Doing business the right way: Pushing for green and social corporate governance

BACKGROUND

One of the most pressing questions facing EU policymakers today is how to ensure that the economic stimulus plans to overcome the COVID-19 crisis are in line with the EU’s sustainability commitments. To succeed, the EU will have to ensure that businesses are active participants in the process.

Corporate governance – the rules and practices that a board of directors follow to ensure transparency, fairness and accountability in a company’s relationship with its stakeholders – can be “an effective tool for making finance and the economy more sustainable”. Against this backdrop, this Policy Brief assesses two instruments in the EU corporate governance toolbox and explains why reforming them now is crucial to enable a green recovery from the COVID-19 crisis:

1) The Non-Financial Reporting Directive (NFRD), which requires large companies to disclose information about how their activities impact the environment and human rights, how they treat their employees, the degree of diversity in the boardroom, and their policies on transparency. The Commission is currently gathering stakeholders’ views ahead of an expected revision later this year.

2) The Shareholder Rights Directive II (SRDII), which aims to encourage long-term shareholder engagement. This Policy Brief will also cover the principle of shareholder primacy – the idea that shareholder interests should take precedence over all else – and executive remuneration.

STATE OF PLAY – BUSINESS AS A BARRIER TO SUSTAINABILITY?

Non-Financial Reporting Directive

The Commission’s planned revision of the NFRD, a component of the European Green Deal, is an essential step in the efforts to align EU action with the 2015 Paris Agreement.

The directive requires large companies and financial corporations to disclose a range of non-financial information, including in relation to human rights and the environment. They are also required to share information about their overall governance and sustainability-related financial risks. All these aspects are known as Environmental, Social and Governance (ESG) factors.
However, by giving companies the flexibility to disclose the information “in the way they consider most useful,” governing boards are hardly encouraged to prioritise environmental, social and governance risks and opportunities. The 2014 directive also did not require companies to follow up on their reporting nor change their business models, strategy and performance accordingly. All in all, the NFRD failed to foster a robust sustainability agenda.

And yet, the importance of a strong ESG performance for higher value creation and ensuring long-term success cannot be underestimated.

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First, companies are highly dependent on environmental resources, human capital and good governance. Second, persisting ecological and social challenges related to companies’ activities, such as increased pressure on local water sources, environmental degradation, rising carbon emissions, and child and forced labour, to only name a few, are leading to direct costs for businesses. Third, investors, employees and consumers are becoming increasingly aware of and sensitive to how companies behave, the values they uphold, and the impact they have in the world.

**Moving beyond shareholder primacy: SRDII and executive remuneration**

Findings by the EU-funded programme Sustainable Market Actors for Responsible Trade (SMART), a project led by professor Beate Sjåfjell that aims to secure the contribution of finance and businesses to sustainability, have shown that the shareholder primacy principle is another barrier to building a more sustainable economy. The Commission seems to have taken this idea on board to some extent. The programme of a recent DG Justice and Consumers event, for instance, highlighted that corporate governance codes have been equating corporate interests with the interests of shareholders and that, as a consequence, the transition to a more sustainable society has been hampered.

Moreover, just this year, the Davos Manifesto of the World Economic Forum (WEF) called on businesses to serve the interests of all of society rather than simply focusing on shareholders. In light of this ongoing shift in perception, and given the need for fresh ideas to support European recovery efforts, there is a window of opportunity to address the issue.

However, despite recent critiques of the shareholder primacy principle in even the most business-minded of circles, it remains deeply ingrained in corporate governance. One obvious case-in-point is the practice of corporate payouts, in particular share buybacks, whereby a company purchases shares of its own stock. Firms see the practice as a good way to get rid of excess cash on the balance sheet and look more financially attractive. They consider these transactions as a way of providing short-term boosts to stock prices and an “efficient way” to give money back to shareholders.

In reality, however, “executives personally capture the benefit”, as U.S. Securities and Exchange Commissioner Robert J. Jackson (Jr) opined. They often do so while arguing that they cannot afford to invest in environmental measures or pay better wages to their employees. Buybacks are, as UMass Lowell Professor William Lazonick puts it, “profits without prosperity”, an obstacle to job creation and innovation.

It was famous economist Milton Friedman who first argued that a corporation’s money is the shareholders’ money (i.e. shareholder primacy). The idea caught on not only because of the reputation of Friedman but also because, at the time, private corporations were starting to feel the pressure of international competition and executives were seeking ways to increase their returns. A few years later, finance professors Michael Jensen and Dean William Meckling, building on Friedman’s claims, posited that corporations could turn executives into major shareholders by offering them generous compensation in the form of shares. That way, firms would focus mainly on making money for the shareholders. "Sadly, as often happens with bad ideas that make some people a lot of money, shareholder value caught on and became the conventional wisdom", and politics soon embraced it, Forbes senior contributor Steve Denning has stated. The EU is no exception. Although the practice of share buybacks was either banned or very difficult to carry out due to legal constraints in most continental European countries until the end of the 1990s, many member states have since reconsidered.

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Perhaps aware of these effects to some extent, the Commission introduced a ban on dividend payments, bonuses and share buybacks in its recently updated state aid rules. The new rules apply to businesses receiving public support during the current crisis, as long as the COVID-19 recapitalisation measures have not been redeemed. This is a very welcome first move to stop public money from benefitting private shareholders and executives at a time when many workers and small and medium enterprises are facing financial uncertainty.

**Shareholder Rights Directive II**

The current economic meltdown might also pose an opportunity to revise the Shareholder Rights Directive
(SRD) II. The EU has rightfully recognised that the 2008 global financial crisis revealed that managers and investors tend to focus on “excessive short-term risk-taking” and that shareholders “in many cases” supported these practices. To fix this, the SRDII tried to encourage investors to adopt a more long-term focus in their investment strategies and to consider social and environmental issues, as well as to encourage more transparency and accountability about executive pay. Although it is too early to assess this directive, which was only adopted in 2017, there are two reasons why the principle of shareholder primacy has remained firmly in place. First, usually it is still the shareholders (not the employees or the communities in which companies operate) who decide (to varying degrees) a company’s ESG agenda and the level of executive remuneration. Second, the WEF’s and Commission’s critique of this principle only came after the adoption of the directive.

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Executive remuneration

As recognised by the European Commission’s Sustainable Finance Action Plan, both executive remuneration and employee relations play “a fundamental role in ensuring the inclusion of social and environmental considerations in the decision-making process”. Not least because executive pay is considered an ESG factor. Given the influence of committed employees and ESG factors on performance and investment performance respectively, and the proven implications of environmental and climate risks for businesses, one might assume that all companies would align executive compensation with ESG metrics. However, because of the prevalence of the view that increasing shareholders’ wealth is a business’s primary goal, and that ESG is a cost rather than an investment, progress towards sustainability has been slow.

PROSPECTS – THE TIME FOR A PARADIGM CHANGE IS NOW

Reporting is caring

A 2019 study of the sustainability reports of a thousand companies has shown that, as long as companies can determine what and how they report, the potential of the sustainable finance agenda will be impossible to achieve and, therefore, the chances of a green, sustainable, Paris-aligned recovery will be reduced. It is high time to address this weakness. That is why in the revision of the NFRD, the Commission should introduce an independently developed, legally binding, standardised, and detailed set of reporting requirements for businesses to assess the impact their operations, and their supply and subcontracting chains have on the climate and society.

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Furthermore, to minimise the risk of focusing on short-term returns and encourage a green, sustainable recovery, shareholders (and better yet, governing boards where employees are represented) should be obliged to cast a vote on businesses’ non-financial statements. Some member states, like Spain, seem to have come to the same conclusion and have introduced a similar measure in transposing the NFRD into national law.

This non-financial information should be contained in both the financial and the management reports to facilitate the comparison, reliability and relevance of reporting. And, as suggested by the European Security and Markets Authority, the role of external (independent) auditors should be strengthened so that not only can they confirm that the non-financial information statement has been submitted, but also verify its content.

‘ESGing’ SRDII and executive remuneration

Member states will probably not be in the mood for a comprehensive reform of SRDII at this stage. But given the obstacles it puts in the way of achieving a sustainable economy, it should be explored nonetheless. Practically speaking, policymakers should consider the following:

a) The SRDII does not give employees the right to be consulted or to provide input on directors’ remuneration. This reduces the pressure employees and other players can put on executives to consider ESG criteria in their management. It gives shareholders carte blanche to govern executive pay and focus solely on short-term financial gains. Employees should, therefore, be put on an equal footing to shareholders. Although not quite there yet, in Denmark, national public limited companies and limited companies employing 35 employees or more can have employee representation in the board of directors. As such, employees have a say in the remuneration policy.

b) Executive remuneration can be a powerful tool to drive a company’s ESG agenda. According to Article 9a.6 of SRDII, remuneration policy “shall explain how the pay and employment conditions of employees of the company were taken into account when establishing the remuneration policy”. However, since not all countries require employees to be represented on boards, future legislative reforms should also introduce
an obligation to disclose the compensation ratio between a CEO-to-average and a median employee. This would help ensure corporate transparency, and (hopefully) increase the accountability of the directors, a goal enshrined in SRDII.

In parallel, the Commission should encourage more member states to explore a salary cap for directors’ fees and bonuses in state-owned enterprises, as Belgium does. Member states should also organise a consultation with social partners, business representatives, government representatives and scholars at the national level and monitor how directors’ remuneration in non-state-owned enterprises is included in their corporate governance codes. The Commission should then launch a consultation with member state experts and the European Parliament.

Moreover, seeing that executives’ compensation has skyrocketed since the late 1970s while workers’ salaries have stagnated, regardless of a company’s progress toward achieving ESG goals, there clearly is room for improvement. Recently, some European companies (e.g. Danone, Siemens) have set a positive example by, e.g. making a share of the executive pay conditional upon meeting ambitious climate commitments (e.g. reduction of CO₂ emissions) and creating a sustainable supply chain. These, as well as other best practices that show how corporations can consider the interests of the society as a whole should be assessed and disseminated across the EU.

The ongoing COVID-19 pandemic has shown the critical necessity to strengthen the sustainability and resilience of our societies and fundamentally change how our economies are run, as recognised by the Commission. By reforming corporate governance and EU company law along the lines mentioned above, the EU would be a big step closer to true sustainable development.

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