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ecoDa’s Reaction to the SMART’s introductory report

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The SMART project has submitted its introductory report outlining a set of reform proposals aiming to change the way in which businesses and finance operate, and the way products are produced and consumed.

The Report explicitly mentions that the writers would welcome input and comments to our proposals over the coming months, prior to their conference scheduled in Brussels on February 19th.

ecoDa is therefore taking the liberty of providing its feedback. ecoDa limits its comments specifically to the part related to the SMART reform proposals concerning businesses.

The Report makes it clear that: “Businesses must shift to sustainable business models and be encouraged to innovate sustainably. To achieve this, the purpose of business and duties of the board needs to be redefined towards sustainability, to protect the decision-makers in businesses against the pressure to maximize financial returns”.

First of all, we would like to acknowledge the role of the SMART team in identifying the opportunities to not only mitigate risks and avert disaster, but also to rebuild, improve and generate an economic transformation.

This being said, please find hereunder our comments highlighted point by point:

<u>2.3 The unsustainability of business:</u>

- ecoDa questions the assumption made in the Report that: “A misconception has become entrenched, namely that the purpose of the leading European business form, the limited liability companies, and thereby the duties of its board, are <u>only</u> to maximize returns for shareholders”.

  According to both statutory law and courts in most European countries, the key obligation of board directors is generally defined as a duty of care and loyalty to the company, in other words this is the duty to promote the *interest of the company*. As already highlighted in previous ecoDa's papers, this does not mean that the purpose of the company must only be to make a profit. Companies are often driven by the willingness to supply good-value-for-money products and innovative products to its customers. Boards have the duty to promote the long-term profitalibility of the company, not short-term. At least in some Member States, this is even requested by law. It is also important to acknowledge that companies still have to be profitable, they cannot be good for the society if they are going bankrupt.

- We believe that the concept of corporate purpose is the best way to clarify the scope of directors' fiduciary duties. It goes beyond the Business Judgment Rule and the presumption of good management decisions (in the sense that it clarifies the conditions of exercise of the business judgment).

  The Corporate Purpose can serve as a safe harbour for directors in the sense that board members would be protected from any compromise between profitability and the company interest, and for any breach of fiduciary duties against shareholder interests.

  The regulators should oblige shareholders to clearly define the corporate purpose at the constitution moment or in a later phase when updating that purpose. Any change in the definition of the corporate purpose should be agreed at the GM.

  By requesting that company law "*take back the power to define what the purpose of the company is in Europe*" and by suggesting that "*corporate purpose of the undertakings is defined in law as creating sustainable value within planetary boundaries balancing the interests of its members and other investors and other involved and affected parties"*, the Report is bringing confusion on the concept of corporate's purpose. Reducing the notion of corporate purpose to environmental awareness alters the value of this concept. Companies must demonstrate greater ambition while defining the corporate purpose. The Corporate Purpose should form the basis for dialogue and a set of agreed principles to guide relations between boards and shareholders. Meaningful statements will not come from the regulators.

- Additionally, the Report requests boards to balance the interests of shareholders with the interests of stakeholders. Although ecoDa recognises the value for companies to interact with their environment, we believe that the wording of the text should be revised. Taking into account all stakeholders' interests on an equal footing should not be the ultimate goal of companies. Stakeholders' interests are often contradictory between themselves: to take the simplest example, the interest of customers is that prices are as low as possible, the interest of the company's suppliers and workforce is that they are as high as possible so as to soften cost-cutting. Boards should not be turned into bargaining bodies where different, often probably mutually conflicting interests are turned against each other, thus hampering efficient decision-making. However, responsible boards must definitely arbitrate between the interests they take into regard and those they ignore. Boards should take into account the interests of both shareholders and the relevant stakeholders of the company which need to be clearly identified and can be specific to certain sectors and companies.

- The Report puts forward some guidelines to make sure that sustainable strategies are implemented: *"To this end, the board shall ensure that a stringent sustainability* *assessment is undertaken at regular intervals (e.g. every five years), including sustainability due diligence – encompassing environmental, social and governance impacts – and including open and participatory processes with affected communities and persons. This would give a basis for rectifying lack of legal compliance and for a continuous improvement process towards the overarching purpose, on which the undertaking annually shall report as a part of the management report"*. Here there is a conflation of different topics. There is no chance that companies could escape from their legal obligations. On the contrary, companies should "co-regulate" the markets in the interest of the society as a whole. However, it is true that companies who fail to deliver on their corporate purpose should take corrective measures.

- The Report is claiming for a full audit of the Corporate's sustainability report. We should not forget that "not everything that counts can be counted and not everything that's counted truly counts". There is a need to acknowledge ongoing work to establish globally applied assurance standards for sustainability disclosures, however ecoDa has some doubts that the sustainability report could be fully audited. Experience in the implementation of the non-financial reporting directive shows the difficulty of finding reliable measurement criteria in that field. We should be weary of developing a costly and irrelevant consultancy business.

2.5 <u>Corporate governance codes as drivers of shareholder primacy</u>

- ecoDa would like to challenge the assumptions made under the paragraphs related to CG Codes.

The Report states that *"Corporate governance codes are created by the financial actors themselves <u>without legislative control</u> and w<u>ithout a sound research-basis for the substance of the codes</u>. Rather, they are informed by and f<u>urther reinforce the shareholder primacy drive.</u> Typically they contain provisions that contradict European company law by promoting the unsustainable, short-term pressure of the shareholder primacy drive. The tentative inclusion of certain sustainability aspects in a number of codes is generally only on a <u>superficial level,</u> varying from Member State to Member State, which does not promote more sustainable business"*.

When we look back in history, CG codes have often served as a reference point, expressing the societal principles and reflecting the common opinion in the field of good governance. Their main purpose has been to improve the independence and efficiency of boards of directors, precisely against the risk of concentration of the power in the hands of management and/or controlling shareholders. In most jurisdictions, codes have had an enormous impact not just for listed companies but also as a model for CG developments in many other types of businesses. In addition, they have been a source of inspiration for not only companies but even courts thereby exerting an indirect impact, like case law. Actually the CG codes have created the transparency requirements and culture of listed companies regarding e.g. remuneration.

Believing that the Codes are written by issuers and investors without full consultation with the regulators (often negotiation) is ignoring the reality. Besides, CG Commissions are not only engaged in updating the Codes but they often have a monitoring role and are engaged with companies to open the dialogue. Furthermore, in the preparation of a CG code, open consultations are launched and ministries and regulators consulted.

CG Codes should not be seen as the antinomy of accountability. On the contrary, in all Member States, there is a legal obligation for listed companies to comply with Corporate Governance Codes and if they don't comply they have to explain the reasons why they don't comply with the provisions of the Code.

The big danger with a legalistic board approach is that box ticking, often involving lawyers and auditors, is taking over and leads to too much focus on formalities. CG Codes offer the possibility to engage more board members and shareholders into a constructive dialogue.

Recently, CG Codes have shown that they can respond quicker than legislative initiatives to new concerns. New initiatives have been taken to emphasize a multi-objective duty for board members. In addition, monitoring reports like the recent FRC report and AFEP-MEDEF reports incentivize best practices through market pressure.

ecoDa considers that CG codes go well beyond the minimum legal requirements applying to all and should permanently identify and propose the best practices for the companies.

Developing common principles for a sound corporate governance applicable across Europe, fitted for the challenges and opportunities of the future would certainly make sense and ecoDa will be working on that objective. However, going for an EU CG Code is a step further that we would not favor.

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See: SMART's introductory report

Contact:

Béatrice Richez-Baum, Director General, ecoDa:
contact@ecoda.org, Tel: 003222315811

About the European Confederation of Directors Associations

The European Confederation of Directors Associations (ecoDa) is a not-for-profit association founded in December 2004 under the laws of Belgium. Through its 22 national institutes of directors (the main national institutes existing in Europe), ecoDa represents approximately 55,000 board directors from across the EU. ecoDa's member organizations represent board directors from the largest public companies to the smallest private firms, both listed and unlisted.

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