DISCUSSION PAPER CORPORATE GOVERNANCE & DUE DILIGENCE

INTRODUCTION

Europe's green transition, and path to sustainability, requires us all to contribute. Europe will only succeed with the right regulatory framework in place. The private sector has a crucial role to play, not least as companies are the engines of innovation. In fact, 85.7% of European companies have a sustainability strategy.

Going forward, the legislators will have to find the right regulatory tools and the right balance between regulatory measures, on the one side, and allowing companies the freedom to run their business and creating growth, on the other. Some of the current sustainability initiatives includes the Non-Financial Reporting Directive (NFRD), the Taxonomy, due diligence and corporate governance. While we should obviously avoid regulating the same area twice, it is equally important not to use more regulatory tools than necessary to achieve the political objectives.

As a first step, it is imperative to distinguish clearly between due diligence and corporate governance. These two policy areas are being mixed up in the current debate. Since the legal specifics of due diligence and corporate governance are very different, their treatment in the regulation should also be addressed separately.

DUE DILIGENCE

The Commission is proposing mandatory human rights and environmental due diligence at the EU level to strengthen and further promote responsible business conduct throughout global supply chains of European companies or companies operating in the EU. Current voluntary frameworks and guidelines are not seen as sufficient to ensure a desired level of compliance with international human rights and environmental standards.

A few Member States have already developed national mandatory due diligence regulations over the past years and more could follow in the coming years. This potential patchwork of national legislation would be burdensome to companies and may endanger the level playing field in the EU's single market. The Commission therefore argues that a horizontal EU regulation on due diligence requirements for human rights could reduce the divergence in the requirements that companies meet across Member States.

If the EU decides to move ahead, any EU legal framework on corporate obligations on human rights due diligence should envision an international level-playing-field and address the following points very carefully:

- EU rules on due diligence must ensure a level playing field and not leave room for national rules that go beyond the EU framework. An EU framework should also apply for companies from third countries active in the EU in order to maintain the competitiveness.

- The roles of states and companies should not be mixed up. While the UN Guiding Principles on Business and Human Rights (UNGP) assign the primary responsibility of protecting human rights to states, it is the responsibility of globally operating companies to respect human rights. Any legal framework set by the state should set the expectation of companies for risk optimisation.

- The Commission should adopt a risk-based approach, based on the UNGPs and OECD Guidelines, which takes into account the size and internationality of companies and the risks of human rights typically associated with business activities. Solely a risk-based approach makes it possible to take account of the corporate reality in such a way that process-driven solutions make it possible to meet the legal requirements. However, it should be noted that these frameworks were specifically designed to be voluntary and therefore cannot be simply transposed into EU-rules on mandatory due diligence.

- Regulation should clearly distinguish between large companies and small and medium-sized enterprises (SMEs) and only cover those companies that can meet the requirements. Even without legal requirements, SMEs will meet demands from major customers that are subject to mandatory due diligence, and their standard will thus be raised by market forces. However, if mandatory due diligence will also be introduced for SMEs, it must be adapted to their specific capacities and circumstances. Moreover, the definitions should be clear and workable, and the Commission should provide SMEs with the right tools and information to fulfil their due diligence obligations.

- Mandatory due diligence should be limited to the first tier of suppliers outside the EU with whom there is an established commercial relationship. There should be a focus on process requirements rather than performance requirements while also considering the complexity of the company's supply chains.

- Existing liability regimes of the Member States already provide sufficient and appropriate rules regarding civil liability of companies. There should be no new provisions. Companies' responsibility should only apply for their direct influence. The applicable UNGP and OECD guidelines expressly take these facts into account by stipulating that there must be no liability merely due to an indirect business relationship.

The vast majority of companies already apply responsible business conduct with due respect for human rights, and support the current voluntary standards presented in the UNGP and the OECD Guidelines for Multinational Enterprises. Therefore, mandatory due diligence requirements should as far as possible be harmonized with the international framework outside the EU so that the competitiveness of European companies in global markets is not compromised. In the framework of its external policy activities, the EU should thus place a particular emphasis on negotiations of international agreements on human rights protection. Moreover, the EU should as a part of its development cooperation give local enterprises in developing and emerging countries targeted support for reaching higher standards in global supply chain networks.

CORPORATE GOVERNANCE

According to the EY Study **"On directors' duties and sustainable corporate governance"**, authorised by the Commission, many companies focus too much on short-term financial performance compared to their long-term development and sustainability aspects. The study concludes that this is due to the current rules on directors' duties in the Member States combined with generally short-term shareholders.

However, companies and investors disagree with the study's assumption on which the entire EU initiative on corporate governance is based. World leading **academics** support this critique calling the study heavily biased and its recommendations unfounded. Before any legislative initiative is taken, the Commission must prove the need for EU intervention. The basis provided so far cannot be relied upon. Notably, the following issues with the initiative have been identified:

- Sustainability is already embedded in the corporate governance systems of the Member States and the assumption that current national corporate governance frameworks do not work is incorrect. Thus, an EU legislative initiative will conflict with the principle of subsidiarity as well as violate the principle of proportionality.

- There is a lack of empirical evidence supporting the assumption that companies are systematically focused on short-term financial performance. On the contrary, there are **studies** showing that corporate short-termism is a much more complex and multi-faceted issue than what is asserted in the EY Study and that pay-outs to the shareholders is at any rate no reliable indicator of short-sightedness in business management. For example, in a recent **Swedish study** the researchers did not find any material indications of financial short-termism in Sweden.

- Furthermore, there can be situations where short-term decisions are necessary to preserve the long-term value creation of the company for the sake of all stakeholders. One does not necessarily exclude the other as it is highlighted in the EY study, leading to a misleading picture of European companies and flawed as well as far-reaching recommendations.

- Sustainability is already a competitive factor for companies. However, such market trends and the impacts of additional EU initiatives have not been taken into account. Some of these initiatives are under way – others are adopted legislation that has not yet had time to work – e.g. shareholders rights directive II, Taxonomy regulation, NFRD.

- Most businesses already take on board stakeholders' concerns e.g. through committees or regular meetings. A lot is already done e.g. through CSR commitments. However, it is impossible to identify stakeholders as ex ante categories, as they often represent different and potentially contradictory interests. Relevant stakeholders must be identified on a case by case basis, but even then, no business decision can balance the interests of all stakeholders equally – nor should this be the aim.

- The impacts of the proposed change to a stakeholder-oriented regulatory system would be dramatic as it interferes with core elements of what constitutes a company. For example, making company directors liable to a wider range of people would lead to stakeholder conflicts and potential deadlocks influencing decision-making efficiency. Reducing the control of owners' rights will naturally have very negative consequences for investment and those seeking to create sustainable businesses. Combining such diffuse director liability - with rights for external stakeholders to enforce it - would only worsen those negative impacts and add new classes of legal claims. This is in no one's interest.

In conclusion, the recommendations of the EY-study simply appear anti economic development and based on unfounded assumptions. Far-reaching and unjustified legislative intervention around directors' duties and company stakeholders would negatively affect the very core of how companies operate (anchored in our market economy model). Companies would become more risk-averse and less entrepreneurial, and ultimately less attractive to investors. As this initiative is excessive as well as potentially harmful, we urge the Commission not to proceed with it.