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Corporate Governance for Sustainability

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Corporate Governance for Sustainability

Statement

INTRODUCTION

The current model of corporate governance needs reform. There is mounting evidence that the practices of shareholder primacy drive company directors and executives to adopt the same short time horizon as financial markets. Pressure to meet the demands of the financial markets drives stock buybacks, excessive dividends and a failure to invest in productive capabilities. The result is a 'tragedy of the horizon', with corporations and their shareholders failing to consider environmental, social or even their own, long-term, economic sustainability.[1]

The urgent need to address adverse impacts and risks produced by and associated with this model is reflected in the Statement on the Purpose of a Corporation issued by the Business Roundtable in the US, the 'Purpose' Letter issued by Larry Fink, CEO of Blackrock, comments by the Governor of the Bank of England and Chairman of the Financial Stability Board Mark Carney, as well as in the corporate governance codes in the Netherlands and South Africa and the Loi PACTE in France.

The *Action Plan on Financing Sustainable Growth* recently presented by the European Commission responds to this urgent need by setting out an ambitious agenda to develop integrated reforms in the areas of sustainable finance, directors' duties, and corporate reporting with the aims of: addressing the root causes of short-termism in capital markets and corporate governance; correcting the failure of relevant actors to manage the financial risks associated with climate change; and moving business towards greater sustainability.[2]

Whilst recognizing that many corporate governance issues still remain to be addressed, the signatories to this statement express their support for the Action Plan's goal of making corporate governance practice significantly more sustainable and focused on the long term. In order to contribute to the development of this agenda, the signatories of this statement put forward the following key proposals.

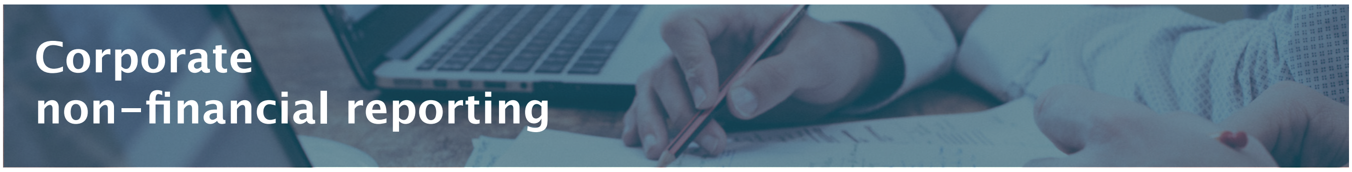
Sustainable Finance

- Sustainable corporate governance requires a financial market in which there is a critical mass of investors willing to invest in companies that implement long-term sustainability plans, even at the expense of short-term returns. Yet executives are under pressure (and have powerful incentives) to focus on short-term issues rather than sustainability, whilst institutional investors report that they too are constrained by an institutional setting that prioritises short-term shareholder value.[3]
- In order to overcome these constraints, a legal obligation to consider, identify and disclose Environmental, Social and Governance (ESG) risks should be imposed at every level of the investment chain, including upon institutional investors and asset managers.
- Such reforms should be complemented by changes to company law that require boards of directors to develop, disclose and implement a corporate sustainability strategy.[4] Rules relating to corporate disclosures should also be reformed with the aim of improving the quality and comparability of the non-financial information provided to shareholders and other stakeholders about key sustainability risks. In what follows we make suggestions as to how this could be done.

Directors' duties and corporate board obligations

- Directors' duties are one way in which company directors can be held accountable for how they carry out their critical corporate governance functions of developing the company's strategy, overseeing its operations, and accounting for its performance. Therefore directors' duties are often considered as a possible method of steering company directors towards the long term interests of companies.[5]
- The underlying idea is that directors could potentially use their discretion under (some variant of) the business judgement rule that exists in every major jurisdiction, and that gives directors discretion to act in what they believe to be in the best interests of the company as a separate entity. In principle, this rule can accommodate either a long- or short-term approach. Hence, where directors pursue the goal of maximising short-term shareholder value, it is a product not of legal obligation, but of the pressures imposed on them by financial markets, activist shareholders, the threat of hostile takeover and/or stock-based compensation schemes.[6]
- These strong pressures from outside company law mean the problem of short-termism cannot be solved simply by requiring or permitting directors to have regard to sustainability and the company's long-term interest.
- In order to: counteract the pressures imposed on directors by financial markets to maximise short-term shareholder value; increase director accountability; and ensure a proper consideration of corporate long-term interests and sustainability risks, we recommend that:
  - › directors should be subject to a legally-binding obligation to develop, disclose and implement, on behalf of the company, a forward-looking corporate sustainability strategy that identifies and addresses material environmental and social issues and significant impacts connected to the company's business model, operations and supply chain.
  - › whilst directors should have discretion as regards identifying which issues are material for the corporate sustainability strategy, the law should clarify that the purpose of requiring companies to produce such a strategy is to ensure respect for the planetary boundaries and human rights,[7] as well as integration of ESG considerations into all aspects of the company's operations. In order to ensure that the strategy covers relevant matters, the law should specify a limited set of sector-specific issues and public objectives that should be addressed on a 'comply or explain' basis.[8]
  - › a specified percentage of the KPIs and remuneration of executive management should be linked to the achievement of measurable targets set in the company's sustainability strategy[9] (and national remuneration disclosure laws should be amended to require publication of these matters).

- In order to ensure directors' accountability for this responsibility, we recommend that:
  - › the board should be required to include in the corporate sustainability strategy verifiable targets and a commitment to making sufficient resources available to management.
  - › the board should be mandated to discuss and sign off on an annual progress report, which should be included in the company's non-financial report.
  - › a non-executive committee, composed of independent experts and chaired by a designated non-executive director, should be set up and tasked with monitoring and reviewing the content and implementation of the sustainability strategy.[10]
  - › non-executive directors should have a duty of care to monitor the implementation of the strategy.
  - › failure to implement the corporate sustainability strategy should be considered a breach of executive directors' duty of good faith (where deliberate) or duty of care (where accidental[11]), and could be enforced by the shareholders by derivative action where the failure causes long-term harm to the company.
  - › a national regulatory body should be empowered to bring proceedings against the executive directors where non-implementation has caused serious harm to third parties or unlawful harm to the environment.[12]



Corporate non-financial reporting

- The function of corporate 'non-financial' reporting is to allow the company's shareholders and other stakeholders to make informed investment and engagement decisions by providing information on the company's social and environmental risks and impacts, and on the implications of such risks and impacts for the company's development.
- Since 2018, the EU Non-Financial Reporting Directive (NFRD) has required large companies, banks and insurers to disclose non-financial information. However, an abundance of standards and the flexibility accorded to reporting entities means that, whilst reports are often lengthy, they are neither comprehensive nor sufficiently comparable.[13]
- The standardisation of non-financial reporting is indispensable for the development of sustainable finance, for effective monitoring of companies' implementation of their corporate sustainability strategies, and for enforcement of directors' duties. Therefore, we recommend that the rules relating to corporate disclosures should:
  - › clarify that information on sustainability matters should be disclosed if it is material either from a financial or from a social and environmental perspective.[14]
  - › stipulate minimum general and sector-specific requirements for form and content of disclosures. Minimum requirements should be imposed in relation to, inter alia, climate change-related targets, strategies and performance, and the results of environmental and human rights due diligence covering supply chains.[15]

CONCLUSION

Current corporate governance practice is contributing to a wide range of systemic risks, as well as devastating social, environmental and economic impacts.[16] With less than a decade left[17] in which to address the catastrophic threat of climate change, and with investors, companies, accountants, policymakers and academics expressing a shared sense of urgency, now is the time to act to reform corporate governance.

The signatories to this Statement call on all those concerned about climate change and sustainability to work together to support and implement the proposals in this statement and to contribute to the achievement of the EC Action Plan's goals.

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FOOTNOTES

[1] See Davies R et al. (2014) Measuring the costs of short-termism. *Journal of Financial Stability*, 12: 16-25.

[2] European Commission, 'Action Plan: Financing Sustainable Growth' (COM(2018) 97 final, Brussels, 8.3.2018).

[3] See the 'Purpose' Letter issued by Larry Fink, CEO of Blackrock; J Veldman et al. 2016 Corporate Governance for a Changing World, Cass and Frank Bold, Brussels

[4] B Eccles and G Serafeim, The Performance Frontier: Innovating for a Sustainable Strategy, *Harvard Business Review*, May 2013

[5] See European Commission, Action Plan on Financing Sustainable Growth, Action 10, which commits to carry out analytical and consultation work on requiring companies to develop and disclose corporate sustainability strategies and possible clarification of directors' duties.

[6] See Company Law Statement point 10; also for an overview of the legal position in a number of jurisdictions, see B Sjåfjell, A Johnston, L Anker-Sørensen and D Millon, 'Shareholder Primacy: the main Barrier to Sustainable Companies' in B Sjåfjell, and B Richardson (eds), *Company Law and Sustainability: Legal Barriers and Opportunities* (Cambridge University Press, 2015)

[7] For further discussion of the centrality of the natural science concept of planetary boundaries to any understanding of sustainability, see: B Sjåfjell and CM Bruner, 'Corporations and Sustainability' in B Sjåfjell and CM Bruner (eds), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge University Press, 2019), 3-12

[8] For example, the directors could be required to explain how the company's strategy and targets are aligned with the national climate change mitigation strategy and the Paris Agreement.

[9] House of Commons, Business, Energy and Industrial Strategy Committee, *Corporate Governance*, Third Report of Session 2016–17, 30 March 2017, Recommendation 19 and para. 86, recommending that bonuses be aligned with company objectives; N Nigam, C Benetti, and S Mbarek, 'Can Linking Executive Compensation to Sustainability Performance Lead to a Sustainable Business Model? Evidence of Implementation from Enterprises around the World' (2018) 27(6) *Strategic Change* 571-85

[10] See the report submitted to the Minister for the Economy and Finance of the French Republic by Patrick de Cambourg, President of the Autorité des Normes Comptables - 'Ensuring the relevance and reliability of non-financial corporate information: an ambition and a competitive advantage for a sustainable Europe (2019)', p. 205.

[11] Executive directors should have a defence to liability for breach of duty of care where they can show that they reasonably relied on reports of the sustainability committee

[12] 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, especially where necessary to restore market confidence and integrity: see M Welsh, 'Raising the Public Potential of Corporate Law: Twenty Years of Civil Penalty Enforcement in Australia' (2014) 42 *Federal Law Review* 1; in the Netherlands, the Enterprise Chamber has far-reaching powers of intervention in the internal affairs of companies, including nullification of corporate resolutions, suspension, dismissal or appointment of directors, and other remedies including dissolution: see J Van Bekkum, S Hijink, MC Schouten and JW Winter, Corporate Governance in the Netherlands (2010) 14 *Electronic Journal of Comparative Law* 1, 4.

[13] The NFRD, which does not specify precise requirements, has so far failed to ensure meaningful disclosures by companies. See Alliance for Corporate Transparency, 'The State of Corporate Sustainability Disclosure under the EU Non-Financial Reporting Directive', 2019

[14] The NFRD adopts a 'double materiality' perspective, according to which companies should disclose information that is necessary for an understanding of their financial 'development, performance [and] position', as well as environmental and social impact. See 'Communication from the Commission — Guidelines on non-financial reporting: Supplement on reporting climate-related information', C/2019/4490, pt. 2.2.

[15] See the letter by the European Securities and Markets Authority addressed to the European Commission: 'Revision of the European Commission's Non-Binding Guidelines on Non Financial Reporting' and the report prepared by Patrick de Cambourg (footnote 10 above).

[16] For other projects addressing these issues, see the Statement of Corporate Purpose Campaign, the Future of the Corporation Project and the SMART project.

[17] See the IPCC report.