option A2 would not affect the current situation and hardly bring changes to it.

### Impacts on companies

Option A2 would have **no relevant impact on companies**.

Option A2 would depend on voluntary initiatives by companies.

Some stakeholders interviewed representing investors, corporate governance committees and a companies recognised the importance of short-term investors (coupled with the existence of long-term investors). It was also considered that mechanisms to promote long-term shareholding (e.g. loyalty shares) could affect the normal functioning of capital markets. and possibly decrease the attractiveness of financial markets for companies and investors. Considering these arguments, mechanisms to give loyal shareholders more control over companies or incentivise investors to take a longer-term approach could be difficult to implement on a voluntary basis.

On the other hand, the vast majority of companies do not have quarterly publishing report obligations and it is not predictable that the ones that have those obligations would diminish the effort on making periodical financial reports (even if they are not subsequently published). Moreover, companies with quarterly reporting will be pressured by shareholders, investors, creditors and analysts to continue delivering the same information to ensure transparency. A change in this behaviour would have costs in terms of the attractiveness and liquidity of the capital markets. A potential benefit would be freeing up executives' time in preparing the announcement and managing reactions from the markets. Thus, it is not expected that the option A2 would be enough to have an effective impact on behaviour changes and, therefore, no relevant change in costs is assumed.

### Economic impacts

Option A2 would have **no relevant economic impact**.

This effect depends on the degree of adoption by companies would adopt the desired behaviours. As explained above, option A2 is not expected to leverage a remarkable change in the behaviour of a large number of market participants (in particular companies and investors). Therefore, no relevant transmission of effects to the economy is foreseen.

### Social impacts

Option A2 would have a **very small positive social impact**.

Under this option, a green paper on long-term shareholder engagement by the Commission (M2.1) and a campaign to discourage the practice of publishing earnings guidance and quarterly financial returns (M2.2) would have no expected negative impact at social level. To the extent that these both measures will lead an increased number of companies to abandon quarterly reporting and adopt mechanisms that reward long-term shareholding, some indirect benefit might result at social level if corporate boards become more long-term oriented and focused on preventing and mitigating adverse sustainability risks and impacts. However, considering that both measures would rely on voluntary initiatives by companies, they might be too "soft" to determine an extensive change in corporate practices and mitigate existing pressures on directors (e.g. from investors and shareholders to have quarterly financial disclosure), the possible positive social consequences of option A2 are expected to be very small.

### Environmental impacts

Option A2 would have a **very small positive environmental impact**.

The adoption by the Commission of a green paper on long-term shareholder engagement and lengthening shareholding periods (M2.1) and the launch of a campaign to discourage the practice of publishing earnings guidance and returns on quarterly financial returns (M2.2) are not expected to have a direct impact at environmental level, neither positive nor negative. If followed by an increasing number of listed companies, M2.2 might contribute to reducing pressure on directors to focus on short-term financial performance and shareholder value, which in turn might possibly have some positive, indirect effects in terms of directors' focus on long-term value creation and prevention and mitigation of environmental impacts. However, as explained for the social impacts, given the non-binding and "soft" nature of both measures, option A2 might be expected to have only very small positive on the environment.

### Impacts on fundamental rights

Option A2 would have **no impact on fundamental rights**.

The adoption by the Commission of a green paper on long-term shareholder engagement and lengthening shareholding periods (M2.1) and the launch of a campaign to discourage the practice of publishing earnings guidance and returns on quarterly financial returns (M2.2) are not expected to affect fundamental rights in any way.

### Impacts on public administrations

Option A2 would have **small negative impacts on public administrations**.

This option is not expected to have significant budgetary consequences for public authorities in the Member States, and it might have minor implications at EU level. In particular, the EU will bear the costs related to producing the green paper (M2.1) and designing and implementing the campaign to discourage companies from publishing quarterly reporting and earnings guidance (M2.2). It is not possible to provide cost estimates in that regard, as the actual amount will depend on the audience engagement strategy and tools adopted for the campaign, with online contents assumed to be less expensive than live events, especially considering the large number of companies to be targeted.

#### *5.2.2.2 Assessment by criteria*

Criteria	Rate
Effectiveness	+0.5
Efficiency	0
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option A2 would be **effective to a very small extent** in strengthening the role of directors in pursuing company's long-term interests.

M2.1 would help stimulate a wider public debate on long-term investment and shareholding, and support the Commission in the preliminary identification of possible policy measures to be further analysed, while M2.2 would raise awareness in market participants (both companies and investors) about the "side effects" of quarterly disclosure and earning guidance in terms of corporate short-termism, and possibly persuading them to abandon these market practices. The combined effects of these measures might start a process of discussion and reconsideration of current practices of investors' engagement with investee companies and disclosure of financial information that put pressure on corporate boards to focus on short-term financial performance. Option A2 might instigate a "cultural" change, which might produce positive effects over time and result in reduced short-term pressure on directors.

However, the effectiveness of option A2 would be very limited. First, both the green paper and the campaign are soft measures, whose effects on companies and investors are difficult to predict. They could start long and heated debates, and the unfolding of their possible positive effects in terms of shareholder engagement and financial disclosure would be uncertain and take time (despite the need for urgent action to make companies more sustainable and long-term oriented). Second, it should be considered that investors might express negative views on both initiatives: on M2.1, because the green paper would discuss possibilities to depart from the "one share, one vote" principle and discuss controlling-enhancing mechanisms (such as loyalty shares) whose adoption would result in lower liquidity;<sup>182</sup> on M2.2, because discouraging companies from publishing quarterly reporting and earning guidance could be perceived by the financial markets participants (especially non-EU investors) as a signal of reduced transparency in EU capital markets, as mentioned by representatives from a corporate governance committee. Moreover, such campaign would be in contrast with existing requirements for quarterly disclosure that still exist for listed companies in some EU countries (e.g. ES, PT), which would further limit its effective implementation unless current regulatory frameworks are reformed.

### Efficiency

#### **Costs**

Option A2 is expected to **increase costs to a very small extent**.

The campaign to discourage listed companies from publishing quarterly reports and earning guidance (M2.2) would not entail the introduction of substantive obligations or requirements for companies to comply with. Therefore, it would not bring about direct compliance costs. It not expected that companies that decide to follow the campaign and stop publishing quarterly reporting will benefit from specific cost savings (as financial data will continue being collected and elaborated, even if not published), although it would free up executives' time in preparing the announcement and managing reactions from the markets.

As regards public administrations, realising the green paper (M2.1) and the campaign (M2.2) would have direct budgetary implications at EU level. Even though the amount of costs will depend on implementation choices (e.g. communication channels used, number of live events, involvement of partners, etc.) and cannot be quantified, it will be comparable in scale to similar initiatives already carried out by the Commission in the past (in other policy fields) and is not expected to be remarkable (considering that it will be targeted mainly to companies).

#### **Benefits**

Option A2 is expected to have **very limited benefits**.

Possible benefits would be mostly indirect, and their extent would depend on the how many companies will change their behaviour.

To the extent that option A2 will lead an increased number of companies to abandon quarterly reporting (following the Commission green paper) (M2.2) and adopt mechanisms that reward

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<sup>182</sup> As reported by 1 representative from investor, "Institutional investors dislike the deviation from the «one share, one vote, one dividend» principle". Moreover, as reported by 2 representatives from investors, asset managers need liquidity in stock markets, because they are contractually obliged to trade their shares if this is required by changes in market circumstances.

long-term shareholding (M2.1), pressures to focus on short-term financial performance might ease (for those companies) and corporate boards might become more long-term oriented and focused on preventing and mitigating risks and impacts at social and environmental level. However, considering that both measures would rely on voluntary initiatives by companies, they are not expected to be able to promote an extensive change in corporate practices and effectively mitigate existing pressures on directors. Expected benefits are therefore very limited.

### Coherence

Option A2 would be **coherent with other main EU policy objectives and initiatives**.

In terms of policy objectives, the Commission green paper to incentivise long-term shareholding (M.2.1) and the campaign to discourage quarterly financial disclosure by listed companies (M2.2) would pursue the aim of raising awareness about the problem of short-termism and discussing possible solutions to reduce pressure on companies to focus on short-term financial performance. Therefore, both initiatives would be in line with the declared goal of the forthcoming renewed sustainable finance strategy to strengthen companies' focus on their long-term development and sustainability aspects. These campaigns would not be in contrast with other current or foreseen policy initiatives.

### Proportionality

Option A2 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

Both the Commission green paper to incentivise long-term shareholding (M.2.1) and the campaign to discourage quarterly financial disclosure by listed companies (M2.2) would be soft policy initiatives, aimed at raising awareness about the problem of short-term pressure on corporate boards and promote a wider debate among stakeholders (companies and investors) on possible policy initiatives to address. These measures would not have legal effects on companies, but could pave the way for a cultural change (for instance on part of investors) and for more incisive EU action in the future. Option A2 is not expected to create disproportionate costs/burdens for companies and public administrations.

## 5.2.3 Assessment of option B2

<b>B2</b>	<ul style="list-style-type: none"> <li>- Commission recommendation for Member States to amend their national regulatory frameworks and provide for mechanisms to incentivise longer shareholding periods (M2.3)</li> <li>- Commission led/funded campaign to discourage listed companies to publish earnings guidance and returns on a quarterly basis (M2.2)</li> </ul>
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### 5.2.3.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	No change
Impacts on companies	0
Economic impacts	-0.5
Social impacts	+0.5
Environmental impacts	+0.5
Impacts on fundamental rights	+0.5
Impacts on public administrations	0

### Expected degree of change in the national regulatory frameworks

Option B2 would bring **no changes in the national regulatory frameworks**.

As described under option A1, the main aspect covered through the legal analysis of the regulatory frameworks is the disclosure of quarterly returns. In this regard, only in Portugal and Spain there is an obligation to disclose quarterly returns. Specifically, in Spain, listed companies, whose stock or securities are admitted to trade on regulated secondary markets or any regulated

market domiciled in the EU, must disclose a mid-term management statement on a quarterly basis, and in Portugal, only certain listed companies which are credit institutions and financial companies, are obligated to file quarterly returns.

In light of the very limited number of Member States where there is an explicit requirement for disclosure, potential changes to the current regulatory frameworks would be minimal. Moreover, considering the non-binding nature of the Commission led/funded campaign to discourage listed companies to publish earnings guidance, it is likely to assume that option A2 would not affect the current situation and hardly bring changes to it.

### Impacts on companies

Option B2 would have a **no relevant impact on companies**.

It is unlikely that a campaign to discourage listed companies to publish earnings guidance and returns on a quarterly basis (M2.2) leads companies to stop these practices, as they will need to respond to persisting demands by investors and other company stakeholders. No major cost saving is expected at company level through this measure.

The Commission recommendation for Member States to amend their national regulatory frameworks and provide mechanisms to incentivise longer shareholding periods (M2.3) could lead to investors with short term horizon to disinvest from companies that adopt such mechanisms, reducing the liquidity of secondary markets with impacts in primary markets, deteriorating the business environment, and leading to increased costs associated with financing needs. In the opposite direction, the measures incentivising longer shareholding periods could help discriminate short-term from long-term shareholders, and reward the loyalty of the latter. By engaging shareholders on a long-term basis, companies could more easily focus on long-term growth, which gradual benefits in terms of higher revenues, earnings and market capitalisation (as also shown by the literature).<sup>183</sup>

As the recommendation would allow flexibility in the adoption of measures by the Member States, the possible negative effects identified could be mitigated by adopting "softer" measures in the Member States where capital markets are more relevant as sources of capital. Assuming that these costs would be mitigated effectively, the positive effects, although more visible in the long term, could offset the costs incurred by companies in the short/medium term.

### Economic impacts

Option B2 would have a **very small negative economic impact**.

The economic impacts of Option B2 would depend on the degree to which each Member State adopts the envisaged recommendations and on the size and dynamism of the capital market in each country. An heterogeneous adoption of these measures across the EU would reduce the attractiveness of the capital markets of the Member States that strictly follow the recommendations, creating different competition conditions within the Internal Market, and could divert capital to more attractive foreign markets.

The measures to incentivise longer shareholding periods will affect the functioning of capital markets, which need all the types of shareholders to ensure the capital flows and liquidity. Liquidity constraints could negatively affect company's business environment, trade flows and competitiveness, while assuming a longer-term business perspective in company decision-making could increase the level of investment and long-term levels of competitiveness, trade flows, and growth. The negative trends in capital markets are expected to outweigh, at least in short/medium term, the positive effects arising from a more longer-term approach.

The expected economic impact of the discouragement of quarterly returns and earnings guidance reports is not high because, as mentioned above, a campaign is not expected to leverage a remarkable change in current behaviours of market participants (investors, shareholders and

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<sup>183</sup> KPMG (2019), 'Winning strategies for the long term'.

analysts will continue pressurising companies for having quarterly financial information, and most companies will continue responding positively to such demands).

### Social impacts

Option B2 would have a **very small positive social impact**.

Option B2 might have indirect beneficial effects at social level – in particular on employees and communities – by increasing directors' focus on long-term value creation and the mitigation of negative social impacts. At the same time, considering that currently loyalty shares are already legally available to companies in some European countries (e.g. Belgium, France, Italy, and the Netherlands) and that quarterly reporting is not mandatory under EU law, this option is not expected to be sufficiently strong to have a significant impact on current corporate practice, including in terms of possible social effects. As a consequence, any social impact from option B2 is expected to be very small.

### Environmental impacts

Option B2 would have a **very small positive environmental impact**.

Considering the legal availability of loyalty shares in some Member States and that quarterly reporting is not mandatory under EU law, option B2 might have indirect positive impacts at environmental level by increasing directors' focus on long-term value creation and the mitigation of negative environmental externalities. However, it would be too weak to bring about remarkable changes in the status quo. At the same time, option B2 is not expected to have a negative environmental impact. Therefore, option B2 would have a small positive impact at environmental level.

### Impacts on fundamental rights

Option B2 would have a **very small positive impact on fundamental rights**.

Option B2 is not expected to have impacts on fundamental rights. To the extent that related provisions will be introduced at national level and influence the behaviour of listed companies, they might incentivise a longer-term approach by directors and greater attention to sustainability aspects - including fundamental rights. However, considering the non-binding nature of this measure and the indirect nature of its consequence on fundamental rights, such development is expected to be very small.

### Impacts on public administrations

Option B2 would have **no impacts on public administrations**.

The measure will not significantly impact national public authorities, while it might have minor implications at EU level. The recommendation (M2.3) might bring an administrative burden at the EU level in a situation in which different Member States apply different laws, as EU bodies may need to follow and monitor national initiatives and possibly facilitate some type of information exchange. On the campaign to discourage companies from publishing quarterly reporting and earnings guidance (M2.2), the EU will bear the costs related designing and implementing it. It is not possible to provide cost estimates in that regard, as the actual amount will depend on the audience engagement strategy and tools adopted for the campaign, with online contents assumed to be less expensive than live events, especially considering the large number of companies to be targeted.

#### 5.2.3.2 Assessment by criteria

Criteria	Rate
Effectiveness	+1
Efficiency	0
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option B2 would be **effective to a small extent** in strengthening the role of directors in pursuing company's long-term interests.

Compared to option A2 (with whom it shares M2.2), option B2 could be slightly more effective in achieving the stated objective. Though without legal force, a Commission recommendation for Member States to introduce in their respective legal frameworks mechanisms for companies to incentivise longer shareholding periods would have more "political weight" than a campaign and could be expected to be more impactful (i.e. to determine a relatively more immediate and widespread change on the ground, as a result of Member States implementation). At the same time, a number of factors that might reduce the effectiveness of this measure are worth considering. First, mechanisms to incentivise longer shareholding periods are already legally available to companies in some EU countries (e.g. loyalty shares in BE, FR, IT, NL), which are not expected to follow up on the recommendation (unless they decide to introduce additional mechanisms). Second, even though this option has been indicated as the preferred line of action in some interviews – mainly by virtue of its flexibility and non-regulatory nature,<sup>184</sup> the concerns for the possible negative effects of recommended measures on market functioning (in terms of reducing the dynamism and attractiveness of capital markets vis-à-vis foreign markets) would remain, which would reasonably disincentivise its application by the Member States. Therefore, option B2 is expected to be effective only to a limited extent.

### Efficiency

#### **Costs**

Option B2 is expected to **increase costs to a very small extent**.

The Commission recommendation (M2.3) would not entail the introduction of substantive obligations or requirements for companies to comply with. The main addressee of the recommendation would be the Member States, which would be invited to make available to companies at national level mechanisms to incentivise longer-shareholding periods. In EU countries where the recommendation is adopted, some companies might decide to adopt such mechanisms (e.g. loyalty share) and bear the related adaptation costs (linked to the process of modifying their articles of association). Such costs would be indirect (not directly related to option B1, but rather to its national adoption, and company's implementations choices), and are impossible to quantify ex ante. Option B2 might lead some short-term investors to disinvest from companies that adopt mechanisms such as loyalty shares, increasing costs associated with financing needs in the short/medium term. In the longer-term, this cost increase could be offset by benefits in terms of higher revenues, earnings and market capitalisation linked to a greater focus on long-term growth.

As regards public administrations, realising the campaign to discourage listed companies from publishing quarterly reports and earning guidance (M2.2) would have direct budgetary implications at EU level. Even though the amount of costs will depend on implementation choices (e.g. communication channels used, number of live events, involvement of partners, etc.) and cannot be quantified, it will be comparable in scale to similar initiatives already carried out by the Commission in the past (in other policy fields) and is not expected to be remarkable (considering that it will be targeted mainly to companies).

#### **Benefits**

Option B2 is expected to have **very limited benefits**.

At economic level, the Commission recommendation for Member States to introduce in their domestic frameworks mechanisms for companies to incentivise longer shareholding periods (M2.3) might have mixed effects. On one hand, the application of different rules and conditions by the Member States might further deepen the differences across the Internal Market, with adverse consequences on internal competition and attractiveness of EU capital markets (as

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<sup>184</sup> Interviews with representatives from 1 trade union, 1 investor, 1 corporate governance code committee, and 4 companies.



short-term investors might divert capital flows towards more dynamic capital markets). On the other, a more stable and long-term shareholder base might reduce the potential for instability and allow corporate boards to focus on the long-term success of their companies (e.g. through increased investments and R&D expenses), with beneficial effects for the resilience and sustainability of EU economy as a whole. Of course, the extent of possible effects would depend on how many Member States will implement the recommendation and in which way, and how many companies will choose to adopt mechanisms to incentivise longer shareholding periods. Certain mechanisms (e.g. tax incentives) can be expected to have less distortive effects, as they would not affect the relation between shares and voting rights.

As for possible benefits at social, environmental, and fundamental rights level, to the extent that M2.2 and M2.3 will be able to influence the behaviour of a large number listed companies, they might incentivise a longer-term approach by directors and promote to greater attention to sustainability aspects at board level. However, considering that quarterly reporting is already optional, that mechanisms such as loyalty shares already available in some Member States, and that option B2 would lack binding legal force, possible indirect benefits are expected to be very small.

### Coherence

Option B2 would be **coherent with other main EU policy objectives and initiatives**.

The Commission campaign (M2.2) would be consistent with EU policies, as already mentioned under option A2. Similarly, the recommendation on the adoption of mechanisms to incentivise longer shareholding periods would be in line with the goal of strengthening companies' focus on their long-term development and sustainability aspects, which will be set in the forthcoming renewed strategy on sustainable finance.

In terms of consistency with other EU initiatives, the Commission recommendation under option B2 (M2.3) would not be in contrast with the Shareholders Rights Directive II (Directive (EU) 2017/828). The Commission's interest in enhancing shareholder long-termism dates back to 2011, when the Reflection Group on the Future of EU Company Law recommended a clear EU framework to ensure that companies all across the EU have the option to include clauses allowing for differential voting rights or additional profit distribution rights in their Articles of association.<sup>185</sup> Even though this recommendation was not implemented in following policy developments, the proposal to introduce in EU law specific mechanisms to reward the loyalty of long-term shareholders came up again during the discussions on the amendment of the Shareholders Rights Directive (MEP Sergio Cofferati, rapporteur for the Committee on Legal affairs of the European Parliament at the time, proposed an amendment requiring Member States to put in place mechanisms to promote shareholding on a long-term basis, including tax incentives, loyalty dividends, and loyalty shares).<sup>186</sup> Even though this amendment was not included in the Shareholder Rights Directive II, the proposed recommendation would be consistent with its objective of improving corporate governance via encouraging long-term shareholder engagement.

### Proportionality

Option B2 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

The recommendation (M2.3) would not have legal force on the Member States, which would be left with the flexibility to choose the modalities to implement Commission suggestions (e.g. in terms of mechanisms made available to companies). Pursuant to the recommendation, an increased number of EU countries might decide to allow the use of such mechanisms, which

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<sup>185</sup> Reflection Group on the Future of EU Company Law (2011), Report of the Reflection Group on the Future of EU Company Law.

<sup>186</sup> Report on the proposal for a directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (COM(2014)0213 - C7 0147/2014 - 2014/0121(COD)). Available ([here](#)).

would ensure more stability and long-term orientation to companies. At the same time, the potential of option B2 to address the problem satisfactorily appears limited, as the recommendation would be non-enforceable and its possible application different across Member States. As regards the campaign to discourage companies from publishing quarterly reports and earnings guidance (M2.2), the same considerations already made for option A2 would apply. Option B2 is not expected to create disproportionate costs/burdens for companies and public administrations.

## 5.2.4 Assessment of option C2

<b>C2</b>	<ul style="list-style-type: none"> <li>- Commission proposal to amend the Shareholder Rights Directive II to introduce binding rules requiring Member States to introduce mechanisms to incentivise longer shareholding periods (M2.4)</li> <li>- Commission proposal to amend the Transparency Directive to prohibit both earning guidance and quarterly reporting for listed companies (M2.5)</li> </ul>
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### 5.2.4.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	Large
Impacts on companies	-1
Economic impacts	-1
Social impacts	+1
Environmental impacts	+1
Impacts on fundamental rights	+1
Impacts on public administrations	0

### Expected degree of change in the national regulatory frameworks

Option C2 would bring **significant changes in the national regulatory frameworks**.

The proposed amendments to the Shareholder Rights Directive II and the Transparency Directive, to introduce a requirement to develop at the national level mechanisms to encourage long-term shareholding (M2.4) and a prohibition of earning guidance and quarterly reporting for listed companies (M2.5) requires several Member States to adopt their national laws and regulations to integrate the new requirements. This is further confirmed by two interviewees representing a corporate governance committee and a trade union.

### Impacts on companies

Option C2 would have a **moderate negative impact on companies in the short term, while in the long term it is expected to be positive**.

A Commission proposal to amend the Shareholder Rights Directive II to introduce binding rules requiring Member States to introduce mechanisms to incentivise longer shareholding periods (M2.4) may reduce the liquidity of companies (as incentives to hold stocks would result in less free float) and make them less attractive for investors that have a preference for liquidity, possibly leading to increased costs associated with financing needs (higher cost in financing markets in EU and/or financing outside EU and lowering the dynamism in internal markets). Given the binding nature of this option, it is expected a higher burden for companies compared to option B2, as the flexibility for Member States to adapt recommendations would not be applicable and all companies will have to comply with the same rules. The burden for investors and companies induced by this option could encourage them to go outside the EU.

In the opposite direction, the measures incentivising longer shareholding periods would promote long-term investors and help companies to focus on long term growth (e.g. through increased investments). Such measures would not only attract a more long-term investor base, but also encourage investors to study the companies' long-term prospects more closely, going beyond short-term numbers. With a more stable and long-term shareholder base, corporate boards

would be less pressured to focus on strategies to improve short-term market valuation and have more room to focus on more sustainable choices for resource allocation that might pay-off in the long-run and contribute to keeping the company productive, innovative, profitable and attractive in the long term, with possible positive consequences in terms of (long-term) shareholder value and employee satisfaction.

A Commission proposal to amend the Transparency Directive to prohibit both earning guidance and quarterly reporting for listed companies (M2.5) could allow corporate managers of listed companies to focus on developing and implementing strategies that spur growth, profitability, and long-term corporate value, rather than on managing quarter-to-quarter reported results and market expectations. Empirical evidence<sup>187</sup> shows that short-term earnings management aimed at "making the numbers" can lead companies to defer valuable projects or decrease R&D expenditures, which might negatively affect their long-term growth. M2.5 might thus help executives and directors focus on long-term value creation. However, it is also argued that M2.5 could have a negative effect on investors' confidence and on the functioning of the capital markets, impacting the financing capacity of listed companies. Many interviewees representing investors, companies and corporate governance committees stressed the importance of quarterly reporting for financial markets. Timely updates of information are required in order to be reflected in the share prices as soon as possible and to promote transparency. Properly functioning capital markets are also an important source of financing for companies. Moreover, quarterly financial reporting is an important source of information for investors, in absence of which investments could be diverted to other markets. Of course, the effects of this measure would be less relevant for non-listed companies and for listed companies that have already ceased quarterly financial reporting.

### Economic impacts

Option C2 would have a **moderate negative economic impact in the short term, while in the long term the impact is likely to be positive.**

In a scenario in which a large share of EU listed companies decide to adopt such mechanisms (in particular the loyalty shares), the proposal to introduce mechanisms to incentivise longer shareholding periods for companies in all Member States (M2.4) could affect the proper functioning of capital markets by reducing stock market liquidity, possibly diverting capital to more attractive foreign markets outside EU, with adverse consequences on overall financing conditions for economic actors.

The prohibition for listed companies to publish quarterly returns (M2.5) could also have a negative economic impact, as it could be perceived by (foreign) investors as reducing transparency in capital markets and might lead them to deviate capital flows to external markets, as explained above.

On the other hand, these bidding measures would create a level playing field compared to the current situation, and would allow corporate boards to focus more on long-term results. Allocating resources with a long-term horizon (e.g. in R&D) would positively contribute to the long-term innovative capacity of the economy and productivity growth, thus bringing positive macroeconomic effects. These measures would favour the increase of investment and, therefore, the long-term levels of competitiveness, trade flows, employment and economic growth.

The negative effects in capital markets are expected to outweigh, at least in short/medium term, the positive effects arising from a more longer-term approach.

### Social impacts

Option C2 would have a **small positive social impact.**

The prohibition for listed companies to publish quarterly returns (M2.5) and the requirement to introduce at national level mechanisms for companies to incentivise long-term shareholding

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<sup>187</sup> See Graham, J. R., Harvey, C. R., & Rajgopal, S. (2006), 'Value destruction and financial reporting decisions'. *Financial Analysts Journal*, Vol. 62, Issue 6, pp. 27-39.

(M2.4) might be expected to ease pressures from markets and investors and support a switch of corporate directors' focus from the short to the long term. In this way, option C2 could also have an indirect positive effect by leading directors to identify and address more closely sustainability issues connected to the long-term development of the company, including the social impacts on employees, communities and consumers in business own operations and supply chains. Since not all companies currently publish quarterly returns (as this is not mandatory) and the possibility for companies to adopt mechanisms to incentivise longer shareholding periods already exists in some countries (e.g. BE, FR, IT, NL), the indirect impact of option C2 at social level is still expected to be small, although relatively larger than options A2 and B2 due to the binding force of its measures.

### Environmental impacts

Option C2 would have a **small positive environmental impact**.

Option C2 might contribute to ease some pressure faced by directors to focus on short-term financial performance. While this is not expected to have any negative consequence at the environmental level, it might result into indirect beneficial effects compared to the baseline, for instance in terms of corporate directors' increased focus on long-term company sustainability, including on environmental matters (including on climate, natural capital, circular economy and resource efficiency). However, similarly to social impacts, the extent of such indirect impact at environmental level might be expected to be quite small.

### Impacts on fundamental rights

Option C2 would have a **small positive impact on fundamental rights**.

Option C2 is not expected to have consequences on fundamental rights. The combined binding effects of these amendments may ease the pressure on company directors to maximise short-term shareholder value at the expense of the long-term company's interest and environmental and social considerations, including long-term impacts on fundamental rights in company's operations or (global) value chain. However, specific positive consequences in that regard would be only indirect and quite small, as already explained for social and environmental impacts. Therefore, also the likely impact of options C2 on fundamental rights is assessed to be small.

### Impacts on public administrations

Option C2 would have **no impacts on public administrations**.

Option C2 will not significantly impact national public authorities, nor implications at EU level. The monitoring of the application of the measures required under this option would follow the current functioning of the corporate governance monitoring, with little role for public authorities.

#### *5.2.4.2 Assessment by criteria*

Criteria	Rate
Effectiveness	+1.5
Efficiency	0
Coherence	Yes
Proportionality	No

### Effectiveness

Option C2 would be **effective to a moderate extent** in strengthening the role of directors in pursuing company's long-term interests.

Option C2 would apply to all European issuers and address a key source of short-term pressures on corporate boards in all Member States. Due to its obligatory power and generalised application, option C2 would be more effective than option A2 and B2 in achieving the identified objective.

Even though it is not mandatory under the current EU regulatory framework, quarterly reporting is a key driver behind short-term pressure,<sup>188</sup> and a campaign might not be sufficient to convince companies to voluntarily change this practice,<sup>189</sup> especially if they lack support from their investors or are afraid of possible negative reactions from the markets. As underlined by different interviewees,<sup>190</sup> only a prohibition could be effective in stopping all listed companies from these practices. The possible negative consequences of such a prohibition in terms of the trust and confidence of capital markets should be closely considered.<sup>191</sup> As concerns the amendment to the Shareholder Rights Directive II, it would be more effective than a non-binding recommendation, as it would oblige all Member States to make available to companies options to reward long-term shareholders (for instance loyalty shares, time-weighted dividends, or tax incentives on linked to the length of shareholding). If all EU listed companies would have this possibility, option C2 could lead to an increased number of companies opting for the adoption of said mechanisms in their articles of association, thereby incentivising shareholding on a long-term basis.

At the same time, some possible problems stemming from the adoption of this measure have been highlighted during the interviews. First, if mechanisms such as loyalty voting rights and loyalty dividends is linked to shares to be held in registered form, this might constitute an obstacle for (cross-border) institutional investors who do not usually hold their shares in registered form, and might preclude them from accessing the benefits of loyalty shares and loyalty dividends.<sup>192</sup> As reported by an investor interviewed, "*Only in the situation of not being obliged to register the shares, the loyalty voting right mechanism could also work for institutional investors*". Second, and related, the increased adoption of loyalty shares to reward long-term shareholding would create additional locks on control by majority shareholders (typically founders and families), who would be the primary beneficiaries of their adoption,<sup>193</sup> and reduce the liquidity of stock markets, penalising those investors (e.g. asset managers) who are under a contractual obligation to sell shares if the market conditions so require. Compared to other mechanisms, tax incentives have been indicated in some interviews with representatives from a corporate governance committees, investors, and companies as a more viable option to reward loyal shareholders.

Some interviewees representing 2 corporate governance committees also underlined that the Shareholder Rights Directive has been revised and transposed only recently, so it should be given the time to produce its effects in terms of promoting long-term shareholder engagement before introducing an additional amendment.<sup>194</sup>

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<sup>188</sup> Interview with representatives from 1 company.

<sup>189</sup> Interview with representatives from 1 corporate governance committee and 1 investor.

<sup>190</sup> Option C2 has been indicated as the preferred line of action by 5 representatives from companies.

<sup>191</sup> Interview with 1 investor.

<sup>192</sup> On this matter, a consultation on loyalty-driven securities carried out by Mercer, Stikeman Elliott LLP, and the Generation Foundation found the following: "A recurring perspective from those interviewed who were familiar with the usage of loyalty-driven securities in France was that the process to register for the reward was overly cumbersome and complex for institutional investors. [...] Investors that were interviewed cited difficulties in registering and the potential time lag associated with de-registering as limiting the attractiveness of loyalty shares and imposing liquidity constraints. This was also confirmed by a French issuer (that provides a loyalty bonus dividend to registered shareholders of longer than two years) that suggested the existing process was "unfriendly" to large, institutional investors and particularly those outside of France". Mercer, Stikeman Elliott LLP, and the Generation Foundation (2013), *Building a Long-Term Shareholder Base: Assessing the Potential of Loyalty-Driven Securities*, p. 12-13. Available at <https://www.warren.senate.gov/imo/media/doc/Accountable%20Capitalism%20Act%20One-Page.pdf>.

<sup>193</sup> Interviews with representatives from 1 corporate governance committee and 1 investor.

<sup>194</sup> A similar point is made also in the recent ESMA report: "ESMA points out that the regulatory framework was not only recently modified, but the goal and rationale underpinning the modifications clearly recognise the importance of reducing potential undue short-term pressures from investors to corporates and their management. Therefore, in line with the Commission's better regulation agenda, there might be merit in further observing the impact of SRD II before considering revisions." See ESMA (2019), *cit.*, p. 67.

## Efficiency

### **Costs**

Option C2 is expected to **increase costs to a small extent**.

Amending the Transparency Directive by prohibiting listed companies from publishing earning guidance and quarterly reporting (M2.5) would not impose direct compliance costs on companies, which would continue elaborating financial data and forecasts (even without disclosing it quarterly). However, indirect costs could be created as a prohibition would reduce the flexibility of issuers to respond to investors that demand quarterly reports.<sup>195</sup> As highlighted by an investor, companies might have very good reasons to report frequently to the market, for instance companies in financial distress might really need to report quarterly to the market to maintain the trust from investors. Especially in such cases, a prohibition might lead investors to disinvest from a company, reducing its liquidity and increasing the costs associated with financing needs. As highlighted for option A2, a positive side-effect would be saving executives' time linked to preparing the announcement of quarterly financial performance and managing the reactions of the markets. As regards amending the Shareholder Rights Directive II by introducing a requirement to make available at national level mechanisms for companies to encourage long-term shareholding (M2.4), the impact on costs borne by companies is expected to be substantially the same as under option B2, but under this option Member States would have less room for adapting the application of the measure to their respective national context (compared to implementing a non-binding recommendation).

As regards public administrations, neither M2.4 nor M2.5 would have direct budgetary implications at EU level or national level.

### **Benefits**

Option C2 is expected to have **limited benefits in the short term, while in the long term possible benefits are expected to be larger**.

At economic level, the combined effects of option C2 would be complex and difficult to predict. M2.4 and M2.5 might be expected to reduce the attractiveness of EU capital markets, by reducing transparency for shareholders and investors (as earnings guidance and quarterly reports would stop) and possibly the liquidity of EU stock markets (in case mechanisms such as loyalty shares are increasingly adopted by a large share of EU listed companies). These (short-term) adverse effects could potentially be offset by long-term benefits (e.g. availability of patient capital, intensified investment and R&D expenditures, contributing to a more innovative and resilient EU economy). The net effect would ultimately depend on the number of companies choosing to adopt loyalty shares (as opposed to other mechanisms that might have limited effects on market liquidity, such as decreasing capital tax gains over time) and, more in general, on the dynamics of the financial markets (as liquidity-oriented investors could be replaced by long-term investors focused on companies' long-term outlook).

Option C2 might reduce pressures on corporate boards of EU listed companies to focus on short-term financial performance and allow them to take a longer-term perspective in managing business and addressing risks and impacts, which might have indirect beneficial effects at social, environmental, and fundamental rights level. However, indirect impacts in that regard are expected to be small, considering that currently not all companies publish quarterly returns (as this is not mandatory) and the possibility for companies to adopt mechanisms to incentivise longer shareholding periods already exists in some countries (e.g. Belgium, France, Italy, and the Netherlands).

## Coherence

Option C2 would be **coherent with other main EU policy objectives and initiatives**.

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<sup>195</sup> Interviews with representatives from 1 corporate governance committee.

Option C2 would be aligned with the goal of strengthening companies' focus on their long-term development and sustainability aspects, which will be set in the forthcoming renewed strategy on sustainable finance.

As illustrated under option B2, the inclusion of a provision on the compulsory introduction of mechanisms to promote shareholding on a long-term basis has been already suggested by the European Parliament during the negotiations for amending the Shareholder Rights Directive. By fostering shareholders' long-run commitment to companies, M2.4 would be in line with the Shareholder Rights Directive II objective of encouraging long-term shareholder engagement.

Amending the Transparency Directive to prohibit both earning guidance and quarterly reporting for listed companies (M2.5) would not impair not affect the application of the Market Abuse Regulation,<sup>196</sup> which require issuers to disclose inside information that is likely to have a significant effect on the prices of financial instruments listed on regulated markets (Article 17). In fact, the prohibition of quarterly financial statements would not impact on the need for issuers to consider the disclosure of price-sensitive information.

### Proportionality

Option C2 would **not respect the principle of proportionality** as it would go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

As highlighted in five interviews with representatives from corporate governance committees, amending the Transparency Directive to prohibit both earnings guidance and quarterly reporting for listed companies (M2.5) could be disproportionate because (i) quarterly reporting is already a voluntary practice under the current EU framework (i.e. companies might decide to depart from it anytime), (ii) prohibiting it could impair issuers' capacity to react to investors' demands and disclose information in the way deemed more appropriate to meet investors' expectations, especially considering that (iii) under certain conditions (e.g. financial distress), companies might want to disclose information more frequently not to lose investors' trust. Moreover, also amending the Shareholder Rights Directive II by introducing a requirement to make available at national level mechanisms for companies to encourage long-term shareholding (M2.4) could raise proportionality concerns. While this measure would promote a more consistent EU level approach to the matter (currently regulated differently by the individual Member States) and ensure that companies across Member States can choose to adopt some mechanisms to encourage long-term shareholding, their generalised application by companies (in particular the use of control-enhancing loyalty shares) might have far-reaching consequences in terms of reducing the liquidity of companies and the attractiveness of EU capital markets for investors. Due to the limitations it would impose on companies and the adverse consequences in terms of transparency and attractiveness for investors, option C2 would be disproportionate vis-à-vis the problem of reducing pressures from investors on boards and promote long-termism in companies.

## **5.3 Driver 3 – Companies lack a strategic perspective over sustainability and current practices fail to effectively identify and manage relevant sustainability risks and impacts**

### **5.3.1 Baseline**

In absence of EU intervention, the adoption, disclosure and implementation of a forward-looking sustainability strategy, encompassing measurable sustainability targets, will remain a voluntary practice. Therefore, the current situation, whereby only certain companies voluntarily commit themselves to greater sustainability by adopting a sustainability strategy with science-based targets and KPIs aligned with global goals, while the majority do not, will not substantially change. Similarly, gaps in the identification and mitigation of risks and impacts will persist across

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<sup>196</sup> Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC

sectors, with certain sectors (e.g. the food and oil and gas sectors) showing a relatively more mature approach than others in terms of the identification and the management of their sustainability risks and impacts.

From an economic perspective, this state of affairs leads to an uneven playing field where companies leading the market on sustainability issues have to compete against companies that do not bear the costs of similar efforts, and do not make measurable contributions to overarching goals (such as the SDGs). Although it can be imagined that the number of companies adopting a sustainability strategy encompassing measurable targets might increase in the future as a result of peer pressure, customers' demands, or the success of voluntary initiatives such as the Science Based Targets Initiative, the current fragmentation will persist and the playing field will not become more even in the EU market, with negative effects on business competition within and across Member States. The lack in many companies of a forward-looking sustainability strategy aimed at identifying, mitigating and addressing the sustainability risks also means that these companies will remain exposed to important social and environmental risks threatening their future profitability and reputation (with potentially negative consequences for the shareholders and other stakeholders). Moreover, many companies will fail to pursue sustainability opportunities in new markets and products and take advantages from cutting costs (e.g. through increased resource efficiency).

From a social and environmental perspectives, the main effects of the persistence of this problem relate to the failure of companies to become progressively more sustainable by working towards measurable and science-based sustainability targets linked to overarching global goals, such as the objectives of the Paris Agreement on climate change or the SDGs, with negative consequences on (i) the monitoring of their contributions and (ii) the final attainment of these goals. The limited availability of data on companies' contributions to these goals might also have a negative impact on policy-makers, as it will continue complicating the monitoring of overall progresses towards their achievement and the elaboration of evidence-based policy measures, either at Member State or EU level.

### 5.3.2 Assessment of option A3

<b>A3</b>	<p><i>Commission guidance document for boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy, to identify and set as part of the business strategy measurable, specific, time-bound, and science-based sustainability targets aligned with overarching goals (such as the SDGs and the goals of the Paris Agreement on climate change), and to disclose appropriate information. The guidance document would be accompanied by a dissemination campaign (M3.1).</i></p> <p><i>This measure would complement and contribute to the implementation of the duty referred to in M1.1 (Commission -led/funded awareness-raising campaign aimed at promoting the principle that identifying and mitigating sustainability risks and impacts, both internal and external, is part of directors' duty of care)</i></p>
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#### 5.3.2.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	Small
Impacts on companies	0
Economic impacts	+0.5
Social impacts	+1
Environmental impacts	+1
Impacts on fundamental rights	+1
Impacts on public administrations	-0.5

#### Expected degree of change in the national regulatory frameworks

Option A3 would bring **small changes in the national regulatory framework**.

A non-binding guidance document for boards providing for measures to i) integrate sustainability aspects (risks, opportunities, impacts) into the business strategy and ii) to identify and set



measurable, specific, time-bound, and science-based sustainability targets aligned with overarching goals (such as the SDGs and the goals of the Paris Agreement), and to disclose appropriate information, would bring limited changes to the baseline scenario as, despite the changes would potentially affect a high number of Member States, the non-binding nature of the guidance document would lack force to change the status quo, and companies less incline to change might still prefer not to integrate sustainability aspects into their business strategy.

In all 12 Member States in scope with the exception of Italy, the integration of sustainability aspects into the business strategy is not required. In Italy, Law no. 208 of 28 December 2015, applicable only to Italian Benefit corporations, includes the obligation to develop a sustainability strategy and to appoint a person liable for pursuing the common benefit purposes. However, with reference to general profit-making companies, in IT directors do not have an obligation to develop sustainability strategies.

The Commission guidance document is expected to be of help to better understand the importance of sustainability aspects, but it will likely engender limited changes to the national regulatory framework given its non-binding nature.

### Impacts on companies

Option A3 would have **no impact on companies**.

Option A3 should raise awareness among companies about the importance of considering sustainability into the business strategy and could be an enabler for companies who already wanted to take this kind of measures, especially if the guidelines incorporate sector-specific issues.

Although interviews with 15 representatives from companies, investors, and corporate governance committees confirm that there is a rising awareness of the importance of sustainability (higher on specific sectors who are subject to stricter rules concerning, for example, environment protection, and on larger enterprises), the literature highlights that the majority of companies lack a real integration of sustainability into their business strategy.

For companies following the guidance, the setting up and monitoring of KPIs always have costs associated (essentially time spent in collecting information and reporting), which will be higher depending on the complexity of KPI considered and if external assurance is used. Benefits can occur in short term if clients (along the value chain) recognise the value of integrating sustainability into business strategies and would be higher for first movers.

As the guidelines are not mandatory, even if they are too complex for companies (namely for the smaller ones) there is margin of flexibility for implementation and that would lower the compliance costs and also the expected benefits, thus we can consider the policy would have no significant impact on companies.

### Economic impacts

Option A3 would have a **very small positive economic impact**.

As this option is not mandatory for companies, the impacts on economy would depend upon the level of application of the guidelines. As it is expected flexibility on the application of the guidelines, cost increase at company level could be mitigated, limited benefits could arise in the long term with more competitiveness resulting from costs avoided by early risks detection, by rising investment, and by differentiation in the market, which can favour trade flows. However, this option would not substantially address the current uneven playing field, leaving the competitive advantage with unsustainable businesses, which would continue "free-riding" on the efforts of more sustainable companies.

### Social impacts

Option A3 would have **small positive social impact**.

This option would provide companies with an additional resource to integrate sustainability aspects into their business strategy and set specific, measurable, time-bound and sustainability

targets aligned with overarching, global goals. A new guidance document would be added to the existing voluntary initiatives and frameworks (such as the Science Based Targets initiative, UN Net-Zero Asset Owner Alliance,<sup>197</sup> Principles for Responsible Banking<sup>198</sup>) to support companies and investors in achieving greater sustainability by setting relevant targets. As noted by an interviewee representing an NGO, such initiatives are increasingly spreading<sup>199</sup> but, being voluntary, might not guarantee a change in corporate practices that is substantial and rapid enough vis-à-vis the pressing social challenges that need to be addressed, for instance the rising inequalities, as discussed in section 3.1.2.2. Thus, even if no negative social impact can be foreseen by this option, the positive social impact would be quite small, as option A3 would probably influence primarily those companies that are already at the leading edge of sustainability and willing to further improve on social issues, while competitors that currently underestimate or even ignore social issues would remain unaffected as they are by existing voluntary initiatives.

### Environmental impacts

Option A3 would have **small positive environmental impact**.

By providing companies with guidance on how to integrate sustainability aspects into their business strategy and identify and set specific, measurable, time-bound and science-based sustainability targets, option A3 would offer companies an additional resource to help them better address sustainability risks, opportunities and impacts in their own business and supply chain, including at environmental level. For instance, this measure might prompt wider adoption of GHG emission reduction targets in line with what is necessary to meet the goals of the Paris Agreement (i.e. to limit global warming to well-below 2°C above pre-industrial levels and pursue efforts to limit warming to 1.5°C) and the setting of measurable targets in relation to energy efficiency and resource intensity of the production (in line with SDG #12). At the same time, as highlighted for the social impacts, currently a number of guidelines and voluntary initiatives are already available to companies, and even though the additional guidance under option A3 (combined with peer pressure and external scrutiny) might give a push in the direction of further embedding sustainability into business strategies, this voluntary measure is expected to be most effective for those companies that already show commitment to and leadership in sustainability, while being too weak to instigate a wider corporate action on climate and the environment.

### Impacts on fundamental rights

Option A3 would have a **small positive impact on fundamental rights**.

On the one hand, the creation and dissemination of guidance for the integration of sustainability aspects into the business strategy and the identification and setting of specific, measurable, time-bound and sustainability targets would provide companies with a useful additional resource to work on the identification, prevention and mitigation of adverse sustainability impacts, including on fundamental rights, in own business operations and/or along their (global) value chains. The momentum created by this initiative, combined with competitive pressures and external scrutiny, might prompt companies to come up with adequate sustainability aspects in their business strategies and specific sustainability targets, with positive effects also on respect for fundamental rights (including as regards the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour in third countries).

On the other hand, it can be observed how, on top of the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises, a number of tools and

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<sup>197</sup> A UN-convened international group of institutional investors, representing over \$4.6 trillion in assets under management, committed to transition their investment portfolios to net-zero GHG emissions by 2050, aligning them with a 1.5°C scenario, addressing Article 2.1c of the Paris Agreement, including establishing intermediate targets every five years in line with Paris Agreement Article 4.9 (see <https://www.uneepfi.org/net-zero-alliance/>).

<sup>198</sup> A framework for a sustainable banking system launched by 130 banks from 49 countries, representing more than \$47 trillion in assets, accelerating the banking industry's contribution to achieving society's goals as expressed in the SDGs and the Paris Climate Agreement (see <https://www.uneepfi.org/banking/bankingprinciples/>).

<sup>199</sup> The Science Based Targets Initiative counts 838 companies.

resources are already available to companies which are willing to identify, prevent, and mitigate their adverse sustainability impacts<sup>200</sup> and to set science-based targets.<sup>201</sup> In analysing the human rights performance of 200 of the largest global companies, the Corporate Human Rights Benchmark (CHRB) found that, in 2019, human rights due diligence (which is key to ensure corporate respect for human rights) is a major weakness for most companies, with 49% of companies scoring zero against every single human rights due diligence indicator. One-third of the 44 European companies considered failed to meet any of the five basic requirements for human rights due diligence, with 55% of companies scoring less than half marks. Even if "soft law" and guidance relying on voluntary adoption, combined with competitive pressure, might lead particularly risk-exposed or sustainability-committed companies to improve, it might not be sufficient to prompt all businesses to change.

Option A3 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option A3 would have **small negative impacts on public administrations**.

The option will not have significant budgetary consequences for national public authorities, and will have minor implications at EU level. These implications relate to (i) the cost of developing the guidance document, and (ii) the costs related to the dissemination campaign for the guidance document, but the actual amount will depend on the tools adopted for the campaign. The costs for developing the guidance document are expected to be relatively small, as the Commission could leverage on existing networks of experts to form an ad-hoc technical expert group in charge collecting and systematise the guidelines. It is not possible to provide cost estimates regarding the campaign, as the actual amount will depend on the audience engagement strategy and tools adopted for the campaign, with online contents assumed to be less expensive than live events, especially considering the large number of companies to be targeted.

#### 5.3.2.2 Assessment by criteria

Criteria	Rate
Effectiveness	+0.5
Efficiency	+0.5
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option A3 would be **effective to a very small extent** in strengthening the role of directors in pursuing company's long-term interests and improving directors' accountability for integrating sustainability into corporate decision-making.

On the one hand, by providing guidance to the companies on integrating sustainability into their business strategy and on setting sustainability targets, option A3 would raise awareness in the European business community about the "business case" of embedding sustainability aspects (risks, opportunities, impacts) into the business strategy and set adequate sustainability targets, and provide companies with a useful resource to put this in practice. Integrating sustainability considerations into the business strategy is important to ensure it has a long-term focus and takes account of the broader context and the risks that a company might face to reach its strategic goals. Option A3 would encourage companies to take sustainability on board while leaving them with the flexibility to implement the guidance in the most suitable way according to the specific business conditions (e.g. sectors, size, etc.), as mentioned by a company.<sup>202</sup> As

<sup>200</sup> For an overview of existing tools and resources, see <https://www.business-humanrights.org/en/un-guiding-principles/implementation-tools-examples/implementation-by-companies/type-of-step-taken/human-rights-due-diligence>.

<sup>201</sup> Most notably the Science Based Targets initiative <https://sciencebasedtargets.org/>.

<sup>202</sup> Interviews with representatives from 1 company.

highlighted by two interviewees,<sup>203</sup> even though most companies are still at an early stage in their ability to collect, read, and incorporate KPIs into their strategies, option A3 would work better in this phase and could prepare the ground for future policy interventions of a more binding nature. Increasing pressure for sustainability from costumers and scrutiny on ESG matters by investors could further strengthen its effects. Option A3 is indicated as the preferred line action by many interviewees.<sup>204</sup>

On the other hand, as highlighted by representatives from two NGOs interviewed, the effectiveness and overall "impact" of option A3 would be very limited, as it would simply add an additional guidance document to already existing voluntary initiatives and frameworks to support companies and investors in achieving greater sustainability by setting relevant targets (see section 5.3.2.1), without binding requirements. Even though such initiatives are increasingly spreading, providing companies with an additional guidance to be adopted on voluntary basis might not be conducive to a change in corporate practices that is substantial and rapid enough vis-à-vis pressing policy objectives (e.g. achieving the SDGs by 2030). Therefore, even though at this stage option A would represent a useful starting point and "enabler" for companies (especially the laggards) to embed sustainability aspects into their business strategies, due to its voluntary and non-enforceable nature, its effectiveness in strengthening the role of directors in pursuing company's long-term interests and improving directors' accountability for integrating sustainability into corporate decision-making would be very limited.

### Efficiency

#### **Costs**

Option A3 is expected to **increase costs to a very small extent**.

Creating and disseminating guidance on the integration of sustainability aspects into the business strategy and the identification and setting of sustainability targets would not create substantive obligations or requirements for companies. Therefore, option A3 would not impose direct compliance costs on companies, which would remain free to decide whether to align corporate practices with the guidance received or not. Companies that will choose to follow the guidance will likely incur in adaptation and implementation costs (e.g. revision of the business strategy, definition of relevant sustainability targets, etc.), which however cannot be directly related to the guidance (as implementation is voluntary).

As regards public administrations, developing the guidance and realising the campaign to disseminate the best practices would have direct budgetary implications at EU level. Since the amount of costs will depend on specific implementation choices (e.g. request of an external study, creation of an ad hoc technical expert group, communication channels used to disseminate results, etc.), it cannot be reasonably estimated ex ante. However, the cost to be borne at EU level will be comparable in scale to similar initiatives already carried out by the Commission in the past (in other policy fields) and is not expected to be remarkable (considering that it will be targeted mainly to companies).

#### **Benefits**

Option A3 is expected to have **limited benefits**.

Similar to costs, also possible benefits would be indirect, and their extent would depend on the how many companies will follow the Commission guidance.

At economic level, the choice to integrate sustainability risks and impacts into the business strategy pursuant to the guidance might lead companies to intensify long-term, sustainability-oriented investments, with possible positive effects in terms of sustainable growth and international competitiveness of EU businesses in the long term. Also short-term benefits can occur if customers, clients and investors recognise the value of integrating sustainability into business strategies, and would be higher for first movers. However, these possible economic effects should not be overestimated, as the voluntary nature of the guidance and the

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<sup>203</sup> Interviews with representatives from 2 investors.

<sup>204</sup> Interviews with representatives from 5 companies, 3 corporate governance committees, and 5 investors.

implementation costs it implies could dis-incentivise its widespread adoption. Moreover, under this option, the current unlevel playing field would be maintained.

Indirect benefits at environmental, social, and fundamental rights level would also be possible (in particular to the extent that companies implementing the guidance also align their sustainability targets to overarching goals, like the SDGs and the Paris goals) but quite limited, as the number of companies voluntarily deciding to apply the guidance could be expected to be rather small.

### Coherence

Option A3 would be **coherent with other main EU policy objectives and initiatives**.

Option A3 would concur to further embedding sustainability into the corporate governance frameworks and strengthening companies' focus on their long-term development and sustainability aspects, in line with the goal of the forthcoming renewed sustainable finance strategy. Moreover, by encouraging the adoption of sustainability targets aligned with overarching global goals, option A3 would clearly be consistent with EU and Member States commitments on delivering on the UN SDGs and the Paris Agreement on climate change.

In terms of consistency with similar existing EU policy initiatives, the guidance under option A3 would need to build on and therefore be aligned with existing reporting guidance material, namely the 2017 TCFD recommendations,<sup>205</sup> the 2017 Commission Non-Binding Guidelines on Non-Financial Reporting,<sup>206</sup> and the 2019 Commission Guidelines on reporting climate-related information.<sup>207</sup>

Moreover, the guidance under option A3 would reasonably be consistent with possible EU initiatives taken on the basis of recently released study on due diligence requirements through the supply chain, as the integration of sustainability risks, opportunities and impacts associated with business' own operations and value chain would imply a requirement to have in place the appropriate human rights and environmental due diligence policies and processes.

### Proportionality

Option A3 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objectives of the intervention.

The provision of guidance could prompt and enable boards in an increased number of companies across Europe to integrate sustainability aspects (impacts, risks, opportunities) into the business strategy and set adequate sustainability targets aligned with overarching goals, strengthening responsibility for sustainable value creation. As following the Commission guidance would be voluntary, option A3 would leave the highest degree of freedom and flexibility to companies on the modalities and timing to align corporate practices to the guidance received. Option A3 is not expected to create disproportionate costs/burdens for companies and public administrations.

## 5.3.3 Assessment of option B3

**B3**

*Commission recommendation (M3.2) for Member States to introduce in their respective national frameworks:*

- *A requirement for boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy*
- *A requirement for boards to identify and set as part of the business strategy measurable, specific, time-bound, and science-based sustainability targets aligned*

<sup>205</sup> Task Force on Climate-related Financial Disclosures (2017), cit.

<sup>206</sup> C/2017/4234.

<sup>207</sup> European Commission (2019), 'Guidelines on non-financial reporting: Supplement on reporting climate-related information', Brussels, C(2019) 4490 final.

*with overarching goals (such as the SDGs and the goals of the Paris Agreement on climate change)*

- *A requirement to disclose appropriate information.*

*This measure would complement and contribute to the implementation of the duty referred to in M1.2 (Commission recommendation to Member States to introduce in their respective national frameworks an explicit directors' duty to identify and mitigate sustainability risks and impacts, both internal and external, connected to the company's business operations and value chain)*

### 5.3.3.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	Moderate
Impacts on companies	-1
Economic impacts	+0.5
Social impacts	+1
Environmental impacts	+1
Impacts on fundamental rights	+1
Impacts on public administrations	-0.5

#### Expected degree of change in the national regulatory frameworks

Option B3 would bring **moderate changes in the national regulatory frameworks**.

Commission recommendation to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy and ii) to identify and set measurable, specific, time-bound, and science-based sustainability targets could be implemented in some Member States.

In all the Member States in scope of the analysis (except for IT) there is no explicit legal requirement to integrate sustainability into the business strategy, even if there is i) the legal requirement to disclose non-financial information and ii) there are self-regulatory measures suggesting the adoption of sustainability measures with particular reference to social and environmental fields.

In this context, a Commission recommendation may increase the awareness on the development of sustainability measures and integration of sustainability aspects and may lay the ground for some national competent authorities to adjust their national regulatory framework (either by adjusting existing laws or revising corporate governance codes). As a consequence, option B3 may bring moderate changes in the national regulatory frameworks.

#### Impacts on companies

Option B3 would have a **small negative impact on companies**.

The impacts on companies would depend on the level of commitment with the policy reflected in the transposition as the Member States will have flexibility to adapt measures to specificities of business framework.

The introduction of new requirements in some Member States would increase compliance and adaptation costs for companies (e.g. the time spent by employees in adapting procedures and systematising information, training costs, hiring employees with new competences or contracting external consultancy, costs at board level with the creation of a sustainability committee chaired by a non-executive director in charge of monitoring the implementation of the strategy, etc.). Science-based sustainability KPIs (for example to evaluate reduction of GHG emissions) were referred by representatives from six companies interviewed as quite complex to measure, often requiring external consultancy to implement, especially in SMEs.

Compliance costs would tend to be higher in the smaller enterprises, which have less flexibility in introducing new tasks on employees' current work without jeopardising the normal functioning of the company and lower in sectors that are subject to stricter rules concerning, for example, environment protection.

On the other hand, this policy could have positive effects if clients (along the value chain) recognise the value of integrating sustainability into business strategies (increasing brand value), increasing sales and turnover and the retention of employees (especially the youngest) more sensitive to sustainability issues.

Although the recommendation would grant Member States with flexibility to adjust requirements according to the national business context and corporate culture, thus allowing to minimise compliance costs, it is not expected that the rise in compliance costs would be offset by the benefits, at least in the short/medium term.

### Economic impacts

Option B3 would have **very small positive economic impact**.

The burden of compliance costs in companies resulting from the introduction of domestic requirements, mitigated with the flexibility given to Member States in the implementation of measures, could be outweighed by long term positive effects in competitiveness resulting from costs avoided by early risks detection, by rising investment (in training, R&D and environmentally friendly solutions/clean energy), and by differentiation in the market, which can favour trade flows. Rising competitiveness and investment could have a positive impact on employment and, therefore, on growth. However, this option would not substantially address the current uneven playing field (on the opposite, might further increase regulatory fragmentation), leaving the competitive advantage with unsustainable businesses, which would continue "free-riding" on the efforts of more sustainable companies.

### Social impacts

Option B3 would have a **small positive social impact**.

Option B3 would incentivise companies to adopt measures to prevent, identify and mitigate their social impacts, such as those on employees, consumers and local communities. However, the recommendation would be probably followed by few Member States, considering that this requirement might negatively affect the competitiveness of businesses (at least in the short term) vis-à-vis companies in Member States and third countries that have not imposed similar obligations. Thus, the extent of the positive social impact is difficult to foresee, but it is expected to be small, as in any case the Member States implementing the requirement would do it in different ways, with more or less stringent rules, making it difficult to monitor the results.

### Environmental impacts

Option B3 would have a **small positive environmental impact**.

The recommendation might be followed by some Member States - most likely those where domestic laws on human rights and environmental due diligence have already been adopted or discussed.<sup>208</sup> This might result in an increased number of companies taking measures to prevent, identify and mitigate their environmental impacts (including on climate, natural capital, circular economy and resource efficiency) and set appropriate environmental targets as part of their business strategy (for instance in terms of GHG emission reduction, reduction of energy consumption, sourcing from renewables, energy neutrality by a certain date, targets on reduced plastic packaging and recycling, etc.). However, the extent of the possible positive environmental impact of option B3 is limited by its non-binding nature, which leaves Member States free either not to adopt them (for instance in light of the adverse impact this measure might have on competitiveness) or to adopt them in different ways (e.g. in terms of scope of application, specific issues covered, binding force of measures, monitoring and enforcement, etc.). Consequently, option B3 is expected to have a limited positive environmental impact.

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<sup>208</sup> Namely AT, BE, DE, DK, FI, FR, IT, LU, NL, SE. For an overview, see <https://www.business-humanrights.org/en/national-movements-for-mandatory-human-rights-due-diligence-in-european-countries>.

### Impacts on fundamental rights

Option B3 would have a **small positive impact on fundamental rights**.

As indicated for the environmental impacts, the Commission recommendation might prompt some Member States - most likely those where domestic laws on human rights and environmental due diligence have already been adopted or discussed - to introduce at national level a requirement for companies based in those countries to integrate sustainability into their respective business strategies and set adequate targets. Of course, this might be expected to result in improved identification and mitigation of sustainability risks and impacts by affected companies and thus enhanced protection of fundamental rights (including as regards the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour in third countries), both in business own operations and in (global) value chains. At the same time, however, the non-binding nature of the recommendation, possibly combined with adverse corporate lobbying at national level (due to the adverse impact this measure might have on competitiveness), might limit the overall potential impact of option B3 and therefore its possible beneficial effects on fundamental rights protection. The final effect of this option in relation to fundamental rights might not differ from the adoption and dissemination of non-binding guidelines, foreseen under option A3.

Option B3 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option B3 would have **small negative impacts on public administrations**.

The option will not have significant budgetary consequences for national public authorities, while it will have minor implications at EU level. These implications relate to the cost of developing the guidance document. They are expected to be relatively small, as the Commission could leverage on existing networks of experts to form an ad-hoc technical expert group in charge collecting and systematise the guidelines.

#### 5.3.3.2 Assessment by criteria

Criteria	Rate
Effectiveness	+1
Efficiency	0
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option B3 would be **effective to a small extent** in strengthening the role of directors in pursuing company's long-term interests and improving directors' accountability for integrating sustainability into corporate decision-making.

Compared to option A3, option B3 has the potential for being slightly more effective the stated objectives, as it combines the "political weight" of a recommendation (which could be expected to be more impactful than releasing guidance) with the non-binding guidance document by the Commission as described under option A3. Therefore, while providing companies with guidance to integrate sustainability aspects into the business strategy and set sustainability targets, option B3 would also encourage Member States to introduce more stringent requirements in their respective regulatory frameworks, while leaving them with the flexibility on how to implement the recommendation.

To the extent that this recommendation is followed by some Member States (most likely those where domestic laws on human rights and environmental due diligence have already been adopted or discussed, see section 5.3.3.1), an increased number of companies will have to comply with sustainability requirements into their business strategies, with positive effects in terms of long-termism and directors' accountability for corporate sustainability. Similarly to option A3, option B3 could prepare the ground for a future EU legislative intervention. Option



B3 has been indicated as the preferred line of action in interviews with stakeholders from different constituencies (companies, investors, corporate governance committees, NGOs).

At the same time, the effectiveness of option B3 would be limited by the non-binding nature of the recommendation, and the possibility that, despite common guidance, the Member States will adopt it in a non-harmonised way (e.g. in terms of scope of application, specific KPIs to be set, enforceability, etc.), with possible distortive effects on competition within the Internal Market. Under such scenario, the positive contribution of option B3 with regard to identified objectives would remain limited, and problems at EU level are likely to persist.

### Efficiency

#### **Costs**

Option B3 is expected to **increase costs to a small extent**.

The Commission recommendation would not entail the introduction of substantive obligations or requirements for companies to comply with. The main addressee of the recommendation would be the Member States, which would be encouraged to introduce in their respective national frameworks requirements for boards to integrate sustainability aspects into the business strategy, to identify and set measurable and science-based sustainability targets aligned with overarching goals, and to disclose appropriate information. In EU countries where the recommendation is adopted, companies will be faced (indirect) compliance and adaptation costs to meet the requirements introduced at national level. Such costs would not be directly related to option B3, but rather to its national implementation (which to a certain extent might differ from country to country, as shown by the experience with the transposition of the Non-Financial Reporting Directive), and are impossible to quantify ex ante. Costs would be mainly related to the identification and setting of KPIs (especially science-based ones) and tend to be higher in the smaller enterprises (which have less resources) and lower in sectors that are already highly regulated (e.g. in the area of environmental protection). The discretion left to Member States in implementing the recommendation would allow them to better adapt it to the national context and somewhat mitigate cost increase for companies.

As regards public administrations, since the recommendation would be accompanied by a guidance document drafted and disseminated by the Commission, the costs would be the same discussed under option A3.

#### **Benefits**

Option B3 is expected to have **limited benefits**.

Similar to costs, also possible benefits would be indirect, and their extent would depend on the number of Member States that will implement the recommendation domestically.

At economic level, option B3 could have positive long-term effects on the competitiveness of companies in EU countries adopting the recommendation, mainly resulting from cost avoidance thanks to early risks detection, from rising investment (in training, R&D and environmentally friendly solutions/clean energy), and from differentiation in the market, which could also favour trade flows. However, under this option, the current unlevel playing field would be maintained.

Considerations on the likely benefits at economic, social, environmental, and fundamental rights level are in line with what already discussed for option A3. Benefits are possible and can be expected at all levels, but they are likely to remain limited, as the Commission recommendation foreseen under option B3 would not have legal force and could be implemented in a limited or patchy way by the different Member States, thus limiting the potential for wider beneficial effects.

### Coherence

Option B3 would be **coherent with other main EU policy objectives and initiatives**.

Also option B3 would contribute to the goal of further embedding sustainability into the corporate governance frameworks, to be sought under the forthcoming renewed sustainable finance strategy, by recommending Member States to introduce in their respective national frameworks

stringent requirements for companies to integrate sustainability aspects into the business strategy and set sustainability targets.

Moreover, similarly to option A3, also option B3 would clearly be consistent with EU and Member States commitments on delivering on the UN SDGs and the Paris Agreement on climate change.

As the recommendation under option B3 would be accompanied by a non-binding guidance document, the latter would need to be in line with similar existing EU policy initiatives, as already explained under option A3.

Finally, as already mentioned for option A3, the recommendation under option B3 might be issued in synergy with possible policy initiatives in the area of corporate duty of due diligence for adverse human rights and environmental impacts.

### Proportionality

Option B3 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objectives of the intervention.

Option B3 would recommend Member States to introduce at national level provisions requiring companies to integrate sustainability aspects into their business strategy and to set and disclose information on sustainability targets. As the recommendation would be non-binding, option B3 would leave the Member States with a high degree of flexibility to introduce the requirements for companies in the way deemed more appropriate in light of the national business context and regulatory framework. While granting implementation flexibility to EU countries and preparing the ground for a more substantial future EU intervention, option B3 could result into slightly different rules from one Member States to the next, which would limit its capacity to address the identified problem satisfactorily. This option is not expected to create disproportionate costs/burdens for companies and public administrations.

### 5.3.4 Assessment of option C3

<b>C3</b>	<p><i>Commission proposal for a new EU directive requiring corporate boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy, to identify and set as part of the business strategy measurable, specific, time-bound, and science-based sustainability targets aligned with overarching goals (such as the SDGs and the goals of the Paris Agreement on climate change), and to disclose appropriate information (M3.3).</i></p> <p><i>This measure would complement and contribute to the implementation of the duty referred to in M1.3 (new EU directive requiring directors to identify and mitigate sustainability risks and impacts, both internal and external, connected to the company's business operations and value chain)</i></p>
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#### 5.3.4.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	Large
Impacts on companies	-1
Economic impacts	+1.5
Social impacts	+3
Environmental impacts	+3
Impacts on fundamental rights	+3
Impacts on public administrations	-0.5

### Expected degree of change in the national regulatory frameworks

Option C3 would bring **significant changes in the national regulatory frameworks**.

Due to the fact that in most of the Member States analysed<sup>209</sup> national laws do not specify i) a requirement for corporate directors of large companies to integrate sustainability aspects into the business strategy and ii) targets to be used when integrating sustainability aspects in the business strategy or designing the non-financial statement, a Commission directive would have a large impact on national regulatory framework and bring several Member States to modify existing rules.

The only legal provisions in place relate to i) the legal requirement to disclose non-financial information and ii) self-regulatory measures suggesting the adoption of sustainability measures, especially in relation to the social and environmental fields (depending on the activities of the company, some requirements to integrate sustainability into business strategies may arise from social sustainability, environmental and safety and health areas).

Option C3 would allow that equal requirements apply to all large companies, thus contributing to a more level playing field. The inclusion of measurable, specific, time-bound, and science-based targets would also bring companies to set sustainability targets in line with broader goals, such as the SDGs.

### Impacts on companies

Option C3 would have a **moderate negative impact on companies in the short term, while in the long term the impact is likely to be positive.**

Under a new EU directive, the compliance costs for companies would increase as a result of the new requirements.

While the typology of compliance costs would be the same discussed under option B3, compared to a non-binding recommendation, the new directive under option C3 would reduce the flexibility given to Member States to adjust the requirements for companies according to the national business context and corporate culture, and to promote a more gradual transition in Member States with baseline situation further away from policy requirements. The generalised application of the requirements of option C3 would rise overall compliance costs for companies.

In terms of benefits, option C3 could strengthen the capacity of companies to manage sustainability risks and dependencies effectively, thus improving their resilience vis-à-vis exogenous shocks that might threaten their continuous operation or even survival in the short term (as shown by the outbreak of the COVID-19 pandemic). Possible benefits identified at company level (increasing brand value resulting from strong sustainability commitment, increasing sales and turnover) would be offset by the increase in compliance costs, at least in the short/medium term, while in the longer term a stronger capacity to deal with sustainability risks and impacts might result in improved corporate resilience to exogenous factors and overall performance (including at financial level) as well as larger shareholder value.

### Economic impacts

Option C3 would have a **moderate positive economic impact, especially in the long term.**

The short-term burden of compliance costs in companies would be higher under this option, although, as in option B3, long-term positive effects on competitiveness resulting from costs avoided by early risks detection, by rising investment and by differentiation in the market could favour trade flows. The cost increase imposed on companies would be offset by the long-term positive impact on competitiveness and investment, also thanks to the creation of a level playing field across EU. Thanks to option C3, EU companies would position themselves among the first movers in the sustainability transition, which would give them remarkable advantages on global markets vis-à-vis later market entrants (e.g. opportunities to gain brand recognition, establish customer loyalty, grab market shares, develop technologies and capabilities, and build economies of scales spurring sustainable growth).

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<sup>209</sup> BE, DE, ES, SE, FR, FI, NL, HU, PL, PT and SI.

### Social impacts

Option C3 would have a **large positive social impact**.

Option C3 would improve the way companies include sustainability organically into their business strategy and move towards a more sustainable business model. A more sustainable business strategy would entail investing into projects that are in line with company's strategic drivers and produce a financial return while also generating positive social impacts (such as in investing in workplace health and safety and in the training of employees). The mandatory integration of sustainability aspects into the business strategy (including through the identification and management of sustainability risks) might have positive consequences for impacted communities, as directors would likely pay increased attention to reputational risks and their "social license to operate" in the territories where the company works, considering these as important factors along the short-term financial performance. In this way, option C3 might lead the boards to take into better account, along the interests of employees and customers, also the interests and concerns of communities affected (either positively or negatively) by business operation. Moreover, setting specific and measurable sustainability targets would allow better monitoring and comparing companies' impacts and contributions to the attainment of social policy goals, especially in term of better working conditions, reduction of poverty and income inequalities (e.g. concerning the wages along the supply chain). The disclosure of data concerning these targets might also support closer monitoring by NGOs and trade unions interested in corporate social impacts, as well as by public authorities for the elaboration of evidence-based policy measures, at Member State or EU level. In interviews with representatives from NGOs (4) and trade unions (2), option C3 has been indicated as the option with the largest potential for positive impact at social level.

### Environmental impacts

Option C3 would have a **large positive environmental impact**.

As for social impacts, Option C3 has the potential to have a large, positive effect also on the environment (including on climate, natural capital, circular economy and resource efficiency). This measure would compel large companies to embed sustainability into their business strategies, which might entail, where appropriate, to adapt their underlying business models to become more (environmentally) sustainable, including by implementing time-bound decarbonisation plans aligned with the Paris Agreement and based on climate-science-based targets. All representatives from NGOs interviewed agreed that, compared to other options under Driver 3, option C3 would be the one with the largest positive impact at both environmental and social level. The disclosure of identified targets and of the plan implemented to achieve them would also enable internal and external stakeholders (such as investors, employees, NGOs, public authorities, etc.) to monitor how each company is integrating sustainability criteria into the business strategy and progressing to meet identified targets, thus contributing to greater public pressure and accountability for corporate sustainability. As a consequence, the likely impact of option C3 on environmental level is expected to be large. Of course, such impact would be further magnified if this requirement is extended also to SMEs in high-risk sectors and is accompanied by the introduction at EU level of a corporate duty for human rights and environmental due diligence.

### Impacts on fundamental rights

Option C3 would have a **large positive impact on fundamental rights**.

Option C3 is expected to have indirect but large positive impacts on fundamental rights (including the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour) by not only driving greater awareness of fundamental rights in companies, but also requiring them to adjust their business strategy and model in a way that addresses fundamental rights impacts and manages related risks, including in their value chains. As option B3 would be the most impactful in promoting an effective sustainability transition by virtue of its scope and binding force, it holds the potential of a significant positive impact on fundamental rights protection. Moreover, the disclosure element of this measure would enable stakeholders (for example employees and investors, but also NGOs and public authorities) to closely monitor

and hold companies accountable for the way they integrate sustainability risks, impacts and opportunities into their respective business strategies. As for environmental impacts, also the impact of option C3 on fundamental rights would be further magnified by extending its scope of application to SMEs and by the concurrent introduction at EU level of a corporate duty for human rights and environmental due diligence.

Option C3 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option C3 would have **small negative impacts on public administrations**.

The option will not have significant budgetary consequences for national public authorities, while it will have minor implications at EU level. These implications relate to the cost of developing the guidance document. They are expected to be relatively small, as the Commission could leverage on existing networks of experts to form an ad-hoc technical expert group in charge collecting and systematise the guidelines.

#### 5.3.4.2 Assessment by criteria

Criteria	Rate
Effectiveness	+2.5
Efficiency	+1
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option C3 would be **effective to a large extent** in strengthening the role of directors in pursuing company's long-term interests and improving directors' accountability for integrating sustainability into corporate decision-making.

The new directive foreseen under option C3 would ensure that equal requirements apply to corporate boards of all large companies (with the possibility for Member States to extend its application to SMEs that operate in high-risk sectors). By virtue of its binding force and its generalised application, option C3 would be effective in driving a change in business and make EU companies more sustainable and "future proof" (in line with the sustainability transition promoted by the European Green Deal), while limiting competition distortions within the Internal Market and bringing about a more level playing field. This measure would also ensure that companies set and disclose sustainability targets aligned with important environmental and social objectives prioritised by national and EU regulators (e.g. those of the Paris Agreement on climate change and the SDGs), thus enabling a better monitoring of corporate sustainability performance and contribution towards their attainment by policy makers, shareholders, investors, and civil society at large. In this way, option C3 would effectively strengthen the accountability of directors for implementing a long-term and sustainable business strategy that prevent, identify and mitigates sustainability risks and negative externalities and seize relevant opportunities. This option has been indicated as the preferred line of action by most NGOs and trade unions interviewed (as it is expected to have the largest positive impacts at social, environmental and fundamental rights level), but also representatives from NGOs (4), trade unions (2), companies (2), and a corporate governance committee underlined its effectiveness.

As underlined by two representatives from NGOs interviewed, the effectiveness of option C3 will depend crucially on the adoption of proper monitoring and enforcement mechanisms, in order to control that companies implement the requirements of option C3 effectively and do not follow a tick-box approach. Moreover, defining the scope of the application on the basis of the size might limit the effectiveness of the measure, as large companies might try to avoid the new requirements through fragmentation into smaller legal entities. A generalised application of the directive to all companies with scalability of obligations for SMEs might further increase the effectiveness of this option.

## Efficiency

### **Costs**

Option C3 is expected to **increase costs to a moderate extent**.

By requiring corporate boards to integrate sustainability aspects into the business strategy, to identify and set appropriate sustainability targets aligned with overarching goals (such as the SDGs and the goals of the Paris Agreement), and to disclose appropriate information, option C3 would introduce substantive requirements for companies to comply with. Companies subject to the new directive (large companies and possibly SMEs) would be faced with increased compliance costs, arising from the need of embedding sustainability into the business strategy (which implies identifying sustainability issues and opportunities salient to the business as well as identifying sustainability risks and impacts to be prevented or addressed, including by means of appropriate due diligence) and setting measurable, specific, time-bound, and science-based sustainability targets, aligned with widely accepted policy goals, to be monitored and disclosed. As highlighted by interviewees with representatives from three companies, costs for companies might be higher in the short term (especially for SMEs), but initial costs might be off-set by medium and long-term benefits (e.g. in terms of reduced materiality risks, financial returns – e.g. from energy efficiency – and positive reputational effects) and value creation for shareholders.

As regards public administrations, as the new directive would be accompanied by a guidance document drafted and disseminated by the Commission, the costs would be the same discussed under option A3.

### **Benefits**

Option C3 is expected to have **large benefits**.

At economic level, option C3 might have adverse short-term effects on internal competition (while creating a level playing field, companies further from the sustainability requirements introduced might find it more difficult to comply with them) and competitiveness vis-à-vis non-EU competitors, but in the long term is expected to prompt sustainable economic growth and harness the innovation potential of European economies.

By requiring companies to set sustainability targets aligned with widely accepted policy goals (like the SDGs and the Paris goals), option C3 would have direct, remarkable beneficial effects at social, environmental and fundamental rights level. Benefits could be far-reaching (for instance, they might regard workers in third countries along global value chains) and diffuse (as they would not regard just single constituencies but the environment and society at large).

## Coherence

Option C3 would be **coherent with other main EU policy objectives and initiatives**.

Option C3 would be consistent with the goal of strengthening companies' focus on their long-term development and sustainability aspects, to be sought under the forthcoming renewed sustainable finance strategy, by making sure that directors in large companies take a substantial and proactive approach in relation to sustainability. By mandating targets in line with global goals and frameworks, option C3 would also contribute to achieving the objective of an effective transition to a climate-neutral, green EU economy, and to implementing the UN SDGs.

As the recommendation under option C3 would be accompanied by a non-binding guidance document, the latter would need to be in line with similar existing EU policy initiatives, as already explained under option A3.

Finally, as already mentioned for options A3 and B3, also option C3 might be taken in synergy with possible policy initiatives in the area of corporate duty of due diligence for adverse human rights and environmental impacts.

### Proportionality

Option C3 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objectives of the intervention.

Option C3 would make corporate boards responsible for guiding their companies' transition towards more sustainable business models and proactively preventing and addressing sustainability impacts in own operations and along the value chain, going beyond the "do not harm" approach. Intervening through a directive would ensure that a common minimum set of requirements are laid down in harmonised way, preventing regulatory differences across EU countries that might be detrimental to EU level playing field and leave the problem unsolved. Relative to voluntary initiatives by individual companies or at Member States level, option C3 would create more leverage and "critical mass" to address the problem identified under Driver 3. At the same time, the directive would not prevent Member States from adopting additional requirements or extending the scope of application at national level (e.g. to SMEs in high-risk sectors). Even though option C3 would be relatively costlier than option A3 and B3 (in particular in terms of compliance costs), it is not expected to create disproportionate costs/burdens for companies and public administrations.

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

### **5.4.1 Baseline**

Share-based remuneration is likely to remain a widespread market practice to align the interest of directors with the interest of the shareholders. As a consequence, in many companies, the use of share options and incentive plans linked to share price would continue exerting pressure on executives to pursue a short-term financial objective, contributing to the negative economic, social and environmental effects discussed under Driver 1.

Similarly, the integration of ESG metrics into directors' remuneration schemes is a trend that can be expected to continue in the future, as a mean to incentivise directors' to pay attention to (at least some) company's sustainability impacts. Nonetheless, in absence of an intervention aimed at further generalising it, this market practice is likely to remain limited to a minority of companies. For most companies, there would be no incentives for directors to meet specific sustainability targets. It could be maintained the absence of these incentives would slow down business transition towards more sustainable value creation.

### **5.4.2 Assessment of option A4**

<b>A4</b>	<i>Commission led/funded campaign aimed at companies to encourage them link board remuneration to long-term, sustainable value creation for the company (M4.1)</i>
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#### *5.4.2.1 Assessment by impacts*

Impact	Rate
Expected degree of change in the national regulatory frameworks	No change
Impacts on companies	-0.5
Economic impacts	+0.5
Social impacts	+0.5
Environmental impacts	+0.5
Impacts on fundamental rights	+0.5
Impacts on public administrations	-0.5

### Expected degree of change in the national regulatory frameworks

Option A4 would bring **no changes in the national regulatory frameworks**.

In most of the Member States analysed,<sup>210</sup> there are no laws or regulatory measures that expressly link board remuneration to sustainability aspects, except in Germany,<sup>211</sup> and only listed companies have strict legal requirements to adopt and disclose the remuneration policy of the directors. However, due to the non-binding nature, this campaign will not be so strong to counterbalance the pressure to include short-term financial targets in companies' remuneration policies. Still, a campaign to encourage companies to link executive remuneration to long-term objectives and to include in the remuneration policy ESG metrics and longer vesting periods may increase the awareness in the business community on the importance of linking board remuneration to ESG metrics as a way to create incentives for directors to consider sustainability aspects.

### Impacts on companies

Option A4 would have **very small negative impact on companies**.

Option A4 would not introduce new obligations and thus create direct compliance costs on companies. However, companies that will choose to adopt the suggestions of the Commission campaign would inevitably face an increase in adjustment costs, mainly linked to the review of the existing remuneration policy – including identifying new ESG metrics – and having it approved by shareholders. At the same time, companies could enjoy the flexibility to adapt the suggestions of the Commission campaign to their corporate characteristics (e.g. sector-specific considerations), which could allow them to mitigate cost increase. Option A4 is not expected to bring about cost savings for companies that will follow the suggestions of the campaign.

A potential mild positive effect in the form of intensified investment (in general and in R&D) increase could arise from this option, as long as an increased number of companies adjusted their executive remuneration schemes to embed sustainability aspects. Positive medium to long run impacts on companies that follow the campaign can also be expected, as a result of a better balance between short-term and long-term (sustainability) objectives in executive pay schemes, without jeopardising the alignment of incentives between shareholders and managers ensured by share-based remuneration. The highest relevance company stakeholders and society at large attach to sustainability issues, the highest the likelihood that a company will adopt the best practices suggested under option A4.

Some interviewees with representatives from companies (5), corporate governance committees (2) and one investor refer that any intervention along this driver should take the form of recommendations and no other legal form, leaving more flexibility in the remuneration policy of companies. In the interviews, a couple of corporate governance committees and companies refer that, as concerns SMEs, the fixed component of staff members' remuneration is clearly prevalent in most cases, so the campaign would not be relevant at least for those companies.

### Economic impacts

Option A4 would have a **very small positive economic impact**.

Option A4 would create some social pressure for companies to adopt better remuneration practices while leaving space for companies to decide how to implement these changes based on their needs. As mentioned before, a limited effect in terms of investment and investment in R&D increase at company level can potentially occur. As a consequence, one may expect only a mild potential positive impact in terms of consumption, jobs and growth and competitiveness of business associated with increased investment and investment in R&D. No impact on the other dimensions is foreseen.

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<sup>210</sup> IT, BE, ES, SE, FR, FI, NL, HU, PL, SI, PT.

<sup>211</sup> In Germany, since 1<sup>st</sup> January 2020, the German § 87 I 2 AktG (Principles Governing Remuneration of Members of the Management Board) states that the remuneration system of listed companies shall be aimed at the company's sustainable development. This means that when determining the remuneration system, non-financial aspects like social and ecological ones, need to be considered.



### Social impacts

Option A4 would have a **very small positive social impact**.

Option A4 could be expected to increase the awareness of all companies on the existence of these practices, which are already developing as a market practice,<sup>212</sup> and further spread their use. This option could have an indirect positive social impact, especially if the targets for the remuneration are linked to some social objectives, such as the satisfaction or the retention of employees. However, as already highlighted for similar options, such campaign is likely to be most convincing towards a minority of (large) companies that are already more sensitive to sustainability issues and mature in addressing them. Moreover, even if successful in terms of engagement, quite a long time might elapse before it produces tangible effects on the ground, including at social level. Therefore, a campaign might be too weak to determine a substantial and relatively fast change and lead companies to revise their remuneration policies to be more sustainable, especially as long as their investors are short-term oriented and prioritise the achievement of short-term financial results. Although no negative social impact is foreseeable by the adoption of this option, any positive impact is expected to be very small.

### Environmental impacts

Option A4 would have a **very small positive environmental impact**.

As highlighted for the social impacts, the Commission campaign foreseen under option A4 might not be sufficient to lead an increased number of companies to change their respective executive remuneration policies vis-à-vis short-term pressure from the investors, and bring about remarkable environmental impacts. Nonetheless, this option might further disseminate best practices for more sustainable remuneration policies and thus have some small, indirect positive impact at environmental level for instance by promoting the adoption of ESG metrics linked to climate (e.g. GHG emissions) or use of natural capital (e.g. reduction of water consumption) or resource efficiency (e.g. reduction of energy consumption). As far as ESG metrics adopted in executive pay schemes are relatively easy to quantify and verify, option A4 could be expected to have a small, positive effect on the environment.

### Impacts on fundamental rights

Option A4 would have a **very small positive impact on fundamental rights**.

The Commission campaign might have a small indirect positive impact also in terms of fundamental rights protection to the extent that (i) an increasing number of companies voluntarily choose to align their executive remuneration policies to the best practices disseminated through the campaign, and (ii) in doing so, companies select and include in their executive pay schemes non-financial performance indicators that are linked to fundamental rights protection. As the realisation of both conditions are difficult to anticipate, and considering that setting of non-financial metrics linked to fundamental rights might be relatively difficult to achieve (as other quantitative indicators might be easier to measure), it is not expected that option A4 would have a relevant impact on fundamental rights. At the same time, it should not lead to any significant negative impacts on fundamental rights.

### Impacts on public administrations

Option A4 would have **small negative impacts on public administrations**.

The option will not have significant budgetary consequences for public authorities, while it will have minor implications for the EU budget. These implications are the costs related to the

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<sup>212</sup> The use of longer vesting periods for share options is suggested in 10 of the corporate governance codes analysed (BE, DE, ES, FR, IT, NL, PL, PT, SE, SI), and the integration of ESG metrics in 7 corporate governance codes (BE, DE, ES, FR, IT, NL, SI). Considering the adoption of such measures by companies, there is no comprehensive study for the EU, but a number of surveys exists. For example, 55% of the respondents to a survey of 64 European companies (Mercer (2019), *Mercer European Executive Rewards – ESG Incentive Plan Metrics: Spot Survey*) said that they include ESG issues in their incentive plans, while an analysis of 231 Italian listed companies shows that 33 of them link their CEOs remuneration to sustainability, while only 8 of them do so also for the other executive directors (Consob (2019), *Report on corporate governance of Italian listed companies*).

campaign to encourage companies to link board remuneration to long-term, sustainable value creation. It is not possible to provide cost estimates in that regard, as the actual amount will depend on the audience engagement strategy and tools adopted for the campaign, with online contents assumed to be less expensive than live events, especially considering the large number of companies to be targeted.

#### 5.4.2.2 Assessment by criteria

Criteria	Rate
Effectiveness	+1
Efficiency	0
Coherence	Yes
Proportionality	Yes

#### Effectiveness

Option A4 would be **effective to a small extent** in promoting corporate governance practices that contribute to company's sustainability.

The Commission campaign aimed at companies to encourage them to link executive remuneration to long-term, sustainable value creation would contribute to increasing the awareness of companies on the importance of creating incentives for executive directors to focus on sustainability. The campaign would provide companies with suggestions and best practices on remuneration policies that create long-term incentives. The list of best practices would be developed by the Commission and might be designed with the support of a targeted consultation, similar to the one performed for the guidelines on the standardised presentation of the remuneration policy.<sup>213</sup>

The Commission campaign would build on existing European recommendations and legislative instruments such as the 2009 recommendation<sup>214</sup> and the Shareholders Rights Directive II, which do not have strict requirements for the use of ESG metrics or vesting periods, but recommend their utilisation. This background would ease the implementation of the campaign. In addition, considering that companies would be already required to modify some of their remuneration policies due to the Shareholder Rights Directive II, they could be expected to be particularly attentive to new guidance on the subject and likely more prone to their acceptance. Moreover, if the campaign will be implemented after the publication of the guidelines on the standardised presentation of the remuneration report on which the Commission is currently working, synergies could be generated and the inclusion of sustainability information in the companies' remuneration policies might be triggered.

However, overall the campaign is expected to be effective only to a low extent. Previously adopted soft measures in this field (such as the 2009 recommendation mentioned above) did not prove to be fully effective in increasing the extent to which companies included in their policies non-financial criteria and vesting periods for share-based remuneration. Thus, it could be expected that without creating more binding requirements such practices will not significantly spread across the market, and the option would only partially succeed in promoting corporate governance practices that contribute to company's sustainability.

#### Efficiency

##### **Costs**

Option A4 is expected to **increase cost to a very small extent**.

The campaign to encourage companies to change their remuneration policies would not entail direct compliance costs for them. However, indirectly companies following the suggestions of

<sup>213</sup> See [https://ec.europa.eu/info/consultations/public-consultation-remuneration-report-guidelines-implementing-shareholders-rights-directive\\_en](https://ec.europa.eu/info/consultations/public-consultation-remuneration-report-guidelines-implementing-shareholders-rights-directive_en).

<sup>214</sup> European Commission (2009), 'Commission Recommendation of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies', 2009/385/EC, final.

the campaign could face costs to adjust their current remuneration policy (e.g. costs for the identification and monitoring of the ESG metrics). At the same time, they would enjoy flexibility to implement the suggestions according to the timing and modalities they deem more appropriate. Moreover, a potential mild positive effect in the form of intensified investment (in general and in R&D) could arise from this option, as long as an increased number of companies adjusted their executive remuneration schemes to embed sustainability aspects.

Regarding public administrations, the design of the campaign would have direct budgetary implications at EU level. Even though the amount of costs would depend on implementation choices (e.g. communication channels used, number of live events, involvement of partners, etc.) and cannot be quantified, it would be comparable in scale to similar initiatives already carried out by the Commission in the past (in other policy fields) and is not expected to be remarkable (considering that it will be targeted mainly to companies).

### **Benefits**

Option A4 it is expected to have **very limited benefits**.

The benefits of the campaign would be both direct and indirect, and their extent would heavily depend on the will of companies to apply the suggested measures.

At economic level, having directors' interests aligned to the long-term value creation for companies, through share-options vesting after a number of years, would influence the decisions taken in terms of investments, with a longer focus, making companies more competitive in the long term. Also ESG metrics would influence the focus of directors, especially if linked to the strategy of the company, creating indirect beneficial effects at social, environmental and fundamental rights level.

### **Coherence**

Option A4 would be **coherent with other main EU policy objectives and initiatives**.

The purpose of the Commission campaign would be in line with 2009 Commission recommendation as regards the regime for the remuneration of directors of listed companies,<sup>215</sup> whereby the structure of directors' remuneration should promote the long-term sustainability of the company and ensure that variable components of remuneration is linked to predetermined and measurable performance criteria, including non-financial nature. Option A4 would also be consistent with the principles of the Shareholder Rights Directive II, which emphasise that the remuneration policy should contribute to a company's business strategy, long-term interests and sustainability and should not be linked entirely or mainly to short-term objectives.

By disseminating best practices on directors' remuneration policy, option A4 would contribute to the goal of embedding sustainability into the corporate governance frameworks and strengthening companies' focus on their long-term development and sustainability aspects, in line with the goal of the forthcoming renewed sustainable finance strategy. Indirectly, this option would also contribute to the broader goals of the European Green Deal.

### **Proportionality**

Option A4 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

Option A4 would raise the awareness of companies on the importance of creating the right incentives for their directors to increase sustainability, providing guidance to them on how to set ESG targets and on the use of share-options for the long-term sustainability. As the campaign would not entail any obligation, companies would maintain the possibility to set their remuneration policy in the most suitable way according to their sector and business plan. Option A4 is not expected to create disproportionate costs/burdens for companies and public administrations.

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<sup>215</sup> Commission Recommendation 2009/385/EC.

### 5.4.3 Assessment of option B4

B4	<p><i>Commission recommendation for Member States (M4.2) to introduce in their respective national frameworks:</i></p> <ul style="list-style-type: none"> <li>▪ <i>A provision to restrict executives' ability to sell shares they receive as pay</i></li> <li>▪ <i>A provision to make compulsory the inclusion of non-financial, ESG metrics, linked to a company's sustainability targets, in executive pay scheme</i></li> </ul>
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#### 5.4.3.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	Small
Impacts on companies	-0.5
Economic impacts	+0.5
Social impacts	+0.5
Environmental impacts	+0.5
Impacts on fundamental rights	+0.5
Impacts on public administrations	0

#### Expected degree of change to the national regulatory frameworks

Option B4 would bring **small changes in the national regulatory frameworks**.

Option B4 may trigger the adoption of measures in those Member States (the majority in the sample of 12 Member States selected for in-depth investigation in this study) that have no law or regulatory measures that expressly link board remuneration to sustainability aspects.

However, the non-binding nature of the recommendation might limit the adoption by Member States considering (i) the difficulty to link a component of the remuneration to a specific sustainability objective and (ii) potential obstacles brought by directors. Even if adopted, the recommendation may create different specific requirements at the national level and Member States may choose to modify national legislation or revise the corporate governance codes.

#### Impacts on companies

Option B4 would have a **very small negative impact on companies**.

The impact on companies of option B4 would be very similar to the one of option A4. Option B4 would not introduce new obligations and thus create direct compliance costs on companies. However, some companies in the Member States where the recommendation will be implemented will need to revise their current remuneration policies and bear the related adjustment costs (as highlighted during the interviews)<sup>216</sup>. Compare to option A4, it could be expected that companies will enjoy relatively less flexibility in revising their policies (as the national implementation would come with more stringent requirements). Also Option B4 is not expected to bring about cost savings for companies that will follow the suggestions of the campaign. Similar to option A, while no cost saving is foreseen at company level, some potential mild positive effect could be possible in the form of intensified investment and investment in R&D.

As mentioned for option A4, interviewees referred that in SMEs the fixed component of staff members' remuneration is clearly prevalent in most companies and so the issue is not relevant at least for those companies. As in option A4, companies report a potential mild positive effect in the form of investment and investment in R&D increase arising from this option, but they report in addition some possible positive effects in terms of turnover and investment in training.

<sup>216</sup> Interview with representatives from 1 company, 1 investor and 1 corporate governance committee.

### **Economic impacts**

Option B4 would also have a **very small positive economic impact**.

The impact of option B4 would depend on the baseline of the Member States concerning these issues.

This option has the risk of conducing to the introduction of different specific requirements at national level that might end up further complicating the regulatory picture across Member States, with possible adverse consequences for internal competition, As mentioned before, some costs of adjustment can be expected whereas no cost savings are foreseen and only a limited effect in terms of investment and investment in R&D increase at company level are likely to potentially occur. As a consequence, one may expect only a mild potential positive impact in terms of consumption, jobs and growth and competitiveness of business, associated with increased investment, investment in R&D, and investment in training. Some potential impacts on internal market can arise if practices in different Member States become very different. No impact in the other dimensions is foreseen.

### **Social impacts**

Option B4 would have a **very small positive social impact**.

The non-binding recommendation might be expected to have a positive, indirect effect on the social performance of the companies based in those Member States where the recommendation will be adopted. It is not possible to anticipate the number of Member States that will implement the recommendation at national level, and what would be the content of the different national implementation measures (e.g. in terms of type and size of companies covered, binding force, etc.). Similarly, it is not possible to anticipate the non-financial performance indicators that could be preferred at company level, as this is very company-specific.

### **Environmental impacts**

Option B4 would have a **very small positive environmental impact**.

The non-binding nature of the recommendation would limit the positive environmental impact that could be expected by such a measure, as it would be difficult to anticipate how many Member States would adopt measures, and which form would these measures take. The status quo would probably remain unaffected, with some companies including simple environmental targets in their remuneration policies. No negative environmental impact is foreseen with this option.

### **Impacts on fundamental rights**

Option B4 would have a **very small positive impact on fundamental rights**.

Option B4 is not expected to result in a remarkable change of the status quo as regards the protection of fundamental rights. In fact, similar recommendations have already been formulated by the Commission, and to a certain extent they have also been internalised in national corporate governance codes and implemented by companies. Although option B4 might further strengthen the message of linking remuneration to long-term value creation and sustainability and push more Member States to implement relevant provision at national level, including as regards fundamental rights risks and impacts along the value chain, this non-binding measure might still be too weak to lead an increased number of companies to adjust their executive remuneration policies in a way that produces consequences for the fundamental rights protection, at least as concerns the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour. However, the extent of any positive impact is difficult to foresee, as it is hard to anticipate how many Member States might implement the recommendation and in which way. Estimating the impact on fundamental rights is difficult also because every company would be rightly free to choose the most appropriate ESG metrics, which might regard environmental and social aspects other than fundamental rights. While only very small, indirect positive impacts are expected, option B4 is not foreseen to have any negative effect on fundamental rights.

Option B4 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option B4 would have **no impacts on public administrations**.

The measure will not have significant budgetary consequences for national public authorities, nor implications at EU level. An administrative burden might be expected at the EU level in a situation in which different Member States apply different laws, as EU bodies may need to follow and monitor national initiatives and possibly facilitate some type of information exchange. However, it can be expected that this would be covered by existing operational structures and budgets since this would be a normal process of monitoring policy developments in Member States.

#### 5.4.3.2 Assessment by criteria

Criteria	Rate
Effectiveness	+1
Efficiency	0
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option B4 would be **effective to a small extent** in promoting corporate governance practices that contribute to company's sustainability.

The Commission recommendation would demand Member States to introduce in their respective national frameworks a provision to restrict executives' ability to sell shares they receive as pay and a provision to make compulsory the inclusion of non-financial ESG metrics in executive pay schemes, and would promote a more sustainable corporate governance. The recommendation would complement the existing Commission recommendations and the national provisions. It would build on the previous Commission recommendations (2004/913/EC, 2005/162/EC, 2009/385/EC) on board remuneration and the remuneration committee, complementing the principles expressed there and focusing specifically on sustainability aspects. It would also complement the Guidelines on the standardised presentation of the remuneration report that should be published soon by the Commission, supporting companies in explaining them what the expected components of the variable remuneration for executives are, and similarly could integrate the implementation of the new Shareholder Rights Directive II in its requirements on the remuneration policy and remuneration report.

The recommendation could be easily implemented, considering its non-binding nature, without additional costs for European authorities, and national authorities could give effect to the main principles of the recommendation through either legislation or best practice rules based on the "comply or explain" principle, such as in corporate governance codes. The codes, in particular, have seen a recent trend of amendments to include new principles, including on remuneration, such as requiring shares be held at least three years after they were granted. Among the Member States in scope, examples of this trend can be found in Belgium (with the 2020 Belgian Code on Corporate Governance), in France (with the 2020 French Corporate Governance Code of Listed Corporations) and in Italy (with the 2020 Italian Corporate Governance Code). In Germany a new version of the code was approved by the national commission and sent to the Federal Ministry of Justice and Consumer Protection on 23 January 2020 and is waiting official adoption, and, considering the draft versions, the elements discussed on executives remuneration are likely to be included.

The recommendation would bring limited direct costs for companies, while, if it is implemented, it could negatively influence companies' ability to attract executives with the necessary sustainability skills. Nevertheless, it could create incentives for the board to take a long-term perspective, with positive effects on investments and competitiveness. Moreover, improvements are expected also in term of social and environmental sustainability, especially on the

sustainability aspects identified by the companies as relevant for their business model and chosen as targets.

However, these changes are expected to be limited, as the recommendation would not be legally binding for Member States and would leave them flexibility as to the way to implement these provisions domestically. Similar to other forms of non-binding instruments adopted in the same field in the past (such as the recommendations on board remuneration mentioned above), also this recommendation risks not being implemented widely or only superficially, without real commitment by Member States to require companies to respect its principles and by companies to substantially change their remuneration policy. For instance, according to the impact assessment of the Commission for the Shareholder Rights Directive II,<sup>217</sup> the application of the three recommendations mentioned above by Member States was not satisfactory, since only 6 Member States had fully implemented the principles of such recommendations.

### Efficiency

#### **Costs**

Option B4 is expected to **increase costs to a very small extent**.

Under this option companies would not be obliged to change their remuneration policy, and even if they accept to do so, there would be flexibility in the choice of ESG criteria or vesting periods. The main addressee of the recommendation would be the Member States, which would be invited to introduce the mentioned requirements in the national legislative framework. Thus, the implementation of the recommendation would create indirect cost for companies based in EU countries where the recommendation is adopted, mainly related to adjusting their remuneration policy. Such costs would not be directly ascribable to option B1 and are impossible to quantify ex ante.

As regards public administrations, the adoption of the recommendation would not have budgetary implications, neither at national nor at EU level.

#### **Benefits**

Option B4 it is expected to have **very limited benefits**.

The expected benefits would be mainly indirect, and linked to the number of Member States deciding to apply the recommendation in their national framework.

At economic level, the practices suggested could incentivise directors to focus their companies towards long-term growth, with CAPEX and R&D investments at company level in the EU countries where recommendations are implemented. Considering that a number of companies is starting to develop similar remuneration policies and a number of corporate governance codes suggest them, it could be expected not much resistance against such recommendation, but the benefit would also be limited, not favouring extensive changes vis-à-vis the current situation.

Similarly, for the beneficial effects at social, environmental and fundamental rights level, it could be expected from the ESG metrics a slightly larger benefit, but still limited due to the non-binding nature of the recommendation.

### Coherence

Option B4 would be **coherent with other main EU policy objectives and initiatives**.

Over the past 15 years, the Commission has already adopted several recommendations (2004/913/EC, 2005/162/EC, 2009/385/EC) on remuneration policies in listed companies. The recommendation under option B4 would have the same purpose of the previous ones (i.e. to foster an appropriate regime for the remuneration of directors and ensure it is linked to long-

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<sup>217</sup> European Commission (2014), 'Impact Assessment Accompanying the document Proposal for a Directive of the European Parliament and of the Council on amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement and Commission Recommendation on the quality of corporate governance reporting ('comply or explain'), SWD/2014/127 final.

term objectives, including of non-financial nature) and would be aligned to principles and requirements on the disclosure of the remuneration introduced by the Shareholder Rights Directive II.

By recommending the inclusion of restrictions on executives ability to sell shares they receive as pay as well as of ESG metrics in the executives' variable pay, option B4 would be in line with existing recommendations and contribute to the goal of fostering executive' focus on long-term value creation and non-financial performance, thus contributing to the goal of further embedding sustainability into the corporate governance frameworks, in line with the declared goal of the forthcoming renewed sustainable finance strategy. Indirectly, this option would also contribute to the broader goals of the European Green Deal.

### Proportionality

Option B4 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

The non-binding recommendation would provide Member States with a high degree of flexibility to introduce the recommended modifications on the remuneration policy at national level, thus respecting the wide room for manoeuvre that companies are used to have in this field. It is not expected to create disproportionate costs/burdens for companies and public administrations.

#### 5.4.4 Assessment of option C4

<b>C4</b>	<p><i>Commission proposal to amend the Shareholder Rights Directive II (M4.3) to align executive remuneration policy with the long-term and sustainability goals, in particular by:</i></p> <ul style="list-style-type: none"> <li>▪ <i>Regulating executives' ability to sell the shares they receive as pay</i></li> <li>▪ <i>Making compulsory the inclusion of non-financial, ESG metrics, linked to a company's sustainability targets, in executive pay scheme</i></li> </ul>
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##### 5.4.4.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	Large
Impacts on companies	-1.5
Economic impacts	+1.5
Social impacts	+2
Environmental impacts	+2
Impacts on fundamental rights	+1
Impacts on public administrations	0

### Expected degree of change in the national regulatory frameworks

Option C4 would bring **significant changes in the national regulatory frameworks**.

Amending the Shareholder Rights Directive II to align executive remuneration policy with the long-term and sustainability goals would require most of the Member States in scope of our analysis to introduce new rules in their national regulatory framework to comply with the new requirements. Indeed, in IT, BE, ES, SE, FR, FI, NL, HU, SI, PL, PT there are no law or regulatory measures that expressly link board remuneration to sustainability aspects and only listed companies have strict legal requirements to adopt and disclose the remuneration policy of the directors. Only in DE, since 1<sup>st</sup> January 2020, the German § 87 I 2 AktG (Principles Governing Remuneration of Members of the Management Board) states that the remuneration system of listed companies shall be aimed at the company's sustainable development. This means that when determining the remuneration system, non-financial aspects like social and ecological ones, need to be considered.

Therefore, this option would imply significant modifications and would introduce the requirement for companies to align their remuneration policies to the best practices tending towards sustainable long-term value.



### Impacts on companies

Option C4 would have a **moderate negative impact on companies in the short term, while in the long term the impact is likely to be positive.**

Amending the Shareholding Rights Directive II would introduce substantive requirements for the remuneration policy of European listed companies, linking it to long-term sustainable value creation. Companies that have assessed these dimensions report again that they do not expect any cost savings arising from the implementation of this option and expect the same level of costs as in the case of option B4.<sup>218</sup> However, one shall expect that a policy intervention introducing generalised, specific requirements for executive remuneration policies will determine at least a moderate increase in compliance costs (for listed companies not at all aligned with new requirements) or adjustment costs (for listed companies only partly aligned with them).

In terms of positive impacts, a remuneration policy linked to sustainable value creation is expected to lead directors to become more focused on ESG aspects (such as GHG emissions, employee satisfaction, and talent attraction – which could be possible pay metrics), and consequently to take more sustainable and long-term-oriented business decisions (especially in terms of investments), with positive effects at company level. Moreover, publishing a remuneration policy more oriented towards sustainability might result in improved company reputation and brand value.

### Economic impacts

Option C4 would have a **moderate positive economic impact, especially in the long term.**

The review of the Shareholder Rights Directive II with the inclusion of sustainability targets would create positive effects for the competitiveness of businesses, as ESG capture risk and opportunities that are not captured in the financial analysis,<sup>219</sup> and thus contribute to more sustainable economic growth. Option C4 might create incentives for executives to focus on strategies and actions to increase innovation, build more sustainable business model, and ultimately improve long-term financial performance and shareholder value. Moreover, this option would have positive effects on internal competitiveness, introducing harmonised requirements and thus promoting a more level playing field for companies.

### Social impacts

Option C4 would have a **moderate positive social impact.**

Option C4 would guarantee that all listed companies would establish vesting periods for share options and set ESG targets. Thus, it is possible to expect a larger presence of social indicators, especially those that are easier to quantify, such as the satisfaction of employees, measured through annual turnover or internal surveys, the satisfaction of consumers, or the acceptance by suppliers of codes of conduct. At the same time, there is a risk that companies will focus primarily on the KPIs included in the executive pay scheme, relegating to the background other sustainability aspects (both at social and environmental level). The extent of the positive social impact might also be reduced by the possibility that companies might prefer linking executive remuneration to social KPIs easier to measures (as the ones mentioned above), rather to KPIs more difficult to elaborate (e.g. indirect impact on local communities) but more representative of the effective social impacts in the territories where the company operates. Thus, it is possible to expect an indirect moderate positive impact from this option.

### Environmental impacts

Option C4 would have a **moderate positive environmental impact.**

Option C4 would favour the use of environmental indicators, pushing directors to focus on sustainability KPIs and achieve the sustainability targets set in the company strategy (see as Box 5 in Annex I.7), including at environmental level. By addressing the executive remuneration

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<sup>218</sup> Interviews with representatives from 2 companies.

<sup>219</sup> Interview with 1 investor.

structure, it would be possible to better incentivise directors to focus on environmental aspects, such as reducing GHG emissions (to mitigate risk of climate change), preserving and enhancing the natural capital and eco-system services, or increasing the company rate of recycling, improving the resource efficiency. As highlighted for the social impacts, there is a risk that companies will focus primarily on the KPIs included in the executive pay scheme, without considering also other sustainability aspects (both at social and environmental level).

### Impacts on fundamental rights

Option C4 would have a **small positive impact on fundamental rights**.

Option C4 should reinforce directors' focus on long-term value creation and sustainability, potentially also on goals related to the protection of fundamental rights in their business direct operations and value chains (possibly including the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour in third countries). However, the amendment will not require companies to adopt non-financial performance indicators linked to human and fundamental rights, and therefore it will remain up to each individual company to identify and disclose the non-financial indicator deemed more appropriate in light of the specific company's situation (e.g. business model, sector, specific types of social and environmental impacts. etc.). Therefore, though positive, the possible impact of option C4 in terms of fundamental rights is expected to be only small.

Option C4 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option C4 would have **no impacts on public administrations**.

The measure will not have significant budgetary consequences for national public authorities, nor implications at EU level. The modifications for the requirements on the remuneration policy included in the Shareholders Rights Directive II will not require additional controls on such policies by public authorities. In fact, Member States lay down the rules on measures and penalties applicable to infringements of national provisions adopted pursuant the Directive, and this is not expected to be modified.

#### *5.4.4.2 Assessment by criteria*

Criteria	Rate
Effectiveness	+2.5
Efficiency	+0.5
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option C4 would be **effective to a large extent** in promoting corporate governance practices that contribute to company's sustainability.

Option C4 would strongly influence the remuneration policy of companies in the EU. This measure would create a stronger link between pay and sustainable value creation, with the interests of directors better aligned to the long-term interest of the company and those of company stakeholders at large.

The amendments would be defined by the Commission with the support of relevant expert groups, and after consulting relevant stakeholders, such as companies. This process should make the implementation of these amendments easier, but companies might still need guidance, similar to Driver 3, in terms of process for the identification of targets that are relevant for their business model and sector, and ways to implement them in their remuneration policy. No major additional costs are expected for national and EU public authorities, as the control mechanisms would remain the same of the existing Directive. Moreover, similar requirements already exist

for banks and institutional investors, and their uptake have been positive according to the interviewees.<sup>220</sup> It could thus be expected to achieve similar results for non-financial companies.

The inclusion of these requirements in the Shareholder Rights Directive II would ensure a larger presence of social and environmental indicators to evaluate the performance of directors, and a stronger focus in the pay schemes on the long term. Representatives from 5 NGOs interviewed underlined the importance to include in the remuneration policy ESG targets aligned with the companies' strategy to create the right incentives for directors and realign their action towards sustainability.

Three interviewees from corporate governance committees and companies also stressed the fact that to be effective this measure requires a certain degree of flexibility, meaning that the requirements included in the Directive should leave enough room to companies to choose the most relevant targets for them, considering their business model and their sector, and the length of the vesting periods for the share options. In fact, the measure would be effective if it would not discourage companies to use share-options and the variable part of remuneration policies, but at the same time it should be guaranteed that the part of the remuneration linked to sustainability is significant.

One NGO interviewed also mentioned that including the requirements on remuneration in the Shareholder Rights Directive II might continue working in the direction of shareholder primacy, *"as the Directive is focused on shareholders exclusively, while the whole purpose of this corporate governance issue is to repurpose companies and provide more power to other stakeholders (workers, consumers, local communities, etc.), the society as a whole and the planet"*.

### Efficiency

#### **Costs**

Option C4 is expected to **increase costs to small extent**.

Amending the Shareholding Rights Directive II would introduce substantive requirements for the remuneration policy of European listed companies, linking it to long-term sustainable value creation. As a result, option C4 would create some compliance and adjustment costs for companies, linked to the need to review their remuneration policies to align them with the new binding rules. As some companies already introduced such practices, the cost increase will depend on the current situation within each company.

As regards public administrations, the adoption of the new binding rules would not have budgetary implications, neither at national nor at EU level.

#### **Benefits**

Option C4 is expected to have **moderate benefits**.

At economic level, the review of the Shareholder Rights Directive II would ensure that all listed companies include in their remuneration policies elements favouring the attention of directors to long-term value creation of the company, encouraging long-term, sustainability-oriented CAPEX and R&D investments by EU companies. The inclusion of sustainability targets would create positive effects for the competitiveness of businesses, as ESG capture risk and opportunities that are not captured in the financial analysis, as mentioned by an investor consulted. Moreover, this option would have positive effects on internal competitiveness, introducing harmonised requirements and thus promoting a more level playing field for companies.

Option C4 could also have large benefits at social, environmental, and fundamental rights level, by incorporating in the incentive schemes of directors sustainability elements for all listed companies in Europe, that linked with sustainability elements in the strategy considered under Drive 3 could strongly influence the approach to these themes by companies.

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<sup>220</sup> Interviews with representatives from 3 investors.

### Coherence

Option C4 would be **coherent with other main EU policy objectives and initiatives**.

Similarly to option B4, also the purpose and content of option C4 would be consistent with existing Commission recommendations on remuneration policy and disclosure requirements under the Shareholders Rights Directive II. By promoting the company's long-term value creation, this option would be in line with the objective of further embedding sustainability into the corporate governance frameworks, in line with the declared goal of the forthcoming renewed sustainable finance strategy, and contribute to the broader goals of the Green Deal.

### Proportionality

Option C4 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

Option C4 would create a new obligation for listed companies to include vesting periods for share-based remuneration schemes and ESG targets for directors, leaving to them the possibility to choose how to adapt these requirements to their business model and sectorial specificities. Option C4 would be costlier than option A4 and option B4, but the modifications in the incentive plans for directors concern only a part of the variable remuneration. Thus, it is not expected to create disproportionate costs/burdens for companies and public administrations.

## **5.5 Driver 5 – The current board composition does not fully support a shift towards sustainability**

### **5.5.1 Baseline**

It can be maintained that board composition will progressively shift towards greater diversity in the future. As concerns sustainability, a number of factors that are already in place (e.g. the introduction of legal obligations concerning sustainability, such as those related to non-financial disclosure; the increase in consumers' demand for more sustainable products and services; competitive pressure, etc.) might persuade an increasing number of companies to include sustainability-related competence and expertise at board level. Similarly, the measures to promote gender-diversity on board, which are already implemented in many EU Member States, could be adopted also by remaining EU countries (possibly as a result of increased pressure from the public opinion, or peer pressure from other Member States). However, in absence of an EU intervention, such shift is likely to be fragmented and slow. Moreover, the existing differences as concerns rules on board composition would persist across Member States.

From an economic perspective, increasing board diversity is important to break away from the business-as-usual and group think. Board diversity creates the conditions for taking business decisions leaning towards change and innovation, including on sustainability matters. Therefore, boards that lack diversity might be less inclined to consider sustainability risks and impacts and eventually change their activities or even business model to be more sustainable, which might even threaten companies' economic success in the long term. Moreover, having sustainability-related competences in the board can support companies in seizing business opportunities related to sustainability. Companies lacking the necessary competences will also miss out new growth opportunities stemming from sustainability. In aggregate and in the long run, the lack of diversity at board level might turn out having a negative effect on the innovative and competitive edge of EU economy.

From a social perspective, the lack of board diversity would continue adversely affecting equal opportunities for men and women in employment and occupation, as the considerable imbalance between women and men in economic decision-making at the board level, and the gaps existing among Member States' legislation on this matter, would remain substantially unaddressed (at least until the block on the Women on Board Directive proposed by the Commission persists).

## 5.5.2 Assessment of option A5

**A5**

Commission information campaign in collaboration with relevant stakeholders (in particular business associations) to promote the consideration of sustainability-related expertise in the board nomination process of companies (including by creating a new board role, the Chief Value Officer) (M5.1).

### 5.5.2.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	No change
Impacts on companies	0
Economic impacts	+0.5
Social impacts	+0.5
Environmental impacts	+0.5
Impacts on fundamental rights	+0.5
Impacts on public administrations	-0.5

#### Expected degree of change in the national regulatory frameworks

Option A5 would bring **no changes in the national regulatory frameworks**.

As of today, in none of the 12 Member States analysed there are legal provisions that require the board to be composed of directors with sustainability expertise. It is however allowed that the articles of association of the company and/or the board regulations include provisions regarding the need for directors to have a specific expertise. Therefore, a campaign to promote the consideration of sustainability-related expertise in the board nomination process of companies would not automatically lead national competent authorities to modify existing rules and eventually companies to change the current status quo. However, a Commission campaign would help raising awareness among companies on the importance of sustainability expertise at board level.

#### Impacts on companies

Option A5 would have a **no impact on companies**.

While not creating direct compliance costs, the implementation of option A5 might increase costs for companies that will follow the campaign's recommendation, as an extra criterion on the nomination of the board would turn this process even more challenging and costly. In SMEs, due to the small size of the boards, this problem could be proportionally more salient. As this option is non-mandatory, it is expected that possible cost increase will discourage the adoption of the guidelines by a wide range of companies. The awareness triggered by option A5 could in turn increase companies' investment in sustainability training for board members instead of having one more element on the board.

A Commission information campaign to promote the consideration of sustainability-related expertise in the board nomination process of companies may not be attractive for several reasons. Representatives from a company and two investors mentioned that, currently, listed companies already have difficulties in nominating the board because several requirements/criteria (e.g. length of term, gender) have to be met. For SMEs the adoption of this policy would be even more complicated as the boards are smaller and there is not much division of roles. In the interviews, different stakeholders<sup>221</sup> considered that the concept of sustainability should be something already included in the business model of the company and there was no need for sustainability experts in the board. The importance of a sustainability expert on the company board is also not a consensual issue and there are representatives from a company and a corporate governance committee that prefer board members with a knowledge of the company/business and a strategic vision. According to representatives from a company,

<sup>221</sup> Interviews with representatives from 2 companies, 2 corporate governance committees and 1 EU-level association.

a corporate governance committee and an investor interviewed, the concept of sustainability is not clear and could differ among sectors, being difficult to assess whether a board member is a sustainability expert or not, and the inclusion of sustainability expertise at board level could be better achieved by establishing sustainability advisory bodies (see section 7.7.1 in Annex I.7) or by engaging external experts on relevant sustainability aspects, as needed on a case-by-case basis. Moreover, the same stakeholders also considered that the board members' required competences should be decided by each company without external interference. The availability of directors with expertise in sustainability matters is a constraint for companies.

### **Economic impacts**

Option A5 would have a **very limited positive economic impact**.

Although it is expected that companies will follow the campaign only to a limited extent, option A5 could be a good way to start considering the sustainability issues on the business model of the company. The adoption of more sustainable corporate governance practices could improve the consumers and investors' perception, which could increase the company attractiveness and turnover. The attractiveness associated with this improvement could increase the level of investment in companies (namely in training and sustainability issues) and thus promoting the competitiveness in the long term.

No impact on the other dimensions (competition in the market, trade flows, jobs and growth) is foreseen.

### **Social impacts**

Option A5 would have a **very small positive social impact**.

Considering the sensitivity of the issue of board composition, as underlined by representatives from corporate governance committees (5), a simple information campaign to promote the consideration of sustainability-related competence and expertise in the board nomination process might be expected to have a very limited impact, due to the reluctance of companies to accept external indication on this, which is considered a topic of internal discussion and linked to the business model. Thus, there could be an indirect limited positive social impact that could be achieved by promoting a stronger understanding of social issues at board level, but this could be expected to be small due to the limited adoption of this practice by companies, while no negative social impact is expected.

### **Environmental impacts**

Option A5 would have a **very small positive environmental impact**.

Option A5 is expected to have some limited indirect positive environmental impact, with some companies implementing this suggestion and having stronger competence at board level. However, it might be expected that such implementation will be very limited, as board composition is a topic on which companies would prefer no interference, and thus also the indirect positive environmental impact will be reduced. No negative environmental impact is foreseen.

### **Impacts on fundamental rights**

Option A5 would have a **very small positive on fundamental rights**.

Option A5 would have no direct impact on fundamental rights. If successful, the campaign might lead an increased number of companies to systematically consider competence in sustainability matters when nominating the board, which in turn may result in greater attention to corporate sustainability risks and impacts, including on fundamental rights (for instance as concerns the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour). However, the likelihood and extent of such development is difficult to anticipate, especially considering the non-binding nature of this measure. At the same time, option A5 would not adversely impact fundamental rights.

Option A5 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option A5 would have **small negative impacts on public administrations**.

The option will not have significant budgetary consequences for national public authorities, and will have minor implications at EU level. These implications are the costs related to the information campaign, but the actual amount will depend on the tools adopted for the campaign, with online contents less expensive than live events, especially considering the large number of companies to be targeted.<sup>222</sup>

#### 5.5.2.2 Assessment by criteria

Criteria	Rate
Effectiveness	+1
Efficiency	0
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option A5 would be **effective to a small extent** in promoting corporate governance practices that contribute to company's sustainability.

Option A5 would encourage companies to consider sustainability in the board nomination process, raising the awareness on the importance of having this expertise at board level to allow directors to act in an informed way.

The campaign would be implemented through various channels (e.g. conferences, roundtables, stakeholder meetings, etc.), and would likely be easy to implement, without requiring additional costs for companies. It would start a dialogue on the issue, similar to recent debates on the inclusion of IT and cybersecurity related expertise. If successful, the campaign might lead to an increased number of companies that systematically consider the competence in sustainability matters when nominating the board, which in turn may result in greater attention to corporate sustainability. Also the appointment of new board roles recommended by the campaign (such the chief value officer) could ensure that all relevant aspects of value creation and destruction are accounted for and communicated to boards, management, and external stakeholders.

However, the likelihood and extent of such developments is difficult to anticipate, especially considering the non-binding nature of this measure. As discussed by a number of interviewees,<sup>223</sup> and highlighted by the legal analysis conducted for this study, the composition of the board is usually a matter of internal discussion which is strictly linked to the business model of each specific company. In this light, even soft such as those included in an information campaign, on the board composition risk being seen as intrusive and will hardly be followed.

### Efficiency

#### Costs

Option A5 is expected to **increase costs to a very small extent**.

The Commission campaign would not entail the introduction of substantive obligations or requirements for companies to comply with. Therefore, it would not bring direct compliance costs. Indirect costs could be linked to the complication of the board nomination process, for which already exist a number of criteria, such as diversity, and this would be particularly relevant for companies with small boards, in particular SMEs. Companies might need to recruit HR specialists or headhunters to search for the needed expertise. Yet, these costs are hard to estimate and will vary from one company to another. Some companies may want to increase

<sup>222</sup> According to the impact assessment for the Shareholder Rights Directive II, there were 10,409 domestic listed companies in the EU in 2012.

<sup>223</sup> With representatives from 2 corporate governance committees, 1 company and 1 EU-level association.

the number of board members thus bringing to additional costs for their remuneration, while others may choose to replace existing board members to achieve the needed competence mix.

As regards public administrations, the campaign would have direct budgetary implications at EU level. Even though the amount of costs will depend on implementation choices (e.g. communication channels used, number of live events, involvement of partners, etc.) and cannot be quantified, it will be comparable in scale to similar initiatives already carried out by the Commission in the past (in other policy fields) and is not expected to be remarkable (considering that it will be targeted mainly to companies).

### **Benefits**

Option A5 is expected to have **very limited benefits**.

Similar to costs, possible benefits would be both direct and indirect, and their extent would depend on how many companies will be influenced in their practices by the campaign.

At economic level, introducing sustainability expertise in the board nomination process could increase the capacity of executives to assess long-term risks for their business strategy and increase investment necessary for the sustainable development of companies. However, the extent of the possible economic effects could be limited by the voluntary nature of the promotion campaign.

Indirect benefits would be a bit larger at environmental, social, and fundamental rights level, as the level of expertise in these issues would increase.

### **Coherence**

Option A5 would be **coherent with other main EU policy objectives and initiatives**.

By stressing the importance of having sustainability competence, knowledge and expertise in the board room and of considering sustainability as a criterion in the board nomination process, this option would be clearly in line with the objective of further embedding sustainability into the corporate governance frameworks and strengthening companies' focus on their long-term development and sustainability aspects, which is a declared goal of the forthcoming renewed sustainable finance strategy. It would also be in line and indirectly support the sustainability transition that lays at the core of the Green Deal.

### **Proportionality**

Option A5 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

The campaign would be a soft policy initiative, aimed at increasing the awareness of companies about the importance of such competence at board level. The measure would not create binding requirements, but could have benefits in terms of cultural change and lay the ground for more incisive EU action in the future. Option A5 is not expected to create disproportionate costs/burdens for companies and public administrations.

## **5.5.3 Assessment of option B5**

**B5**

*Commission recommendation for Member States to introduce in their respective national frameworks a provision to ensure that sustainability-related expertise is systematically considered in the board nomination process of companies (M5.2).*

### *5.5.3.1 Assessment by impacts*

<b>Impact</b>	<b>Rate</b>
Expected degree of change in the national regulatory frameworks	Small
Impacts on companies	-1
Economic impacts	-0.5
Social impacts	+0.5



Impact	Rate
Environmental impacts	+0.5
Impacts on fundamental rights	+0.5
Impacts on public administrations	0

### Expected degree of change in the national regulatory frameworks

Option B5 would bring **small changes in the national regulatory frameworks**.

The Commission recommendation would bring some national competent authorities to adjust their national rules either by modifying existing laws or revising the national corporate governance code.

As highlighted under option A5, as of today, in none of the 12 EU Member States in scope of this study (IT, BE, ES, SE, FR, FI, NL, HU, PL, SI, DE, PT) there are legal provisions that require the board to be composed of directors with sustainability expertise, and this remains a requirement that may potentially be included in the companies' articles of association and/or board regulations.

This option would raise the need to introduce at the national level a specific provision considering the importance of sustainability expertise at board level. However, it will likely not bring to a level playing field for listed companies across EU Member States as some Member States might decide not to follow the Commission's recommendation and do not change the status quo or change it in different ways.

### Impacts on companies

Option B5 would have a **small negative impact on companies**.

The (indirect) costs of compliance mentioned for option A5 also apply for this option, but given the more formal requirements that would be adopted in case of national implementation, slightly higher costs are expected for companies. The total costs of implementation are dependent on the level of transposition to the national framework among Member States, on the percentage of SMEs in the economy and on the availability of directors with expertise in sustainability matters. Also in this option, and depending on the flexibility of the recommendations, training board members on sustainability matters could reduce the compliance costs associated with this option.

The benefits for companies in Member States that decide to adopt the recommendation as per option B5 are substantially the same as those mentioned for option A5.

### Economic impacts

Option B5 would have a **very small negative economic impact**.

The economic impacts of option B5 depend on the perception of stakeholders (consumers and investor, mostly) about sustainability issues in EU countries that adopted the policy. The impact on competitiveness would depend on whether investment and consumption arising from attractiveness overcome implementation costs. On average the assessment by stakeholders<sup>224</sup> points to a limited positive impact on competitiveness and trade flows, indicating a low capacity to compensate for the expected costs. The compliance costs and the impact on competitiveness could be higher in SMEs, as already explained. No impact on the other dimensions (jobs and growth) is foreseen.

### Social impacts

Option B5 would have a **very small positive social impact**.

<sup>224</sup> Interviews with representatives from 2 companies, 4 investors, 2 NGOs, 2 trade unions organisations, 5 corporate governance committees, with the latter being the ones that evaluate most negatively the impacts on competitiveness and trade flows).

Under this option, a non-binding recommendation for Member States to include in their national legal frameworks a requirement for companies to systematically consider sustainability in their board nomination process can be expected to have an indirect positive social impact to the extent, bringing the discussion on social issues at board level. However, a non-binding recommendation might be too weak to lead to the consideration of sustainability criteria in the board nomination process by a large number of companies, limiting the extent of the indirect positive social impact resulting from the adoption of this option B5.

### Environmental impacts

Option B5 would have a **very small positive environmental impact**.

A non-binding recommendation would probably have some positive indirect environmental impact, with an official EU document mentioning the importance of having sustainability at board level. This could drive companies to consider climate change, the preservation of natural capital or the alignment to circular economy principles more often, but would be limited by the non-binding nature of the recommendation and by the fact that board composition is considered by companies a sensitive issue, a topic of internal discussion and linked to the business model, with increasing difficulties in finding the right persons with the set of competences and diversity features required.

### Impacts on fundamental rights

Option B5 would have a **very small positive impact on fundamental rights**.

The recommendation is not expected to result in any remarkable change of the status quo as regards the protection of fundamental rights. Although option B5 might lead an increased number of listed companies to elect a corporate board better equipped to deal with sustainability matters in general (including on fundamental rights, such as the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour in third countries), the realisation of this scenario will depend on the extent to which Member States will introduce such requirement domestically, and in what form (e.g. as an obligation included in listing rules or as a "comply or explain" requirement). As due to its non-binding nature option B5 might be too weak to lead many more companies to systematically and substantially consider sustainability when nominating the corporate board, it seems unlikely that there will be a significant positive impact in terms of fundamental rights resulting from the adoption of this measure. At the same time, option B5 is not expected to have a negative impact on fundamental rights.

Option B5 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option B5 would have **no impacts on public administrations**.

The measure will not have significant budgetary consequences for national public authorities, nor implications at EU level. An administrative burden might be expected at the EU level in a situation in which different Member States apply different laws, as EU bodies may need to follow and monitor national initiatives and possibly facilitate some type of information exchange. However, it can be expected that this would be covered by existing operational structures and budgets since this would be a normal process of monitoring policy developments in the Member States.

#### 5.5.3.2 Assessment by criteria

Criteria	Rate
Effectiveness	+1.5
Efficiency	0
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option B5 would be **effective to a moderate extent** in promoting corporate governance practices that contribute to company's sustainability.

The recommendation would create a stimulus for change in the national regulations and/or corporate governance codes.

As the current legislation in the 12 Member States analysed does not include provisions on the expertise of directors, the implementation of the Commission recommendation would require Member States to introduce new instruments and provisions. Interviews with representatives from a corporate governance committees and an investor clarified that similar corporate governance discussions in the past, for example on IT and cybersecurity expertise in the board, eventually resulted in no action. In this light, considering that the recommendation would not be legally binding for Member States, it could be expected that many of them would not implement it.

### Efficiency

#### **Costs**

Option B5 is expected to **increase costs to a very small extent**.

The recommendation would be addressed to Member States, and only companies in the countries applying it would be affected. In these countries, some companies might decide to adopt sustainability criteria in the board nomination process, bearing some indirect costs, namely to study which expertise is necessary and to find the right candidates, and these costs are impossible to quantify ex ante.

As regards public administrations, the adoption of the recommendation would not have budgetary implications, neither at national nor at EU level.

#### **Benefits**

Option B5 is expected to have **very limited benefits**.

At economic level, the recommendation might increase, in the Member States where it is applied, the capacity of the boards to deal with sustainability risks, which in turn might improve the resilience of companies to these issues improving their competitiveness in the long term.

At social, environmental, and fundamental rights level, some benefits might be expected to from a larger expertise at board level on sustainability issues, but the level of implementation of the recommendation might influence such effect.

### Coherence

Option B5 would be **coherent with other main EU policy objectives and initiatives**.

The recommendation would contribute to strengthening companies' focus on their long-term development and sustainability aspects, in line with the declared goal of the forthcoming renewed sustainable finance strategy. Moreover, option B5 would also be broadly in line with the objectives of the Green Deal, as it could work as an enabler/facilitator on the corporate side of the transition towards a climate-neutral and green economy.

### Proportionality

Option B5 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

The non-binding recommendation for Member States to include in their national regulatory frameworks requirements for companies to consider sustainability expertise in the executive recruitment process would leave to Member States flexibility on the modalities to implement Commission suggestions. Companies would be left to decide in which way to consider sustainability expertise. Option B5 is not expected to create disproportionate costs/burdens for companies and public administrations.

## 5.5.4 Assessment of option C5

**C5**

Commission proposal for a new EU directive laying down rules on board composition of listed companies, including a requirement for companies to consider sustainability criteria in the board nomination process (M5.3).

### 5.5.4.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	Large
Impacts on companies	-1.5
Economic impacts	-1
Social impacts	+2
Environmental impacts	+2
Impacts on fundamental rights	+1
Impacts on public administrations	0

#### Expected degree of change in the national regulatory frameworks

Option C5 would bring **significant changes in the national regulatory frameworks**.

A new EU directive laying down rules on board composition of listed companies, including a requirement for companies to consider sustainability criteria in the board nomination process, will require all 12 Member States in scope to transpose the new provisions and thus modify existing national rules.

#### Impacts on companies

Option C5 would have a **moderate negative impact on companies in the short term, while in the long term the impact is likely to be positive**.

Ensuring that the board encompasses members with expertise and competencies on sustainability matters through a Commission proposal for a new EU directive laying down rules on board composition of listed companies, including a requirement for companies to consider sustainability criteria in the board nomination process will have consequences in terms of compliance costs, as already mentioned. Moreover, considering that the nomination of the board on listed companies is already a complicated process, an extra-criterion would turn this process even more challenging, increasing the associated burden. The limitations and costs associated with option C5 may impose a high risk of companies refraining from becoming listed or leaving the listed environment, adversely affecting the capital markets.

Similarly to option B5, the effects will also depend on the percentage of listed SMEs in the economy and on the availability of directors with expertise in sustainability matters. The benefits would be substantially the same as considered for option A5 and option B5.

However, including sustainability expertise at board level would improve the reputation of companies, and could increase their capacity to attract investments from those financial actors focusing on long-term sustainable value creation. Moreover, it would guarantee informed sustainability discussions at board level and thus improve company decision-making on such issues (including in terms of resource allocation and investments). Arguably, with the implementation of option C5, boards of EU listed companies would also become better able to design more sustainable business strategies, and to assess and take the business opportunities opened up by sustainability challenges (e.g. costs savings resulting from energy efficiency investments to mitigate climate change), with positive consequences on long-term value creation.

#### Economic impacts

Option C5 would have a **small negative economic impact in the short term, while in the long term the impacts is likely to be positive**.

On the one hand, a new binding instrument at EU level on the sustainability expertise of board member would have positive effects on internal competition (by creating a more level playing field at EU level) and could increase the capacity of European listed companies to create long-term value, through investments and R&D expenditures. This option could contribute to a more balanced integration of sustainability issues in board decisions, but, as in option B5, the impact on competitiveness would depend on the ability of investment and consumption arising from attractiveness to overcome compliance costs. On average, the assessment of stakeholders<sup>225</sup> points to a small negative impact on competitiveness and trade flows, indicating a low capacity to compensate for expected cost increase. Moreover, as already referred for option B5, the burden and limitations associated with this policy could decrease the attractiveness of the business environment and affect negatively capital markets in the short term. This option will have higher economic impact than option B5. Under a new EU directive, the Member States would have less flexibility to mitigate potential negative effects on the national economies.

### Social impacts

Option C5 would have a **moderate positive social impact**.

A new directive would improve the diversity of the board in terms of expertise. It could be expected from companies which have board members more aware of sustainability aspects, to better address social issues, having more frequent discussions on the matter and raising the issue systematically in all their decisions. However, the extent of the indirect positive social impact is expected to be slightly reduced by the vagueness of the requirement on what is sustainability expertise, so that whether expertise on social issues will be included will depend on the business model of each company.

### Environmental impacts

Option C5 would have a **moderate positive environmental impact**.

The proposal for a new directive on the composition of the board would institutionalise sustainability in the company, as we can expect it will put climate change, biodiversity and natural capital, the circular economy and resource efficiency more frequently on the agenda of the board. This would create a positive environmental impact from the option, especially if a sustainability committee is created as well. One NGO suggested that it would be difficult to measure the results, but there could be metrics, such as discussion time on environmental topics in the board, and how many decisions are taken.

### Impacts on fundamental rights

Option C5 would have a **small positive impact on fundamental rights**.

The new EU directive would include an obligation to consider sustainability criteria in the board nomination process. This would ensure that all listed companies across Europe systematically consider sustainability competence, knowledge and expertise when nominating the corporate board, which might result into greater attention on the part of the board to the sustainability of the business model as well as to sustainability risks and impacts in company's direct operations and value chain, including in terms of protecting fundamental rights (including the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour). The impact on fundamental rights of option C5 thus is expected to be positive, although mainly indirect and very limited (as the requirement would refer to sustainability in general and not specifically to competence and expertise in fundamental and human rights matters, each company will remain free to look for specific sustainability competence and expertise that is more in line with its business context and situation).

Option C5 is not expected to affect property rights or the right to conduct business.

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<sup>225</sup> Interviews with representatives from 2 companies, 3 investors, 2 NGOs, 2 trade unions, 5 corporate governance committees, with the latter being the ones that evaluate more negatively the impacts on competitiveness and trade flows, followed by investors.

### Impacts on public administrations

Option C5 would have **no impacts on public administrations**.

The measure will not have significant budgetary consequences for national public authorities, nor implications at EU level. It can be assumed that the cost of monitoring compliance would be minimal, as reviewing a report on the composition of the board would not be time consuming.

#### 5.5.4.2 Assessment by criteria

Criteria	Rate
Effectiveness	+2.5
Efficiency	0
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option C5 would be **effective to a large extent** in promoting corporate governance practices that contribute to company's sustainability.

Option C5 would strongly affect the requirements for companies.

The new directive would require Member States to include in their respective national frameworks an obligation for listed companies to consider sustainability-related expertise and competence (e.g. expertise on sustainability related issues relevant to the company's business model, on sustainability risk assessment, on non-financial reporting, etc.) as a selection criteria in the board nomination process. As a consequence, companies throughout Europe would be requested to adjust their practices in this regard.

A number of interviewees representing two corporate governance committees, a company and an EU-level association stressed the importance of leaving to the company the freedom to define the sustainability expertise more relevant for them, so as to avoid "box ticking" approaches, and to trigger a substantial change in the approach instead. An alternative solution to bring sustainability expertise to the boardroom could be the creation of a sustainability advisory body. Such mechanism could work in synergy with option C6 on stakeholder engagement mechanisms, to the extent that members of the advisory body are not only representatives of relevant stakeholder categories, but also sustainability experts bringing the necessary expertise to the board.

One NGO suggested that the EU approach in this field could be similar to the one adopted in the banking sector, where a series of criteria, called "fit and proper", are assessed for selecting the members of the management of the financial companies, with guidelines developed jointly by ESMA and the European Banking Authority (EBA).

### Efficiency

#### Costs

Option C5 is expected to **increase costs to a small extent**.

Option C5 would introduce substantive requirements for companies to modify the way they recruit board members. Such requirements would entail compliance costs, particularly related to the availability of directors with the right expertise in the market. As underlined by an investor, having this requirement at this point in time (as the number of professionals with sustainability skills is still limited) may create the risks that the largest companies will attract all the talents with sustainability knowledge, while the other companies would struggle to find suitable profiles.

As regards public administrations, the new legislative instrument would not have direct budgetary implications at the EU or national level.

#### Benefits

Option C5 is expected to have **limited benefits**.

At economic level, a new binding instrument at EU level on the sustainability expertise of board member would have positive effects on internal competition (by creating a more level playing field) and could increase the capacity of European companies to create long-term value, through investments and R&D expenditures.

The increased knowledge on sustainability issues at board level would also have positive effects at social, environmental, and fundamental rights level, putting these elements firmly on the agenda of the company decision makers.

### Coherence

Option C5 would be **coherent with other main EU policy objectives and initiatives**.

Similar to option A5 and B5, the EU directive foreseen under option C5 would serve the goals of the renewed sustainable finance strategy (i.e. strengthening companies' focus on their long-term development and sustainability aspects) and of the Green Deal (i.e. an effective and fair transition to climate neutrality by 2050).

In terms of consistency with other EU initiatives, it should be underlined that currently the Non-Financial Reporting Directive already requires companies (on a comply or explain basis) to disclose in their management report their diversity policy with regards, among other aspects, also to the educational and professional backgrounds of the management and supervisory bodies.

Moreover, in the financial sector, EU legislation already covers board composition by laying down 'fit and proper requirements'. In particular, Article 91 (on Management Bodies) of Capital Requirements Directive IV<sup>226</sup> requires that management bodies of the financial institutions must meet certain suitability requirements, so as to foster safe and sound banking and financial practices. In particular, the Joint ESMA and EBA Guidelines<sup>227</sup> on the assessment of the suitability of members of the management body requires that the composition of the management body should reflect the knowledge, skills and experience necessary to fulfil its responsibilities. This includes that the management body collectively has an appropriate understanding of those areas for which the members are collectively accountable, and the skills to effectively manage and oversee the institution, including a list of aspects such as each of the material activities of the institution, risk management, compliance and internal audit, and information technology and security.

Finally, the EU directive laying down rules on board composition of listed companies would reasonably be consistent with possible EU policy developments in the area of promoting gender balance on board, such as the 2012 proposal for a Directive on improving the gender balance on corporate boards, with a recent commitment by the Commission to push for its adoption in the Gender Equality Strategy 2020-2025.

### Proportionality

Option C5 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

A new binding instrument at EU level on the inclusion of sustainability competences and expertise at board level would be proportionate to the objective, as the requirement would leave companies with the possibility to implement it in the way more adapted to its situation and practices. Even if some issues may rise from finding the candidates for executive positions with

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<sup>226</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC. Article 91(1) provides that "Members of the management body shall at all times be of sufficiently good repute and possess sufficient knowledge, skills and experience to perform their duties. The overall composition of the management body shall reflect an adequately broad range of experiences. Members of the management body shall, in particular, fulfil the requirements set out in paragraphs 2 to 8".

<sup>227</sup> ESMA and EBA (2017), Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU – Final Report, EBA/GL/2017/12.

a suitable background and knowledge, this issue will not create disproportionate burdens. Option C5 is not expected to create disproportionate costs/burdens for companies and public administrations.

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

### 5.6.1 Baseline

In absence of EU action, the prevailing social norm of shareholder primacy will not be challenged and will continue affecting corporate governance, leading directors to primarily focus decision-making on short term shareholder value maximisation. The long-term interest of stakeholders other than shareholders is likely to remain on the side-line in board decisions. Similarly, existing differences across Member States in national legislation on workers' involvement at board level would persist, leaving workers from different EU countries with different possibilities to participate in company decision-making.

At economic level, failure to establish and maintain good relations with various stakeholder constituencies with a legitimate interest in their operations (e.g. employees, creditors, suppliers, local communities, and the society at large) will continue leaving companies open to the risk of losing their "social license", with negative consequences in terms of reputation and access to resources.

At social level, due to the persistence of this driver, the voices of many of the companies' stakeholders, including the most vulnerable social groups (such as workers in third countries along global supply chain), will continue being unheard in company decision-making.

The main anticipated effects of excessive focus on shareholder value maximisation have been underlined under Driver 1.

### 5.6.2 Assessment of option A6

**A6**

*Establishment of a Commission Advisory Group on Sustainable Corporate Governance to identify good practices on stakeholder engagement and involvement. Practices identified could be eventually disseminated through a dedicated campaign (M6.1).*

#### 5.6.2.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	No change
Impacts on companies	-0.5
Economic impacts	+0.5
Social impacts	+0.5
Environmental impacts	+0.5
Impacts on fundamental rights	+0.5
Impacts on public administrations	-0.5

#### Expected degree of change in the national regulatory frameworks

Option A6 would bring **no changes in the national regulatory frameworks**.

Currently, none of the 12 Member States analysed include provisions for the involvement of company's creditors, clients and third parties in the company's decision-making processes. According to the actual provisions, only shareholders and employees have the right to be involved in the management of the company only in few Member States.

The establishment of a Commission Advisory Group on Sustainable Corporate Governance may improve the awareness of the importance of adopting mechanisms of stakeholder involvement, but will likely not bring modifications to the existing rules that EU Member States have adopted



in this regard also due to the difficulty to identify what companies should do in concrete to enhance this involvement should be done.

### Impacts on companies

Option A6 would have a **very small negative impact on companies**.

Companies that decide to follow best practices disseminated by the Commission Advisory Group, and to ensure that company's stakeholders are involved in defining and supervising the implementation of the company's processes aimed at identifying, preventing and mitigating company sustainability risks and impacts, will bear indirect compliance costs to implement those practices. Five investors and one NGO reported that identifying the stakeholders to involve, propose the process of involvement, and approve and implement the plan of action might be time consuming and sometimes may prove to be of limited benefit.

Moreover, compliance costs will be proportionally higher in smaller enterprises, which have less flexibility in adding these tasks on top of the employee's current work without jeopardising the normal functioning of the company. However, for companies that follow good practices of the Commission Advisory Group, namely for the first movers, it can be expected a slight increase of the brand value if customers recognise and value the improvements, and this might eventually lead to a moderate rise in turnover. This effect would gradually decrease when practices become more widespread.

### Economic impacts

Option A6 would have a **very small positive economic impact**.

Pushing companies to involve internal and external stakeholders in defining and supervising the implementation of the company's processes aimed at identifying, preventing and mitigating company sustainability risks and impacts can be a starting point to raise awareness on the benefits of considering the different stakeholder interests in the company's strategy design.

In the short run, for first movers, it could be expected a competitive advantage resulting from brand recognition that might translate into an increase in turnover (and a rise in trade flows if they exist in the baseline) and, in the long term, positive impacts on investment could be expected, reinforcing competitiveness. Considering that this option is based on a voluntary approach it is not expected that it would have an overall relevant economic impact, but the economic benefits could slightly outweigh costs.

Overall stakeholder feedback<sup>228</sup> confirms a limited positive impact on competitiveness and trade flows. No impact on the other dimensions (jobs and growth) is foreseen.

### Social impacts

Option A6 would have a **very small positive social impact**.

Option A6 can be expected to positively affect the participation of social actors, such as employees, consumers and local communities, in the discussion around social issues associated with companies own operations and supply chain. Option A6 would support companies to identify and engage with stakeholder constituencies that are most relevant to and impacted by the company, and in this way to address more effectively the possible problems connected to their activities, including at social level. However, the extent of the positive consequences of this options is foreseen to be limited by the fact that companies will not be required to change from business as usual and adopt the identified best practices.

### Environmental impacts

Option A6 would have a **very small positive environmental impact**.

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<sup>228</sup> Interviews with representatives from 2 companies, 3 investors, 2 NGOs, 3 trade unions organisations, and 5 corporate governance committees.

An Advisory Group on Sustainable Corporate Governance would have a very small environmental impact. On the one hand, option A6 might result in larger and more effective involvement of stakeholders by the companies that will adopt the best practices, which might have positive consequences in terms of identifying, preventing and mitigating company's sustainability impacts, including in the environment. On the other hand, the non-binding nature of this option implies that companies will not be compelled to implement any of the best practices identified. As underlined by an NGO, stakeholder engagement can be a burdensome activity (e.g. in terms of organisation, preparation for the meetings etc.) from all parts involved, and this is not expected to incentivise the adoption of voluntary practices. Therefore, its potential for generating a change on the ground in terms of business practices can reasonably be assumed to be quite limited. Overall, any positive impact, also at environmental level, can be expected to be very small.

### Impacts on fundamental rights

Option A6 would have a **very small positive impact on fundamental rights**.

The establishment of an Advisory Group on Sustainable Corporate Governance at Commission level, tasked to identify best practices on stakeholder engagement and involvement, might be conducive to companies' voluntary adopting identified mechanisms to engage with and involve internal and external stakeholders. However, as highlighted for social and environmental impacts, any positive impact of option A6 on fundamental rights can be expected to be very small, as this non-binding option is not expected to be impactful in changing corporate practice on the ground extensively.

### Impacts on public administrations

Option A6 would have **very small negative impacts on public administrations**.

The option will not have significant budgetary consequences for national public authorities, and it will have minor implications at EU level. These implications are the costs related to the establishment of the Advisory Group on Sustainable Corporate Governance, which would be set up as a Commission Expert Group composed of a number of experts representing the public and private sectors, as well as NGOs and academic institutions. The costs of the experts for participation in these meetings will be reimbursed, and operational expenses will be related to research/study/survey budget and human resources' costs. A previous impact assessment quantified the costs for a group of 30 experts for around €2.6 million per year.<sup>229</sup>

#### 5.6.2.2 Assessment by criteria

Criteria	Rate
Effectiveness	+0.5
Efficiency	0
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option A6 would be **effective to a very small extent** in promoting corporate governance practices that contribute to company's sustainability.

Option A6 would create a new forum of discussion open to different stakeholders, increasing the relevance of the identified good practices and their applicability. The Advisory Group would involve representatives from associations representing a broad range of stakeholders interested

<sup>229</sup> European Commission (2018), 'Impact Assessment accompanying the Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment, the Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 and the Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks', SWD(2018) 264 final, p. 165.

in corporate governance topics (e.g. directors, shareholders, investors, workers, civil society organisations and NGOs, etc.), either as full members or observers.

The implementation of the measure would require an effort mainly from the Commission, while companies would not be subject to any requirement, apart from receiving information on the practices identified by the Advisory Group. The discussion and the resulting suggestion might raise awareness to the benefits of considering the different stakeholder interests in the company's strategy design, in economic, social and environmental terms.

However, the measure might not be effective in promoting good practices of stakeholder engagement, as it may be too soft to change the decision-making processes within companies, as they are granted a lot of freedom in organising this kind of processes and could not be willing to change them. Interviewees<sup>230</sup> mentioned in particular the difficulty to engage external stakeholders that would not be interested in the functioning of the company as such, but only on its impacts on them and the environment.

Some interviewees<sup>231</sup> suggested that the Advisory Group should not limit its work on the engagement of stakeholders, but could discuss other aspects of corporate governance, such as the identification of sustainability targets and the development of materiality matrixes. An example to be followed could be that of EFRAG, an advisory group on financial reporting, which recently published guidelines on non-financial information.

### Efficiency

#### **Costs**

Option A6 is expected to **increase costs to a very small extent**.

The identification of good practices on stakeholder engagement by a newly created Advisory Group would not create substantive obligations or requirements for companies. Therefore, option A6 would not impose direct compliance costs on companies, which would remain free to decide whether to follow the engagement mechanisms suggested or not. Companies that will choose to apply such mechanisms will likely incur costs related to the identification of stakeholders and of the way to approach them.

Concerning public administrations, the establishment of the Advisory Group would have direct budgetary implications at EU level. A previous impact assessment quantified the costs for a group of 30 experts for around €2.6 million per year,<sup>232</sup> thus small compared to the overall EU budget.

#### **Benefits**

Option A6 is expected to have **very limited benefits**.

At economic level, the best practices identified by the Advisory Group on Sustainable Corporate Governance on the engagement of stakeholders could improve the capacity of companies to deal with external stakeholders, with the possibility of economic benefits in terms of brand recognition and, in the longer term, also in terms of investments and competitiveness.

Similarly, at environmental, social, and fundamental rights level, those companies deciding to adopt some practices would improve their sustainability performance thanks to a better dialogue with important actors.

### Coherence

Option A6 would be **coherent with other main EU policy objectives and initiatives**.

In terms of policy objectives, the identification and dissemination of best practices for stakeholder engagement would be aimed at supporting companies in engaging with their relevant stakeholders to take into consideration their views and concerns when taking business

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<sup>230</sup> With representatives from 2 corporate governance committees, 1 company and 1 investor.

<sup>231</sup> Interviews with representatives from 2 NGOs and 1 company.

<sup>232</sup> European Commission (2018), SWD(2018) 264 final, p. 165.

decisions for the long-term interest of the company. Subsequently, option A6 would be in line with the goal of strengthening companies' focus on their long-term development and sustainability aspects, as per the forthcoming renewed sustainable finance strategy.

In terms of consistency with other EU initiatives, the creation of a Commission Advisory Group on Sustainable Corporate Governance would be in line with previous, similar Commission initiatives (i.e. Informal Company Law Expert Group)<sup>233</sup> and would complement it with a specific focus on the integration of sustainability into corporate governance aspects.

### Proportionality

Option A6 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

The Advisory Group would provide the possibility to gather different stakeholder views and discuss the best approaches to stakeholder engagement, without imposing them to companies, which would be left free to implement the solution they see more relevant to their specific context. Option A6 is not expected to create disproportionate costs/burdens for companies and public administrations.

### 5.6.3 Assessment of option B6

<b>B6</b>	<p><i>Commission recommendation for Member States to introduce in their respective national frameworks a requirement for companies to engage with and involve both internal and external stakeholders in identifying, preventing and mitigating sustainability risks and impacts as part of their business strategy (M6.2).</i></p> <p><i>This measure could be implemented in synergy with M3.2 (Commission recommendation for the Member States to introduce in their respective national frameworks specific requirements for boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy) as well as with M1.2 (Commission recommendation providing a uniform interpretation of directors' duties and company's interest to the Member States and recommending them to introduce in their respective national frameworks an explicit directors' duty to identify and mitigate sustainability risks and impacts, both internal and external, connected to the company's business operations and value chain).</i></p>
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#### 5.6.3.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	Small
Impacts on companies	-1
Economic impacts	-0.5
Social impacts	+0.5
Environmental impacts	+0.5
Impacts on fundamental rights	+0.5
Impacts on public administrations	0

### Expected degree of change in the national regulatory frameworks

Option B6 would bring **small changes in the national regulatory frameworks**.

An Commission recommendation for Member States to introduce in their respective national frameworks a requirement for companies to engage with and involve both internal and external stakeholders in identifying, preventing and mitigating sustainability risks and impacts as part of their business strategy, may lay the ground for a more extensive (compared to option A6) implementation of these provisions by national competent authorities. However, due to the non-binding nature of this option, Member States will remain free to decide whether to implement

<sup>233</sup> Informal Company Law Expert Group (E03036). For more information, see Register of Commission Expert Groups (<https://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3036&NewSearch=1&NewSearch=1>).

the Commission recommendation and to select how to implement it (either through a legislative change or a modification of the national corporate governance code) depending on the specificities of their national regulatory frameworks.

In this view, despite the fact that in none of the 12 EU Member States analysed there are measures for the involvement of company's creditors, clients and third parties in the decision-making processes, this option would likely bring small changes to the current national regulatory frameworks.

### Impacts on companies

Option B6 would have a **small negative impact on companies**.

Option B6 can bring a wider number of Member States (wider than option B6) to modify existing rules and subsequently require more companies to bear indirect compliance costs to implement new rules.

The magnitude of the impact will be directly related to the time spent by employees and board members that will identify the stakeholders to involve, propose the process of involvement, approve and implement the plan of action.

The increase in the costs may differ among Member States (depending on the flexibility that is given to company's action) and tend to be higher for smaller enterprises, which have less flexibility in introducing these tasks on top of current employee's work without jeopardising the normal functioning of the company. Moreover, companies integrated in long supply chains will face higher costs as they deal with higher numbers of stakeholders.

On average, the interviewees<sup>234</sup> considered that the negative impact on costs would be small to moderate. To limit these costs, it has been suggested in the interviews, to limit the option to the engagement of the employees only.

### Economic impacts

Option B6 would have a **very small negative economic impact**.

Considering that the baseline (practices and other legislative obligations) is different in the Member States and that sectorial differences imply different approaches for involvement, the economic impacts on competitiveness would also differ among countries and sectors.

Some stakeholders interviewed<sup>235</sup> agree that negative impacts on the competitiveness of business can occur through the rise of compliance costs referred above. These impacts will be higher in sectors/companies with long supply chains, which have more stakeholders, and SMEs, who find it more difficult to allocate staff to the stakeholder engagement process. Moreover, the involvement of external stakeholders in the design and monitoring of sustainability strategy was reported to contribute to the deterioration of the business environment by increasing the complexity and delaying the decision-making process, as external stakeholders usually are not fully aware of the business constraints. This would eventually create entropy, especially in SMEs, that have smaller boards with less space to accommodate different stakeholders in the decision-making process.

As highlighted under the option A6, a valorisation of sustainability practices (in board decisions but also by consumers and investors) can be expected and, in the long term, positive impacts on investment could arise, thus reinforcing competitiveness of companies.

On average, interviewees<sup>236</sup> considered that the negative impact on competitiveness and trade flows would be small, thus indicating a low capacity to compensate for the expected costs.

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<sup>234</sup> 2 companies considered that the impact on compliance costs is small and 1 company considered it to be moderate.

<sup>235</sup> Interviews with 11 stakeholders distributed among all categories, except trade unions (which all consider that would be a positive impact in business environment).

<sup>236</sup> Interviews with representatives from 2 companies, 5 investors, 2 NGOs, 2 trade unions, 6 corporate governance committees.

### Social impacts

Option B6 would have a **very small positive social impact**.

Under option B6, all Member States would be encouraged to take the steps necessary to introduce at national level a requirement for companies to actively engage with and involve both internal and external stakeholders at board level, in particular in the process of identifying, preventing and mitigating sustainability risks and impacts. This option has the potential to have an indirect, positive social consequences (including on employees, consumers and communities) by increasing the number of companies that actively engage with key stakeholders and take their views and interests into account to reduce adverse social impacts and define a more sustainable business strategy. In terms of employee participation, option B6 might strengthen dialogue within large enterprises and ensure greater employee involvement on ESG matters in decision-making, especially in those EU countries where employee representation at board level is not foreseen by law.

However, considering the non-binding nature of the recommendation and that, as highlighted in interviews with representatives from three corporate governance committees, stakeholder engagement is regarded as quite a burdensome and company-specific activity and therefore an area in which regulators' intervention is perceived as intrusive, the adoption of the recommendation at national level might be limited. Thus, option B6 is expected to have a very small positive social impact.

### Environmental impacts

Option B6 would have a **very small positive environmental impact**.

By pushing Member States to adapt the national regulatory frameworks, option B6 has the potential to have an indirect, positive environmental consequences (including on climate, natural capital, circular economy and resource efficiency) by leading more companies to actively engage with key stakeholders and take their views and interests into account to address negative environmental externalities and set a more environmentally sustainable business strategy.

However, as for social impacts, despite the recommendation, Member States might prefer not to intervene on corporate stakeholder engagement, as this intervention in an area so company-specific might be perceived as too intrusive of voluntary corporate practices and as creating an additional burden which might also affect their competitiveness vis-à-vis companies from other Member States of third countries. Therefore, the indirect positive impact of option B6 at environmental level is expected to be very small.

### Impacts on fundamental rights

Option B6 would have a **very small positive impact on fundamental rights**.

The recommendation would invite all Member States to take the steps necessary to introduce at national level a requirement for companies to actively engage with and involve both internal and external stakeholders at board level, in particular in the process of identifying, preventing and mitigating sustainability risks and impacts. Clearly, this measure has the potential to have an indirect, positive impact on the protection of fundamental rights (including the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour in third countries), in particular by widening the current scope of companies that actively engage with key stakeholders and take their views and interests into account to reduce their sustainability impacts and define a more sustainable business strategy.

At the same time, however, the non-binding nature of the recommendation, combined with the absence of horizontal EU rules on the matter of non-shareholding stakeholder engagement (except in the area of information and consultation of workers) and the possible adverse consequences for companies in terms of increased burden, might reduce the extent of the positive impact of option B6 and therefore its possible beneficial effects on fundamental rights protection.

Option B6 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option B6 would have **no impacts on public administrations**.

The measure will not have significant budgetary consequences for national public authorities, nor implications at EU level. An administrative burden might be expected at the EU level in a situation in which different Member States apply different laws, as EU bodies may need to follow and monitor national initiatives and possibly facilitate some type of information exchange. However, it can be expected that this would be covered by existing operational structures and budgets since this would be a normal process of monitoring policy developments in the Member States.

#### 5.6.3.2 Assessment by criteria

Criteria	Rate
Effectiveness	+1
Efficiency	0
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option B6 would be **effective to a small extent** in promoting corporate governance practices that contribute to company's sustainability.

Option B6 might result in a stronger commitment by companies to contact the key actors concerned by their activities in social and environmental terms.

The recommendation would leave flexibility to Member States and companies with regard to the type of implementation they could apply, thus making its potential implementation easy. Stakeholders would be enabled to provide their contribution on aspects such as risk mapping, risk assessment, risk mitigation, materiality analysis, and target-setting, thus supporting boards in integrating sustainability considerations into the business strategy.

However, as interviews with representatives from two companies and one investor underlined, engaging a wide number of stakeholders might strongly impact companies decision-making processes by making them more complex and slower. This issue appears to be particularly relevant in case of external stakeholders, that usually have a partial view and understanding of the company's internal functioning and related constraints. In this view, and considering that currently there are no EU and national rules on non-shareholding stakeholder engagement, the Commission recommendation with its non-legally binding nature would hardly be implemented by many Member States, or alternatively they would try to make it as soft as possible.

### Efficiency

#### **Costs**

Option B6 is expected to **increase costs to a very small extent**.

The Commission recommendation would not entail the introduction of substantive obligations or requirements for companies to comply with. The main addressee of the recommendation would be the Member States, which would be encouraged to introduce in their respective national frameworks requirements for companies involve stakeholder in the decision-making process related to sustainability. The costs for the companies established in EU countries where the recommendation is adopted will depend on the number and frequency of stakeholder consultation practices, and will directly relate to the time spent by employees and board members to identify which stakeholders to involve, propose the process of involvement, approve and implement the selected plan of action. These costs are difficult to quantify ex ante.

As regards public administrations, the adoption of the recommendation would not have budgetary implications, neither at national nor at EU level.

## **Benefits**

Option B6 is expected to have **very limited benefits**.

Similarly to option A6, the recommendation, where applied, could improve the capacity of companies to engage with internal and external stakeholders and listen to their opinion concerning the material issues the executives should deal with, bringing in this way benefits, at economic but also at environmental, social, and fundamental rights level.

## **Coherence**

Option B6 would be **coherent with other main EU policy objectives and initiatives**.

In terms of policy objectives, recommending Member States to introduce a national obligation for companies to ensure that their relevant stakeholders (both internal and external) are involved in the process of identifying, preventing and mitigating the company's sustainability risk and impacts would contribute to greater inclusion of the sustainability views and concerns of stakeholders into the business strategy. Consequently, also option B6 would be in line with the goal of strengthening companies' focus on their long-term development and sustainability aspects, as per the forthcoming renewed sustainable finance strategy. To the extent that stakeholder engagement and involvement concerns the identification and setting of sustainability targets, option B6 might also be consistent with and support EU and Member States commitments on delivering on the UN SDGs and the Paris Agreement on climate change.

In terms of policy interventions, option B6 would be in line with current practices under the Non-Financial Reporting Directive, as companies already accept to disclose in non-financial reports how they define materiality and which processes they have put in place to identify their material ESG issues, including through stakeholder engagement activities.

## **Proportionality**

Option B6 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

Option B6 would recommend Member States to introduce at national level provisions requiring companies to engage internal and external stakeholders in their decision-making process concerning sustainability matters. The non-binding recommendation would leave the Member States with a high degree of flexibility to introduce the requirements for companies in the way deemed more appropriate in light of the national business context and regulatory framework. This option is not expected to create disproportionate costs/burdens for companies and public administrations.

### **5.6.4 Assessment of option C6**

<b>C6</b>	<p><i>Commission proposal for new EU binding rules requiring corporate boards to establish mechanisms for engaging with and involving internal and external stakeholders in identifying, preventing and mitigating sustainability risks and impacts as part of their business strategy (M6.3).</i></p> <p><i>This measure could be implemented in synergy with M3.3 (Commission proposal for a new EU directive requiring corporate boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy), as well as with M1.3 (regarding an EU directive providing an EU-wide formulation of directors' duties and of the company's interest, including a duty of board members to identify risks and mitigate negative human and environmental impact in the value chain).</i></p>
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#### *5.6.4.1 Assessment by impacts*

Impact	Rate
Expected degree of change in the national regulatory frameworks	Large
Impacts on companies	-2
Economic impacts	-1.5



Impact	Rate
Social impacts	+2
Environmental impacts	+1.5
Impacts on fundamental rights	+1.5
Impacts on public administrations	0

### Expected degree of change in the national regulatory frameworks

Option C6 would bring **significant changes in the national regulatory frameworks**.

Option C6 would bring national competent authorities to modify the existing rules and eventually large companies to adjust to the new common requirements.

As highlighted under the previous options, none of the 12 EU Member States analysed have specific provisions that require the involvement of both internal and external stakeholders in identifying, preventing and mitigating sustainability risks and impacts as part of their business strategy, and they will be therefore requested to develop specific mechanisms and rules to be compliant with the new EU rules.

### Impacts on companies

Option C6 would have **moderate negative impact on companies in the short term, while in the long term the impact is likely to be positive**.

Option C6 will increase upfront costs for a large number of companies that would be required to adjust their internal processes to comply with the requirements included in the EU rules.

Increase in costs will result from the time spent by employees and board members to identify stakeholders to involve, propose the process of involvement, approve and implement the selected plan of action.

As in the other options (A and B) the costs would tend to be higher in small enterprises, which have less flexibility to introduce these tasks on top of current employee's work without jeopardising the normal functioning of the company and in sectors that have long supply chains.

All 14 companies and 11 investors interviewed mentioned that this option would have high compliance costs, while the majority of stakeholders belonging to other categories acknowledge that these costs would be important, but their assessment is more moderated compared to the one provided by companies and investors.

However, while upfront compliance costs might be high in the short term, wider stakeholder engagement can be expected to bring benefits medium to long-term, in particular by increasing the brand value and facilitating the identification of (material) ESG issues to be addressed by the board, improving the performance of companies and reducing the risk of litigation by adverse stakeholders.

### Economic impacts

Option C6 would have a **moderate negative economic impact in the short term, while in the long term the impact is likely to be positive**.

Depending on the specific obligations that will be defined, this option would have small to moderate negative impacts on competitiveness through the rise of costs and deterioration of the business environment, which could negatively impact the levels of investment, and it is expected to affect more the sectors/companies with long supply chains and many stakeholder constituencies to address, and the SMEs, who find it more difficult to allocate staff to the stakeholder engagement process. Like in option B6, but in a more intensive way due the binding nature of this option, the involvement of external stakeholders in the design and monitoring of the sustainability strategy might contribute to deteriorating the business environment by making decision-making processes more complex and longer. This is mainly due to the fact that external stakeholders are usually not fully aware of the business constraints. This might eventually create entropy, especially in SMEs, that have smaller boards with less space to accommodate different stakeholders in the decision process.

Similar to option B6, it can be however expected a valorisation of sustainability practises and the creation in the long term of positive impacts on investment that could reinforce the competitiveness of companies. In fact, option C6 would favour the inclusion of different perspectives that nowadays are often neglected in the decision-making process, helping mitigate sustainability risks and impacts on workers, local communities and other relevant company stakeholders. This would in turn improve the long-term performance and profitability of companies, as their increased sustainability would make them more successful, with positive aggregate effects at economic level.

On average, the interviewees<sup>237</sup> considered that the negative impact on competitiveness, trade flows would be moderate, thus indicating a low capacity to compensate for the expected costs.

### Social impacts

Option C6 would have a **moderate positive social impact**.

Under this option, a new binding instrument at EU level requiring large companies (and possibly also SMEs) to engage with internal and external stakeholders will allow for the voices of many of the companies' stakeholders, such as employees, consumers and local communities, to be heard in company decision-making, including at board level. In this way, those (negatively) impacted by the activities of the companies will have the possibility to interact with the board, creating a positive social impact as far as their concerns are taken into account. In general, the widespread implementation of mechanisms for engaging with stakeholders (or their representatives) would lead to a more open and continuous dialogue between the companies and their relevant stakeholders, which is a direct, positive social impact in itself. In particular, as highlighted by two trade unions interviewed, it would be very important to further promote employees' representation at board level, as they are a specific category of stakeholders directly involved in the functioning of companies and with a strong interest in their long-term success, and could add value in the understanding of social issues. Considering that such requirement is already present in a number of EU Member States, this option should not contradict existing requirements on workers representation, and might further incentivise employee participation through the adoption of this specific practice (e.g. lay the ground for the adoption of a specific EU directive).

The possible positive effects at social level might be limited by the fact that, under option C6, companies would be free to choose what stakeholder groups should be engaged, and in which way. Consequently, there is the risk that more organised and resourceful stakeholder groups might capture the engagement process, while less organised and more vulnerable stakeholder constituencies (e.g. local communities impacted along the value chain) remain marginalised. Moreover, companies would not be required to disclose how the results of the stakeholder engagement process are used, i.e. if and how they will affect business decisions. Finally, focusing primarily on issues raised by stakeholder groups considered "most relevant" might lead the board to overlook other sustainability aspects that are equally important, but are not brought to the attention of the board by stakeholders engaged. Therefore, option C6 is expected to have a moderate positive impact at social level.

### Environmental impacts

Option C6 would have a **moderate positive environmental impact**.

New EU binding rules requiring corporate boards to establish mechanisms for engaging with and involving internal and external stakeholders at board level would push companies to discuss with a number of actors how to mitigate the impact on the environment, such as reducing pollution and GHG emissions to fight climate change and preserve biodiversity and the natural capital. For instance, a possible engagement mechanism suggested by an NGO interviewed is the establishment of a board-level stakeholder advisory council, with experts on different topics

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<sup>237</sup> Interviews with representatives from 2 companies, 4 investors, 2 NGOs, 2 trade unions, 5 corporate governance committees. Among these only 1 NGO, 1 investor and trade unions assessed positive effects in these variables. Compared to other policy solutions assessments, this in the one that, in average, would have the larger negative effect no economies.

(environmental, social, etc.), giving advice to the board on relevant matters. The possible positive impact of such mechanism would be magnified if relevant expertise and knowledge on sustainability matters are present also within the board, and board members have the necessary competence to have a meaningful discussion (in this respect, see options under section 5.5).

As noted for social impacts, the room left to companies to decide the relevant stakeholders to be engaged and the use to be made of the outcomes of stakeholder engagement activities might somewhat limit the overall positive impact of this option at environmental level. While option C6 would have a direct positive social impact (by incentivising stakeholder dialogue), any positive environmental impact would only be indirect and based on willingness of company boards to take account of and implement (e.g. as part of the business strategy) the conclusions on environmental issues emerging from the stakeholder engagement activities.

### Impacts on fundamental rights

Option C6 would have a **moderate positive impact on fundamental rights**.

Option C6 would ensure that all large companies (and possibly in SMEs operating in high-risk sectors) have in place adequate mechanisms to hear the voices of their relevant stakeholders and factor their views and perspectives into the definition and/or adjustment of their respective business strategies, particularly as regards the identification, prevention and mitigation of sustainability risks and impacts in their business operations or value chains. This measure might "empower" company stakeholders (even more those that currently are more prone to marginalisation, such as local communities in third countries) in voicing their concerns about fundamental rights protection (including the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour in third countries), and in turn have a positive impact in that regard. The impacts is expected to be moderate (rather than large) because the whole stakeholder engagement process would be driven by the companies, which would be in charge of identifying both the stakeholders and the engagement mechanism. Therefore, there would still be some risk that very critical stakeholder voices remain unheard or marginalised in the process, or that feedback received on sustainability risks and impacts - including on fundamental rights - is not duly taken into account in subsequent business decisions. Moreover, contrarily to the social impacts, which are direct, any positive impact on fundamental rights would be indirect and resulting from the adoption of company actions to follow up the conclusions emerging from stakeholder engagement activities.

Option C6 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option C6 would have **no impacts on public administrations**.

The measure will not have significant budgetary consequences for national public authorities, nor implications at EU level. Considering that option would apply primarily to large companies, and assuming that information on stakeholder engagement mechanisms and activities realised by companies would be disclosed in their annual reports (e.g. sustainability reports or non-financial statements), it can be assumed that the effort of monitoring compliance by national authorities would be minimal, as the monitoring should involve sample reviews of non-financial statements or reports and the burden of such activity would not be significant, with costs met from existing operational budgets.

#### 5.6.4.2 Assessment by criteria

Criteria	Rate
Effectiveness	+2.5
Efficiency	0
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option C6 would be **effective to a large extent** in promoting corporate governance practices that contribute to company's sustainability.

Option C6 would strongly influence the decision-making process of companies, favouring the inclusion of different perspectives that nowadays are often not considered. Internal and external stakeholders would be enabled to express their views to the boards on sustainability-related aspects and contribute to defining and supervising the effective integration of sustainability into the companies' business strategies.

This legislative intervention would lay down an obligation for the boards of directors to set up and disclose specific stakeholder engagement mechanisms, and the implementation would be simplified by leaving companies room to decide the most relevant mechanisms for their sector of activity and their business model. The importance of this flexibility has been underlined by a number of interviewees,<sup>238</sup> as too specific rules might jeopardise the efficiency of the decision-making process and thus the competitiveness of companies. Other risks mentioned are that of the identification of the relevant stakeholders to engage, as confidential information might leak to the advantage of competitors within or outside the EU.

The measure would be particularly relevant for the due diligence process on human rights of companies. According to two NGOs responding to the survey "*affected stakeholders should be always engaged in the design of due diligence processes intended to protect them, including in monitoring of the implementation of the measures taken in response to the identified problems. This should be supported by a corresponding reporting obligation, in particular concerning human rights due diligence in the context of supply chains*". Thus, a link to other EU action on this issue could be made, improving the effectiveness of stakeholder engagement, giving them an important role in monitoring the due diligence process.

### Efficiency

#### **Costs**

Option C6 is expected to **increase costs to a moderate extent**.

A new requirement for companies to establish stakeholder engagement mechanisms, would introduce substantive requirements for companies to comply with. The costs for companies subject to the new directive would be linked especially to the time spent by employees and board members to identify which stakeholders to engage, propose the process to do so, approve and implement the selected plan of action. Indirect costs could be related to additional length and complexity these procedures might add to the normal functioning of company decision making processes.

As regard public administrations, the new legislative instrument would not have direct budgetary implications at the EU level or national level.

#### **Benefits**

Option C6 is expected to have **moderate benefits**.

At economic level, option C6 would slightly improve the capacity of European companies to deal with sustainability issues, bringing them directly in the board, and thus making them more resilient to shocks related to these issues and able to survive in the long term.

At social, environmental and fundamental rights level, similar benefits might be expected by the capacity of the board of discussing sustainability in a strategic way.

### Coherence

Option C6 would be **coherent with other main EU policy objectives and initiatives**.

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<sup>238</sup> Interviews with representative from 1 company and 2 investors.

In terms of policy objectives, laying down EU binding rules requiring corporate boards to establish mechanisms for engaging with and involving both internal and external stakeholders at board level would contribute to greater consideration of the sustainability views and concerns of stakeholders into the business strategy, especially as concerns the identification and mitigation of sustainability risks and impacts associated with business own operations and value chain. Subsequently, also option BC would be in line with the goal of strengthening companies' focus on their long-term development and sustainability aspects, as per the forthcoming renewed sustainable finance strategy. Moreover, similar to option B6, also option C6 might support meeting EU and Member States commitments on delivering on the UN SDGs and the Paris Agreement on climate change, in so far as stakeholder engagement and involvement concerns the identification and setting of relevant sustainability targets.

Finally, in terms of policy interventions, also option C6 would be in line with current practices under the Non-Financial Reporting Directive, as companies already accept to disclose in non-financial reports how they define materiality and which processes they have put in place to identify their material ESG issues, including through stakeholder engagement activities.

As concerns employees, option C6 would also be consistent with Article 27 of the Charter of Fundamental Rights of the EU (giving workers' rights to information and consultation the status of a basic right of European citizens) and possibly strengthen current EU framework concerning the right of workers to information, consultation and participation (in particular Directive 2002/14/EC).<sup>239</sup> Moreover, it would not impact nor prejudice the freedom of association and the effective recognition of the right to collective bargaining between workers and employers, recognised in Article 28 of the Charter of Fundamental Rights of the EU, in Article 12 of the Community Charter of the Fundamental Social Rights of Workers, and in the 1998 ILO Declaration on Fundamental Principles and Rights at Work.

### **Proportionality**

Option C6 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

New EU rules on stakeholder engagement would change the decision-making process of companies concerning their sustainability practices, making it more open and allowing the collection of all the necessary inputs to identify the material ESG issues for each company. The risk of making the decision-making process too complex or long would depend on the way companies decide to implement such requirement, and the new rules would remain flexible to leave companies enough room to decide on the stakeholders to engage and the mechanisms to use. Even though option C6 would be relatively costlier than option A6 and B6, it is not expected to create disproportionate costs/burdens for companies and public administrations.

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

### **5.7.1 Baseline**

If EU were not to act, current enforcement levels of directors' duty of care in Member States can be expected to remain low, in line with the existing trend. Directors would remain substantially accountable to the board and the shareholders, while stakeholders would continue lacking legal standing to enforce directors' duty of care, even when they have a legitimate interest in the long-term sustainability of the company.

At social level, the persistence of this problem means that interested stakeholders (such as NGOs or trade unions) will continue being unable to act against companies and directors that fail to address their social or environmental risks or impacts.

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<sup>239</sup> Directive 2002/14/EC of the European Parliament and of the Council of 11 March 2002 establishing a general framework for informing and consulting employees in the European Community

## 5.7.2 Assessment of option B7

**B7**

*Commission recommendation for Member States to consider measures to strengthen enforcement of directors' duty to act in the interest of the company in their respective national frameworks (M7.1).*

*This measure would provide for a proper enforcement mechanism for M1.2 (Commission recommendation providing a uniform interpretation of directors' duties and of the company's interest to the Member States and recommending them to introduce in their respective national frameworks an explicit directors' duty to identify and mitigate sustainability risks and impacts, both internal and external, connected to the company's business operations and value chain) and M3.2 (Commission recommendation for the Member States to introduce in their respective national frameworks specific requirements for boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy), and could therefore be implemented in synergy with them.*

### 5.7.2.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	Moderate
Impacts on companies	-1
Economic impacts	-1
Social impacts	+1
Environmental impacts	+1
Impacts on fundamental rights	+1
Impacts on public administrations	-0.5

### Expected degree of change in the national regulatory frameworks

Option B7 would bring **moderate changes in the national regulatory frameworks**.

In all the 12 Member States analysed, directors' duties are owed to the company, i.e. to the legal entity and not to the shareholders, which implies that directors are liable towards the company for a breach of their duties. In this regard, in all 12 Member States the organs authorised to act on behalf of the company in enforcing directors' duties are either the board, the supervisory board, or the shareholders through the general meetings. Based on the legal review, there are neither provisions of company law nor self-regulatory measures which expressly allow the stakeholders of a company to instigate legal proceedings on behalf of the company to sue its directors for not having taken the stakeholder interests into account as part of their duty of care.

Despite the high number of Member States that would be concerned by this option, the Commission recommendation to Member States to consider measures to strengthen the enforcement of directors' duty to act in the interest of the company would leave the possibility to Member States to decide whether to follow the recommendation and how to do it, thus creating a heterogeneous pattern of national rules. Still, the Commission recommendation would raise awareness among Member States on the low level of enforcement of directors' duties.

### Impacts on companies

Option B7 would have **small negative impact on companies**.

Option B7 would bring to an increase of administrative and compliance costs for companies that decide to implement the new indications. Increase will be mainly linked to the expected rise in the number of legal actions and in the creation of entropy in the normal functioning of boards.

More accountability for board members may reduce the competitiveness of companies, by discouraging investment in risky places, markets and sectors and by increasing the difficulty in hiring directors. According to three representatives from Corporate Governance Committees and one from a company, this option is expected to increase the discomfort of directors in playing their roles, and this might reduce the potential pool of resources for this position and/or the rise in their compensation.

This can be even more amplified in risky sectors and in Member States that will be more rigorous in implementing the recommendation or where the national frameworks in the baseline are more distant from the desired level of enforcement.

No benefits in the form of cost savings are expected, at least in the short term. In the long term, this measure would likely strengthen the responsibility and accountability of directors to take a more long-term orientation and better manage company sustainability risks and impacts, which might ultimately have positive consequences on corporate performance, e.g. in terms of increased financial returns and innovation.

### Economic impacts

Option B7 would have a **small negative economic impact**.

This option might not be enough to achieve a similar level of enforcement in all Member States. With an EU recommendation each Member States will be free to adopt the measures that are considered the most suitable to the national context thus creating differences and potentially decreasing competitiveness of companies located in Member States that decided to adopt more stringent rules. Moreover, the attractiveness of riskier sectors for investors may also decrease, which may eventually result in a decrease in the levels of investment.

If M7.1 is implemented together with of M1.2 (recommendation to uniform interpretation of directors' duties and company's interest and introduce an explicit directors' duty to identify and mitigate sustainability risks) and M3.2 (recommendation to introduce specific requirements for boards to integrate sustainability aspects into the business strategy) negative impacts might be smoothed as the recommendations foreseen under these measures would lay the ground for a more harmonised implementation of the new enforcement rules.

### Social impacts

Option B7 would have a **small positive social impact**.

Option B7 might lead some EU countries to review their current enforcement mechanisms and take into consideration possible reforms to further strengthen them. For instance, pursuant to the recommendation, Member States might made available additional judicial mechanisms (such as a formal notice to comply, injunctions to pay a fine, or legal action against directors) to non-shareholding stakeholders adversely affected by the directors' failure to identify sustainability risks and impacts, or the mis-execution of measures aimed at addressing them. Of course, judicial mechanisms would be available to affected corporate stakeholders (including employees, consumers and communities) also in case of failure to address social risks and impacts in company's own operations and (global) value chain. Therefore, option B7 can be expected to have some indirect positive impact at social level by empowering affected stakeholders and strengthening directors' accountability.

However, due to its non-binding nature, and considering also the likely resistance by the national business communities to a possible legal reform in the area of directors accountability (as this measure will strengthen accountability of board members to non-shareholding stakeholders), the implementation of this recommendation by the Member States could be limited, and thus the extent of the possible positive social consequences of this option would be small.

### Environmental impacts

Option B7 would have a **small positive environmental impact**.

The Commission recommendation might prompt some EU countries to review their current enforcement mechanisms and consider the most appropriate measures strengthen pursuant to the recommendation. Stronger judicial mechanisms would be available to affected corporate stakeholders also in case of directors' failure to address environmental risks and impacts in company's own operations and (global) value chain. Thus, similarly to social impacts, option B7 can be expected to have some indirect positive impact at environmental level by empowering affected stakeholders and strengthening directors' accountability.

However, the implementation of this recommendation by the Member States could be limited by its non-binding nature and the likely resistance by the national business communities to a possible legal reform in the area of directors' accountability. Therefore, the extent of the possible positive environmental effects of option B7 would be small.

### Impacts on fundamental rights

Option B7 would have a **small positive impact on fundamental rights**.

Option B7 might lead EU countries to take stock of their current enforcement mechanisms and consider measures to further strengthen them. For instance, pursuant to the recommendation, Member States might make available additional judicial mechanisms (such as a formal notice to comply, injunctions to pay a fine, or legal action against directors) to non-shareholding stakeholders adversely affected by the directors' failure to identify sustainability risks and impacts, or the mis-execution of measures aimed at addressing them. Of course, judicial mechanisms would be available to affected stakeholders also in case of failure to address risks and impacts on fundamental rights in company's own operations and (global) value chain (including the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour in third countries). However, due to its non-binding nature, and considering also the possible resistance by the national business communities to a possible legal reform in the area of directors' accountability, the extent of the likely positive consequence of this option in terms of fundamental rights might be limited.

Option B7 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option B7 would have **very small negative impacts on public administrations**.

The measure will have very limited budgetary consequences for national public authorities, as well as for the EU level. It can be expected that indications included in the recommendation would be covered by existing operational structures and budgets and integrated into already existing processes of monitoring. An administrative burden might be expected at the EU level in a situation in which different Member States apply differently the content of the recommendation as EU bodies may need to follow and monitor national initiatives and possibly facilitate some type of information exchange.

#### *5.7.2.2 Assessment by criteria*

Criteria	Rate
Effectiveness	+1
Efficiency	0
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option B7 would be **effective to a low extent** in improving directors' accountability for integrating sustainability into corporate decision-making.

Option B7 might prompt some EU countries to review their current enforcement mechanisms, broadening the access to justice to other stakeholders than directors or shareholders. The recommendation could be drafted with the support of a technical expert group composed of legal experts from the Member States, making it easier to implement it in different legal frameworks.

However, the implementation of this recommendation by the Member States could be limited by its non-binding nature and the likely resistance by the national business communities to a possible legal reform in the area of directors' accountability. A non-binding recommendation will be applied differently in Member States, generating different conditions of competition in the internal market and loss of competitiveness vis-à-vis external competitors.



## Efficiency

### **Costs**

Option B7 is expected to **increase costs to a small extent**.

A recommendation for Member States to open their enforcement mechanisms to stakeholders would not create new direct costs for companies. However, some indirect burden for companies in the Member States where the recommendation is applied may derive from the necessity to consider new legal implications linked to possible legal action by stakeholders, especially in the sectors more exposed to sustainability risks, such as the energy one. Indirect costs might also be linked to the potential increasing difficulties that companies might face to identify directors. As a result of this option people might feel uncomfortable in taking responsibilities in the board or might require comparatively higher compensations.

As regards public administrations, the adoption of the recommendation would have very limited budgetary implications, at the national and EU level.

### **Benefits**

Option B4 is expected to have **very limited benefits**.

The introduction of a recommendation to strengthen the enforcement of directors' duties will empower affected stakeholders and eventually strengthen directors' accountability. However, the possibility for the recommendation to create benefits at economic, social, environmental, fundamental rights level would depend by the number of countries deciding to apply it and to ensure the availability of enforcement mechanisms for stakeholders, which could push companies to assess thoughtfully sustainability risks to avoid possible legal actions, pushing them to a long-term sustainability.

## Coherence

Option B7 would be **coherent with other main EU policy objectives and initiatives**.

In terms of objectives, measures to strengthen the enforcement of directors' duties are a corollary of measures aimed at strengthening corporate board duties regarding sustainability and clarifying the responsibility of directors to manage long-term sustainability risks and impacts, included under option A1, B1 and C1. Therefore, option B7 would be consistent with the same EU policy objectives already mentioned when discussing options addressing Driver 1.

As a more general consideration, option B1 would be in line with a broader, long-term trend highlighted in the literature, i.e. EU's increasing involvement in regulating matters of national enforcement by setting up enforcement standards in EU hard, soft and case law.<sup>240</sup> These norms can prescribe procedural and substantive requirements for direct national enforcement and influence the methods of national enforcement, including by requiring the establishment of specialised national enforcement agencies.

## Proportionality

Option B7 would **respect the principle of proportionality** as it would not go beyond what is necessary to address the identified driver and achieve the specific objective of the intervention.

The non-binding recommendation for Member States to consider measures to strengthen enforcement of directors' duty to act in the interest of the company in their respective national frameworks would create incentives for directors to assess and mitigate sustainability risks and impacts, while leaving Member States the necessary flexibility to implement such measures in the different legal systems in the EU. Option B7 is not expected to create disproportionate costs/burdens for companies and public administrations.

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<sup>240</sup> See Scholten, M. (2017), 'Mind the trend! Enforcement of EU law has been moving to 'Brussels'', *Journal of European Public Policy*, Vol. 24, Issue 9, pp. 1348-1366

### 5.7.3 Assessment of option C7

#### 5.7.3.1 Assessment by impacts

Impact	Rate
Expected degree of change in the national regulatory frameworks	Large
Impacts on companies	-1.5
Economic impacts	+1
Social impacts	+2
Environmental impacts	+2
Impacts on fundamental rights	+2
Impacts on public administrations	-2

#### Expected degree of change to the national regulatory frameworks

Option C7 would bring **significant changes in the national regulatory frameworks**.

Option C7 would require all Member States to adjust their national measures to be compliant with the new requirements.

As highlighted under option B7, so far, due to the lack of specific regulations in this regard, in 11 out of 12 Member States analysed there are neither provisions of company law nor self-regulatory measures which expressly allow the stakeholders of a company to instigate legal proceedings on behalf of the company to sue its directors for not having taken the stakeholder interests into account as part of their duty of care (this because directors' duties are owed to the company and not to the shareholders nor to any other stakeholder).

#### Impacts on companies

Option C7 would have **moderate negative impact on companies in the short term, while in the long term the impact is likely to be positive**.

The option will increase indirect costs for companies, namely costs of compliance, administrative costs and hiring costs, that result from the increase in the obligations that directors need to follow in terms of the identification of risks and respective mitigation plan and that will eventually make the search for the right profile more difficult. Increase in costs will also be linked to the increase in the legal actions that companies will likely need to face as a consequence of giving to stakeholder (other than shareholders) the right to enforce directors' duty to act in the interest of the company and launch some legal action on behalf of the company against board members in case the company failed to consider sustainability risks. Option C7 might create problems in the recruitment of directors, as the uncertainty concerning how (and how long) the past legal actions can impact new hires will make the recruitment processes more difficult and increase the compensation of directors. Finally, increase in costs will also be linked to potential increases in the compensation of directors that would require a higher compensation to counterbalance the increased exposure.

In terms of benefits, enhanced enforcement could lead to a more effective implementation of board responsibilities with regard to sustainability, and could thus have positive impact in companies in terms of better governance, more long-term orientation, and overall sustainability. The positive impact of option C7 on companies would be maximised if this option is implemented together with EU-wide measures defining board duties regarding corporate sustainability, as per option C1 and C3. Furthermore, compliance with other possible new obligations, including environmental and human rights due diligence, would decrease likely litigation costs and strengthen companies' social license to operate.

#### Economic impacts

Option C7 would have **small positive economic impact in the long term**. In particular, short-term negative economic impacts could be mitigated if option C7 is implemented together with EU-level measures strengthening directors' duties for corporate sustainability, as per option C1 and C3.

Option C7 would likely strengthen the accountability of directors not only to shareholders, but also to other stakeholders, in a framework where the business models still prioritise profit. In the short term, this might constrain the action of the board and discourage investment in high-risk locations, markets and sectors, reducing the competitiveness of EU companies and their position *vis à vis* external competitors. The survey results, although not representative, highlight the negative impacts that option C3 might have on competitiveness.

At the same time, the short-term negative effects described above could be mitigated through the systematic integration of sustainability aspects into the business strategy, which would improve investments and competitiveness in the long term. Thus, increased costs in the short term would be partly offset by economic benefits in the long run, as option C7 would contribute to more sustainable companies, with positive consequences on economic growth and innovation. Negative impacts would be further reduced if the Commission proposal for new EU binding rules to strengthen the enforcement of the directors' duty to act in the interest of the company will be implemented together with M1.3 (EU-wide formulation of directors' duties and company's interest, including a duty of board members to identify risks) and M3.3 (requiring corporate boards to consider and integrate sustainability aspects into the business strategy).

### Social impacts

Option C7 would have a **moderate positive social impact**.

Option C7 would ensure that in all Member States judicial mechanisms (such as a formal notice to comply, injunctions to pay a fine, and legal actions) are in place for stakeholders that are adversely affected by the directors' failure to take their interests into account in their decisions, to identify and mitigate the sustainability risks and impacts, or by the mis-execution of measures to address stakeholder interests. Affected stakeholders will be allowed to act against directors that fail to address the social risks and impacts stemming from companies' own operations and value chain. This would be added to the existing remedies in sectoral law, such as those in the area of workers' rights, and might be expected to have a moderate positive social impact by strengthening directors' accountability and empowering non-shareholding stakeholders compared to the current situation.

However, it will be up to the claimant to demonstrate (i) a directors' breach of their duty to take stakeholder interests into account in their decisions, and to identify and mitigate the sustainability risks and impacts, (ii) the damage suffered, and (iii) a causal link. To hold directors' liable, the burden of proof would be on the claimant who has to prove the case satisfies all three conditions. Breach and causation are likely to be difficult elements for a claimant to establish. Such burden of proof weighing on affected stakeholders might discourage them from taking legal actions. At the same time, it should be noted that these mechanisms would have some positive effects even in absence of legal actions undertaken against directors, as they would still put pressure on company boards to prevent negative impacts and minimise risks to avoid the possibility of future litigation.

Possible positive social (and environmental) impact of option C7 would be magnified if as a proper enforcement mechanism in association with option C1 (clarifying directors' duties) and option C3 (requiring the integration of sustainability aspects into the business strategy).

### Environmental impacts

Option C7 would have a **moderate positive environmental impact**.

As underlined for social impacts, the strengthening of directors' duty to act in the interest of the companies through the introduction of new rules at EU level would increase the accountability of directors to a number of non-shareholding stakeholders, which would be empowered through stronger enforcement mechanisms. Thus, the interest of the environment could be better protected by stakeholders (such as local communities) that are interested in the company's environmental sustainability and are adversely affected by company's actions or omissions, or by a national regulatory body empowered to bring legal actions against directors' that caused unlawful harm to the environment (including negative externalities on the climate, natural capital, or on resource efficiency). These mechanisms would be added to the existing remedies

in environmental law, and might be expected to have a moderate positive environmental impact. Even if the burden of proof weighing in stakeholders might discourage them from acting, option C7 would have a positive effect even if no legal action is brought against directors, as it would put pressure on companies to act in a preventive way to avoid future lawsuits.

### Impacts on fundamental rights

Option C7 would have a **moderate positive impact on fundamental rights**.

Option C7 would ensure that, in all Member States, stronger mechanisms are available to adversely affected stakeholders to make directors accountable for their failure to identify and mitigate sustainability risks and impacts. By improving the possibilities for stakeholders to take action against directors for harm resulting from a failure to identify and mitigate sustainability risks and impacts, including in the area of fundamental rights (for instance the right to dignity, equal treatment and opportunities, and the prohibition of forced and child labour in third countries), option C7 is expected to have a moderate positive impact on the protection of fundamental rights, especially if it is adopted as proper enforcement mechanism in association with option C1 and option C3.

Option C7 is not expected to affect property rights or the right to conduct business.

### Impacts on public administrations

Option C7 would have a **moderate negative impacts on public administrations**.

This option would require Member States to ensure that judicial mechanisms are in place for stakeholders adversely affected by the directors' failure to take their interests into account in their decisions. Judicial remedies are not likely to have additional costs for Member States, insofar as these costs would fall within existing budgets for the judicial system. Option C7 would also require each Member State to set up or designate a public regulatory body empowered to bring proceedings against corporate directors. In case a public body would need to be created ex novo, additional costs for public authorities would be relatively higher compared to financing additional staff within existing bodies. If existing regulatory bodies are empowered with enforcement functions, this would most likely imply additional costs for training and specialised staff with expertise on sustainability issues. The cost for such a national regulatory body would also depend on its specific tasks and powers (e.g. investigatory powers, power to issue warnings and fines, etc.). The more comprehensive such tasks and powers would be, the more training and/or specialised staff would be required. Given these open implementation points, at this stage it is not possible to reasonably estimate the costs of this measure. Overall, it is expected that this option will not have implications for the EU budget, while it might have some limited impact on public administrations at national level.

#### 5.7.3.2 Assessment by criteria

Criteria	Rate
Effectiveness	+2
Efficiency	+0.5
Coherence	Yes
Proportionality	Yes

### Effectiveness

Option C7 would be **effective to a moderate extent** in improving directors' accountability for integrating sustainability into corporate decision-making.

Option C7 would directly affect the legal systems of the Member States, changing the enforcement mechanisms in a significant way.

This legislative intervention would require Member States to ensure that judicial mechanisms are in place for stakeholders that are adversely affected by the directors' failure to take their interests into account in their decisions and to identify and mitigate the sustainability risks and impacts. This measure would also require Member States to empower a national regulatory body

to bring proceedings against the directors where the failure to identify and mitigate sustainability impacts and risks, or the mis-execution of measures aimed at addressing stakeholder interests, caused serious harm to third parties or unlawful harm to the environment, stakeholders, or the company itself. One company interviewed also suggested to consider alternative dispute resolution mechanisms.

The measure would only increase the sustainability of companies if combined with a reformulation of directors' duties foreseen under Driver 1. One interviewee from a corporate governance committee underlined that this measure should not interfere with the business judgment rule, otherwise the competitiveness of European companies could be put at risk. Many<sup>241</sup> also signalled the risk for companies to have more difficulties in finding suitable executives willing to work in a riskier situation, especially in the sectors more exposed to sustainability risks.

### Efficiency

#### **Costs**

Option C7 is expected to **increase costs to a moderate extent**.

Option C7 would not create substantive requirements for companies, but would modify the legal framework within which their directors operate. This would create indirect costs. Specifically, companies may be expected to increase the commitment for the identification of risks and respective mitigation plan, and there could be a possible rise in the legal costs linked to the increase in the number of legal actions<sup>242</sup> as well as in the compensation of directors, to attract suitable candidate in a riskier business environment.

As regards public administrations, option C7 would have moderate budgetary consequences for national public authorities, linked to the establishment of a new regulatory body tasked to bring proceedings against directors in case of misconduct. Depending on whether the body should be established ex novo or the task could be allocated to an existing one, the costs will vary. There would be no budgetary implications at EU level.

#### **Benefits**

Option C7 is expected to have **moderate benefits**.

At economic level, option C7 is expected to have beneficial effects in the long-term. Stronger enforcement mechanisms would incentivise directors to give greater consideration to sustainability risks and impacts in their decisions, increasing the capacity of the companies to resist in adverse conditions and survive in the long term, and eventually increasing investments and competitiveness of EU businesses.

At social, environmental and fundamental rights level, moderate benefits are expected as option C7 would ensure a stronger protection of the interests of non-shareholding stakeholders and of the environment.

### Coherence

Option C7 would be **coherent with other main EU policy objectives and initiatives**.

By strengthening directors' accountability to stakeholders when acting in the long-term interest of the company, option C7 would be consistent with the goal of the forthcoming renewed sustainable finance strategy (i.e. further embedding sustainability in corporate governance and strengthening companies' focus on their long-term development and sustainability aspects) and with the broader sustainability-related policy goals in the framework of the European Green Deal (in particular as concerns climate neutrality and implementation of the SDGs).

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<sup>241</sup> Interviews with representatives from 1 corporate governance committees, 3 companies and 1 investor.

<sup>242</sup> Representatives from 3 corporate governance committees mentioned that stakeholders do not have a direct interest in the company, so a legal action against the company would not cause problem to them, while shareholders would use this instrument more cautiously, as the value of their shares would be at stake.

Moreover, as already mentioned for option B7, also option C7 would be in line with trend of increasing EU involvement in the enforcement of EU law.

### Proportionality

Taken alone, option C7 would arguably not meet the principle of proportionality. Even though the current enforcement level of directors' duties is generally low in all Member States, this fact by itself would not be sufficient to justify an EU level intervention in the area of enforcement, as per option C7. As highlighted in several interviews,<sup>243</sup> remedy mechanisms are already present in national legislative frameworks, especially in sectoral legislation on environmental protection or social issues, and available to stakeholders that suffered damages as a result of companies' actions or omissions.

Introducing new binding rules in the area of remedies and liabilities would be justified only if specific, explicit duties for directors to act in the long-term interest of the company, to balance the interest of shareholders and other company stakeholders, to identify and mitigate sustainability risks and impacts, and to integrate sustainability into the business strategy are also established at EU level (as per options C1 and C3). Such duties would necessitate a proper enforcement mechanism to ensure that directors could be held liable by stakeholders for how they manage sustainability issues. Therefore, **taken in conjunction with option C1, option C7 would be justified and proportionate to the objective of improving companies' sustainability.** Together, these measures would promote a more consistent EU level approach in the area of director's duties, remedies and liabilities.

## 5.8 Synthetic overview

The following table provides an overview of the assessment.

Driver	Impacts	PO A	PO B	PO C
1	Effectiveness	+1	+1	+2.5
	Efficiency	0	0	+1.5
	Coherence	Yes	Yes	Yes
	Proportionality	Yes	Yes	Yes
2	Effectiveness	+0.5	+1	+1.5
	Efficiency	0	0	0
	Coherence	Yes	Yes	Yes
	Proportionality	Yes	Yes	No
3	Effectiveness	+0.5	+1	+2.5
	Efficiency	+0.5	0	+1
	Coherence	Yes	Yes	Yes
	Proportionality	Yes	Yes	Yes
4	Effectiveness	+1	+1	+2.5
	Efficiency	0	0	+0.5
	Coherence	Yes	Yes	Yes
	Proportionality	Yes	Yes	Yes
5	Effectiveness	+1	+1.5	+2.5
	Efficiency	0	0	0
	Coherence	Yes	Yes	Yes
	Proportionality	Yes	Yes	Yes
6	Effectiveness	+0.5	+1	+2.5
	Efficiency	0	0	0
	Coherence	Yes	Yes	Yes
	Proportionality	Yes	Yes	Yes
7	Effectiveness	N/A	+1	+2

<sup>243</sup> Interviews with representatives from 5 corporate governance committees, 5 companies and 1 investor.

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Driver	Impacts	PO A	PO B	PO C
	Efficiency	N/A	0	+0.5
	Coherence	N/A	Yes	Yes
	Proportionality	N/A	Yes	Yes

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