

Sustainable Corporate Governance

NGO Policy Briefing

The European Commission is [committed](#) to present an initiative on Sustainable Corporate Governance (SCG) in 2021, following the presentation of the Green Deal last December, as part of the Action Plan on Financing Sustainable Growth.

The related [Inception Impact Assessment](#) and the [public consultation](#) outline two issues the initiative sets out to resolve. First, the European Commission intends to address the lack of a European legal framework for corporate human rights and environmental due diligence. Second, the Commission aims to identify how corporate governance can foster sustainability and long-term thinking. This paper addresses the latter part of the initiative.

Adjusting corporate governance is not a trivial task. Corporate governance is influenced by complex factors, including company law, market and regulatory incentives, type and interests of corporate shareholders and business culture, all of which are influenced by specific national contexts.

Therefore, to guide policy-makers towards an effective reform, **this paper focuses on presenting recommendations on elements of sustainable corporate governance that clarify the specific responsibilities of the board to oversee sustainability but do not further address broader aspects of corporate governance.** The focus is on the responsibility of directors within a framework of corporate interests and directors' duties determined by national regulators. These recommendations are based on current best practice, are easily implementable and are coherent with existing key aspects of company law and corporate governance frameworks across Europe. The involvement of directors, who lead and steer companies, is paramount to ensure that companies are able to consider and take the necessary strategic decisions with regards to the management of sustainability risks and impacts, and integrate them in overall corporate strategies and business operations .

We stress that **these recommendations on sustainable corporate governance would both support and require a comprehensive legislation on [mandatory human rights and environmental due diligence](#).** Taking this into account, the below proposals are divided into two categories.

1. The first category (**package 1**) includes **proposals that are intrinsically connected to due diligence**, and thus should be explored as part of a single proposal.
2. The second category (**packages 2 and 3**) outlines other **supportive reforms in the field of corporate governance**, which promote good practice and more broadly provide safeguards against malpractice.

We strongly suggest to reflect the below recommendations in the legislation that should apply to all companies and in particular those whose business activities are linked to significant sustainability risks and impacts. This will be critical to ensure that relevant risks and impacts are appropriately addressed, for the long-term sustainability of those companies and the financial and economic system, and protection of people and planet.

This briefing is supported by the following organisations:

Anti-Slavery International, Business and Human Rights Resource Centre, Economy for the Common Good, European Coalition for Corporate Justice, Fair Trade Advocacy Office, Finance Watch, Frank Bold, Global Witness, Oxfam, ShareAction, Themis Research and WWF.

The European Commission is set to put forward a **legislative proposal for a mandatory human rights and environmental due diligence (mHREDD)** establishing the corporate duty to identify, assess, prevent and mitigate adverse impacts on people and the planet caused by, contributed to by, and directly linked to the company. Furthermore, the Commission **proposal for a Corporate Sustainability Reporting Directive (CSRD)**, reforming the Non-Financial Reporting Directive, properly embeds a double materiality approach in the European corporate reporting framework. CSRD requires companies to: 1) identify the principal risks to the company related to sustainability, 2) report on the company's sustainability strategy and targets adopted to address those risks, as well as 3) identify and report on the company's own principal adverse impacts on people and the planet.

To establish and effectively implement the aforementioned processes requires effective governance and oversight from the company's senior management and the board. This is particularly relevant where sustainability risks and impacts are connected to the company's core business model, which in turn may require the directors to oversee changes to the company's corporate strategy, including necessary business model changes, and financial planning.

Such an **oversight of a company's due diligence, double-materiality determination processes, and strategies** to address identified sustainability impacts and risks, **fully fits within the framework of existing directors' duties** and accountability mechanisms. However, [as found in corporate sustainability reports](#), while some leading companies' boards provide effective oversight, the overwhelming majority currently fails to do so.

Legislative Recommendations

In order to address these limitations, **a critical step is for the forthcoming legislation to simply clarify the following procedural obligations for directors**, noting that this does not expand or change existing directors' duties but would provide important clarification and direction. **To that end, directors should:**

- › **Approve a forward-looking corporate strategy fully integrating sustainability considerations**, including necessary changes to the company's business model, financial planning and targets, based on the following:
 - Companies should **adopt targets relevant for the prevention and mitigation of salient sustainability risks and impacts, identified by the company during the due diligence process** and according to the rules to be provided in the forthcoming Commission proposal. Targets need to enable an assessment of the **company's progress** with regards to addressing identified sustainability risks and impacts, and should be **measurable, time-bound and where relevant, science-based**.
 - With regards to **climate change**, companies that (a) operate in high-impact sectors and those that (b) identify the issue as material based on the double materiality assessment to be required by the Corporate Sustainability Reporting Directive, should **adopt climate objectives and a transition plan compatible with the goals of the Paris Agreement** to keep global warming below 1.5°C and consistent with the EU climate policy milestones.
 - Concrete **action plans and transition pathways** that turn the company's sustainability strategy into **specific actions needed to meet its targets**, in particular in the short term. Ensure that sufficient financial and human resources are available for the implementation and monitoring of the sustainability strategy, targets and plans.
- › **Be required to oversee the quality of the double-materiality determination and due diligence processes, and regularly discuss the results** of the sustainability risk and impacts' assessments delivered through these processes;
- › **Monitor the progress and challenges** linked to the implementation of the sustainability strategy and ensure that it is addressing all salient risks and impacts.
- › Be equipped to **provide meaningful oversight**. This would require that they are informed by:
 - Appropriate expertise; and,
 - The perspective of stakeholders affected by severe impacts identified through human rights and environmental due diligence processes where the company must consult with affected stakeholders as part of its ongoing risk identification, analysis and prevention and mitigation obligations.

PACKAGE 2

Alignment of incentives with sustainability objectives

To support the alignment of the company's short-term actions and objectives with its long-term sustainability strategy, the variable component of directors' remuneration, performance incentives for the executive management, and dividends and share buy backs should be linked to the achievement of the company's measurable sustainability targets.

Linking such incentives to the company's sustainability targets, set following a careful consideration of principal risks and impacts using the company's double-materiality assessment, minimises the chance that companies would incentivise short-term oriented activities focusing solely on attainment of momentary financial profits at the expense of the company's long-term and sustainable success.

Legislative Recommendations

Specifically, the forthcoming legislation should introduce the following requirements:

- › **The flexible components of Board and executive remuneration**, if used by the company, should be **significantly linked to the achievement of measurable sustainability targets** (time-bound and science-based in the case of environmental targets) set in the company's strategy; and a dedicated separate portion should be based on emission reduction targets.
- › **Stock options granted to directors should not form a disproportionate part of their remuneration**, as this would counter the effect of performance incentives aimed at sustainability targets;
- › **Shareholder payouts**, that is, payout of dividends and share buy backs, **should be subject to meeting the company's sustainability targets**. They should also ensure capital alignment with the implementation of these targets in the future (e.g. allowing investments necessary for the climate transition).
- › Overall, **remuneration policies**, whenever relevant, should **endeavor to limit the wages gap** between CEO to median worker.

PACKAGE 3

Board composition

In order to enable effective governance, **the board as a collective organ needs to:**

- a) **be aware of the interests of the company's stakeholders** (including but not limited to affected stakeholders identified during the company's due diligence process -see Package 1-), and
- b) **have sufficient expertise** on sustainability matters to be able to **understand and assess sustainability risks and potential adverse impacts, adopt relevant strategies and targets and assess progress**. The board should also be sufficiently representative of the company's workforce diversity.

Legislative Recommendations

The forthcoming legislation should set principles that can be implemented with respect to composition, expertise, representation and engagement that are based on and adapted to the company's specific circumstances:

- › The **composition of the board** should reflect the company's unique situation, the diversity of its workforce, and the nature of the challenges it faces; in particular the composition should consider diversity of gender, ethnicity and expertise.
- › The board as a collective organ should have **expertise on the company's sustainability risks and impacts**; this can be achieved through a requirement for the board to self-assess the adequacy of its own expertise, for a specific number of board members to have relevant expertise, or for a board to undergo training to ensure this expertise is obtained.
- › As part of the board obligations, **workers should be consulted on key strategic matters**, including the development and monitoring of the implementation of the company's sustainability strategy and targets. The interests of employees could be represented directly or, for example, by requesting workers' councils to nominate a supervisory member.

Briefing supported by:

 <p>Frank Bold</p>	 <p>WWF</p>	 <p>Upro anti-slavery</p>	 <p>ECCJ European Coalition for Corporate Justice</p>
 <p>Fair Trade ADVOCACY OFFICE</p>	 <p>global witness</p>	 <p>ECONOMY FOR THE COMMON GOOD An economic model for the future international</p>	 <p>Themis RESEARCH</p>
 <p>Business & Human Rights Resource Centre</p>	 <p>ShareAction</p>	 <p>OXFAM</p>	 <p>Finance Watch Making finance serve society</p>