

INCEPTION IMPACT ASSESSMENT

TITLE OF THE INITIATIVE	Sustainable corporate governance
LEAD DG – RESPONSIBLE UNIT	DG JUSTICE, A3 Company law unit
LIKELY TYPE OF INITIATIVE	Legislative and possible guidance
INDICATIVE PLANNING	Q1 2021
ADDITIONAL INFORMATION	

A. Context, problem definition and subsidiarity check

Context

The political guidelines of the Commission foresee strong focus for the EU to deliver on the UN Sustainable Development Goals, and the EU submitted its strategy for climate neutrality by 2050 to the United Nations Framework Convention on Climate Change in March 2020. The Communication on the [European Green Deal](#) sets out that “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.” Sustainability encompasses encouraging businesses to frame decisions in terms of environmental (including climate, biodiversity), social, and human impact for the long-term, rather than on short-term gains. The sustainable corporate governance initiative was listed among the deliverables announced in the [Action Plan on a Circular Economy](#), the [Biodiversity](#) and [Farm to Fork](#) strategies and would be part of the renewed [Strategy on Financing Sustainable Growth](#). The recent Communication “[Europe's moment: Repair and Prepare for the Next Generation](#)” also announces this initiative with the objective to “ensure environmental and social interests are fully embedded into business strategies”, in the context of competitive sustainability contributing to the COVID-19 recovery and to the long-term development of companies. The initiative is complementary to the [review](#) of the [Non-Financial Reporting Directive](#) which requires certain large public-interest companies to disclose sustainability-related matters.

Problem the initiative aims to tackle

A new [study](#) shows that many companies, in particular those listed on regulated markets, face pressure to focus on generating financial return in a short timeframe and redistribute a large part of the income generated to shareholders, which may be to the detriment of the long-term development of the company, as well as of sustainability. Short-term focus in corporate directors’ remuneration incentivises improving share price performance and corporate income distribution patterns show a strong trend towards declining investment. Between 1992 and 2018 the ratio of total shareholder payouts – i.e. dividend payments and share buybacks – to corporate net income, increased from 20% to 60% in listed European companies. Simultaneously, business investment – in terms of the ratio of capital expenditure and research and development spending to net income – has declined by 45% and 38% respectively. Over the last two decades, these indicators seem to have stabilised around high levels of pay-outs and low investment intensity.

This trend appears to be stable across the EU. Thus, it may hamper investment crucial for the sustainability transition, into productive facilities, innovation, upgrading and employee retraining, upskilling and reskilling. It may also contribute to income inequality as short-termism creates pressure to depress non-executive wages and employees often do not benefit from shareholder payouts. It may have

an impact on the resilience of companies, including in the COVID 19 crisis. On the other hand, a [meta study](#) of 2000 studies shows that companies performing well on sustainability factors outperform their peers and are more competitive. [New research](#) about the COVID-19 crisis also shows that companies with better social and environmental performance are more resilient in the crisis.

However, pressure to focus on short-term financial performance reduces companies' ability to integrate sustainability considerations adequately into business strategies and decisions. This has two aspects: on the one hand, companies do not properly identify and address climate change and other environmental, social and human rights (including workers' rights, child labour etc.) risks and impacts in their operations and supply chains. Many EU companies are sourcing supplies from entities based in countries with lesser social, human rights or environmental standards and the identification and mitigation of related risks and impacts is weak. On the other hand, companies fail to integrate potential new opportunities either for investment or for building resilience. While several large companies are frontrunners, most corporate strategies are rarely elaborated with proper measurement or aligned with science-based targets such as for example the goals of the Paris agreement on climate change. In addition, frontrunner businesses face issues of level playing field, which could hamper their leading efforts in the long run.

The drivers of these problems are both market and regulatory failures. Though (national) company laws in essence require corporate boards to act in the interest of the company *as a whole*, the company interest and directors duties are interpreted narrowly favouring maximisation of short-term financial value. Shareholder pressure also plays a role as well as directors' remuneration linked to financial performance. This market failure has been facilitated by shortcomings in corporate legislation and governance codes as they foster directors' accountability towards shareholders and do not sufficiently cover the interest of other stakeholders, including those affected by the company and the local and global environment. Furthermore, the legal framework lags behind the development of global value chains and corporate structures when it comes to the responsibility of a limited liability company for identifying and preventing harm in its group-wide operations and production channels¹. Relevant national law standards and requirements for companies differ among Member States.

Basis for EU intervention (legal basis and subsidiarity check)

The exact type of initiative should be identified based on the impact assessment. It could include modifying the codified company law Directive (2017/1132) and the consolidated Directive on Shareholder rights (2007/36).

For a legislative initiative, the legal basis could be Article 50(1) and (2)(g) TFEU, which gives EU competence to coordinate safeguards for the protection of interests of companies' members and other stakeholders in order to attain freedom of establishment. Article 114 TFEU, which allows the EU to approximate legislation with the object of ensuring the proper functioning of the internal market also applies.

Some Member States have already legislated on sustainable corporate governance (FR, NL, IT), while others consider action (DE, FI, SE, AT, DK, BE, LU). However, Member States' action alone is unlikely to be sufficient and efficient as sustainability problems are of a global dimension and have cross-border effects (climate change, pollution). National action alone is unlikely to tackle corporate short-termism either which characterises EU capital markets across the board.

Many companies are growing and becoming EU-wide or even global, and even smaller companies have cross-border supply chains. Furthermore, national intervention is likely to result in market fragmentation, which increases the costs for companies as well as for their investors and other stakeholders. Finally, an EU-wide legislation would create leverage and enable building a global level

¹ The international standards that exist for responsible business practises (i.e. the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles on Business and Human Rights, and the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy) are voluntary.

playing field for EU companies to operate on sustainable terms.

B. Objectives and policy options

The initiative aims to ensure that sustainability is further embedded into the corporate governance framework with a view to align better the long-term interests of management, shareholders, stakeholders and society. It aims at improving the framework to incentivise corporate boards to integrate properly stakeholder interests, sustainability risks, dependencies, opportunities and adverse impacts into strategies, decisions and oversight. It would serve the following specific objectives: help companies' directors to establish longer-term time horizons in corporate decision-making and withstand short-term pressures, strengthen the resilience and long-term performance of companies through sustainable business models and help reducing adverse impacts. It would create legal certainty and level playing field as to the necessary measures to be taken by companies to identify, assess and mitigate adverse impacts in the value chain.

In the baseline scenario, without any policy change at EU level, Member States will continue to apply or allow a variety of solutions as regards corporate and board duties. If left to voluntary market action, short-termism is unlikely to decrease. Environmental and human rights risks and impacts in companies' value chains will not be sufficiently integrated into corporate strategies. Under the Non-Financial Reporting Directive, companies will continue to disclose information about their risks and impacts. Although the revised Non-Financial Reporting Directive is expected to clarify the requirement to report on due diligence processes, such requirement would still not be underpinned by a corporate obligation to carry out due diligence, including mitigation of adverse impacts. Sector and product group specific substantive due diligence requirements will continue to apply². A growing number of Member States may introduce mandatory horizontal due diligence schemes or initiatives related to corporate governance leading to extra costs and lack of level playing field.

An EU level initiative could include the appropriate combination of the following corporate (company) and directors' duties with a view to requiring (still to be determined categories of) limited liability companies "not to do harm" and to empowering corporate directors to integrate wider interests into decisions, building also on existing corporate governance mechanisms:

- companies to take measures to address their adverse sustainability impacts, such as climate change, environmental, human rights (including workers and child labour) harm in their own operations and in their value chain by identifying and preventing relevant risks and mitigating negative impacts (due diligence duty). Such duty could be designed by building on existing authoritative guidelines using well-established definitions as developed by the UN and later expanded by the OECD³. The performance standards could be set in line with the goals of relevant international conventions and EU goals, such as those on human rights, climate and environment including biodiversity;
- company directors to take into account all stakeholders' interests which are relevant for the long-term sustainability of the firm or which belong to those affected by it (employees, environment, other stakeholders affected by the business, etc.), as part of their duty of care to promote the interests of the company and pursue its objectives; company directors to define and integrate stakeholders' interests and corporate sustainability risks, impacts and opportunities into the corporate strategy – following appropriate procedures – with measurable and time-bound, science-based targets where relevant, including as regards climate targets aligned to the Paris agreement, biodiversity and deforestation targets, etc. and according also to the company's size and activity, and to implement such strategy through proper risk management and impact mitigation procedures;

² Timber Regulation ([Regulation \(EU\) No 995/2010](#)) and Conflict Minerals Regulation ([Regulation \(EU\) 2017/821](#)).

³ The OECD Due Diligence Guidance for Responsible Business Conduct supporting the implementation of the OECD Guidelines for Multinational Enterprises lists the steps and processes that companies need to take and establish to identify and address adverse human rights and environmental impacts in their operations and supply chains. It builds on the UN Guiding Principles on Business and Human Rights.

- an appropriate facilitating, enforcement and implementation mechanism accompanying these duties, including possible remediation where necessary;
- other possible corporate governance arrangements for example regarding directors remuneration etc.

Depending on the scope and detail of the initiative, it would also need to be assessed to what extent legislative and to what extent non-legislative measures would be best suited to meet the objectives. In particular, it will need to be established which issues would need to be laid down in legislation and which issues would rather have their place in complementary guidance. This initiative will need to be coherent and consistent with the review of the Non-financial Reporting Directive.

C. Preliminary assessment of expected impacts

Likely economic impacts

A preliminary assessment of likely economic impacts, including implications for the companies, could draw on two studies delivered to the Commission in 2020: a [study](#) on due diligence requirements through the supply chain and a [study](#) on directors' duties and sustainable corporate governance.

These studies estimate that complying with new corporate and directors' duties would present one-off and ongoing costs. For example, the obligation to set up due diligence procedures is estimated to be less than 0.14% of the revenues for SMEs and 0.009% for large companies. Mitigating adverse impacts and implementing sustainability targets aligned with the overall long-term carbon-neutrality objective and other environmental objectives (including biodiversity-neutrality and circular economy) would also imply further costs, which could be higher in certain sectors. In this respect, in particular the company's size will need to be taken into account when determining the retained policy option. However, these extra costs should not be attributed solely to the new corporate and director duties as they derive from the necessity to attain the high-level sustainability goals to be reached at the level of the economy.

In addition, the new sustainable corporate governance framework would bring benefits to companies as well as to the economy as a whole, in particular in the medium- to long-term. The majority of a large sample of surveyed companies (mostly large) expect significant or very significant economic benefits arising from a corporate due diligence duty. This, together with potential new directors' duties and other elements of the new sustainable corporate governance framework would positively contribute to the productivity, profitability and attractiveness of EU businesses due to a better management of sustainability-related risks, reaping opportunities and better taking into account the interests of all stakeholders. It would improve the resilience of companies vis-à-vis changing environmental or social circumstances, or to sudden exogenous shocks (like the COVID-19 pandemic), that might threaten their continuous operation or even survival in the short term. As first movers in the sustainability transition, EU companies could gain remarkable competitive advantages on global markets. Introducing harmonised EU rules would level the playing field in the EU internal market, which may also save certain costs compared to what companies are doing now, trying to keep up with various recommendations and expectations. The new framework would also contribute to macro-economic growth and the increased investment into innovation, research and technological development, which would help the sustainability transition of our economies and societies.

Due consideration will need to be given to limiting and alleviating the burden for SMEs, for instance by the inclusion of exemptions from certain substantive and possible reporting obligations and/or by simplified standard(s), according to the proportionality principle based on the size and impact of the company.

Likely social impacts

Overall positive impacts are expected on the quality of jobs, wages, work conditions, ending child labour in the supply chains and respect of the human rights of vulnerable stakeholders affected by business operations. As regards the implementation of specific targets, such as of Paris-aligned climate targets, the impact will in this case be more significant on employment levels in high CO₂-emission sectors transitioning to climate neutrality; however the initiative also incentivises retraining and supporting

mechanisms which are likely to alleviate possible negative impact. The initiative is expected to contribute to reducing inequality both within the EU and beyond.

Likely environmental impacts

The impacts would be overall positive as regards fighting climate change, loss of biodiversity, fostering the efficient use of resources (renewable and non-renewable), preserving the quality of natural resources and preventing pollution (water, soil, air etc.), protecting and restoring biodiversity, ecosystems and their services, reducing and managing waste, fighting deforestation etc.

Likely impacts on fundamental rights

The initiative would promote compliance with all relevant obligations under the EU Charter of Fundamental Rights and ensure the coherence of the EU's internal and external policies in the area of human and labour rights.

Likely impacts on simplification and/or administrative burden

The impact on simplification and administrative burden, including a possible burden on Member States' authorities will depend on the option chosen. EU harmonisation may lead to simplification compared to different national legislation in EU Member States. Both courts and possibly national authorities would play a role in enforcing new duties depending on the enforcement option chosen.

D. Evidence base, data collection and better regulation instruments

Impact assessment

An impact assessment will be prepared to support the preparation of this initiative and to inform the Commission's decision. It will have due regard for the comparative impact/benefit of the various policy options.

Evidence base and data collection

Evidence on the drivers of the short-term approach in corporate decision-making has been collected since the 2008-2009 financial crisis. Following up on Action 10 of the 2018 [Action Plan for Financing Sustainable Growth](#), the Commission has been looking at further obstacles that hinder the transition to an environmentally and socially sustainable economy, and at the possible root causes thereof in corporate governance regulation and practices. As part of this work, the two aforementioned studies were commissioned: one on human rights and environmental due diligence in the supply chain, and one on board duties and sustainable corporate governance. Moreover, in Q4 2019 the three European Supervisory Authorities published reports on undue short-term pressures on corporations from the financial sector, within their respective areas of oversight, in response to the call for advice of the Commission⁴. In addition, the EU's Horizon 2020 research programme has funded a three-year research project ([SMART](#)) led by Oslo University which gathered evidence and formulated policy recommendations. The EU Fundamental Rights Agency is preparing a study to be finalised in October 2020 on access to remedy in case of human rights violations in supply chains.

Consultation of citizens and stakeholders

This inception impact assessment takes into account the views of the various stakeholder groups, collected throughout analytical and consultative activities. Both studies referred to above involved stakeholder consultations. The survey of the study on human rights and environmental due diligence in the supply chain generated more than 600 responses; its results show support for a policy change from all stakeholder groups. The study on board duties and sustainable corporate governance also included a

⁴ [ESMA Report "Undue short-term pressure on corporations"](#); [EBA Report on Undue short-term pressure from the financial sector on Corporations](#); [EIOPA Advice on "Potential undue short-term pressure from financial markets on corporates: Investigation on European insurance and occupational pension sectors"](#).

public survey the results of which are largely supportive. Furthermore, the Commission organised a [high-level conference on sustainable corporate governance](#) in January 2019, and the Commission services participated in numerous stakeholder workshops and other events, including the half-yearly high-level conferences on corporate governance organised under the auspices of the Council Presidencies. The research project in the context of Horizon 2020 has involved stakeholder consultations, including on their proposals for a regulatory reform. The [public consultation on the future renewed Sustainable Finance Strategy](#) has already gathered general feedback on sustainable corporate governance. Furthermore, in accordance with the Better Regulation Guidelines of the Commission, a specific online public consultation will be launched to seek stakeholders' views on all key questions that will form part of the Commission's impact assessment. Replies are expected to be received from all main types of stakeholders, covering national and EU level, all relevant sectors and companies of all types and sizes.

In addition, the Commission will consult its standing Company Law Expert Group of Member States and its advisory group of academics (Informal Company Law Expert Group) the mandate of which has recently been extended to cover advising on policies related to “sustainable companies”.

Will an implementation plan be established?

The need for an implementation plan will be assessed in light of the outcome of the impact assessment and the decision about which policy option to retain.