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EU2022.CZ
Czech Presidency of the Council of the European Union

European Corporate Governance Conference 2022

Sustainability is one of the greatest challenges facing the world today as a result of climate change, equality issues, and other major social and environmental concerns. In response to this challenge, policymakers, regulators and intergovernmental organizations are taking far-reaching actions to change the ways we live, work and achieve prosperity, with the aim of securing the long-term sustainability of our planet. The EU's European Green Deal, the US's Inflation Reduction Act and the United Nations' Sustainable Development Goals are among the major international initiatives that are helping to drive the transformation of the global economy.

Companies can play a key role in accelerating the transition to a climate-neutral and more sustainable economy. To play this role, however, they need governance practices that ensure they understand the impact of their activities on the world around them and take society and the environment into account when making business decisions.

The role of both companies and corporate governance in helping to create fairer and more sustainable socio-economic models was central to the European Corporate Governance Conference 2022, held under the auspices of the Czech Presidency of the Council of the EU. The conference was organized by EY, ecoDa and the Czech Institute of Directors, in international partnership with ACCA, BusinessEurope and EuropeanIssuers. Over 450 people, from 43 countries, registered to attend the event, either online or in person.

Co-organizers

ecoDa The European Voice of Directors

BUSINESSEUROPE

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Czech Institute of Directors

ACCA Think Ahead

Corporate Sustainability Due Diligence Directive

Probably the most significant sustainability-related topic in European corporate governance today is the proposed Corporate Sustainability Due Diligence Directive (CSDDD). The CSDDD will apply to all EU companies with more than 500 employees and global turnover over €150 million, as well as smaller companies in specific sectors and non-EU companies active in the EU that meet the same criteria, based on their EU turnover.

Under the CSDDD, companies will be required to identify and, where necessary, prevent, end or mitigate adverse impacts of their activities on human rights and the environment. This corporate due diligence duty applies to companies' own operations, their subsidiaries, and their value chains. The directive also requires large companies to have a plan to ensure that their strategy is compatible with the goals of the Paris Climate Agreement. Furthermore, the duties of company directors are clarified to ensure that their decisions consider human rights, climate change and the environment.

Speaking at the conference, Michal Franěk, Deputy Minister of Justice for the Czech Republic, said the CSDDD represents a big step forward in corporate sustainability legislation since it aspires to "create binding EU legislation, the first of its kind, built upon existing international soft law instruments". The directive recognizes the principle of proportionality since SMEs do not fall directly within the scope of the proposal. Nevertheless, they will be indirectly affected since they belong to the value chains of larger businesses.

The CSDDD responds to concerns from EU citizens and other stakeholders about companies' impact on the environment and respect for human rights.

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Consumers don't want goods that could be the products of forced labor and they don't want products that are linked to deforestation.

Didier Reynders, European Commissioner for Justice

He added that the directive would lead to "real and all-industry impact", providing companies with a "transparent and harmonized regulatory framework to assess and manage their global value chains and sustainability risks".

In time, the CSDDD is likely to influence policymaking and business practices well beyond the EU.

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We expect responsible business conduct to spread from the EU to value chains across the world. This proposal is essential for the competitiveness of businesses since sustainable companies can gain an edge over their competitors.

Maija Laurila, Head of the Company Law Unit, DG JUST , European Commission

Sustainability in corporate governance: from concepts to practices

The overall objective of the CSDDD – to defend human rights and the environment – is widely lauded in principle. Nevertheless, there is some disagreement among stakeholders about how the proposal should be implemented in practice.

The European business community is supportive of the CSDDD, provided it is fair, balanced, manageable for companies and fully harmonized, said Bruno Zabala, Chair of the Company Law Working Group for BusinessEurope. He emphasized the need to find "a proportionate path between the means to the objectives" so that the text of the directive and the outcome are workable. He also called for legal certainty and for the liability regime for companies to be limited to damages that companies have either caused or contributed to.

Sustainability is already a reality for companies, which are increasingly embedding environmental, social and governance (ESG) factors into their corporate strategies. The CSDDD will require them to undertake more in-depth due diligence on their risks and strategies for meeting their sustainability objectives, however, including the need for possible culture change.

Reporting is key since it informs senior-level decision-making while enabling companies to hold themselves to account over their ESG targets – and be held to account by others. That reporting should be verified by independent bodies, noted Jan Juchelka, CEO and Chairman of Komerční banka, but it should not be regarded as a goal in its own right. Goals should relate to actual impact on society and the environment.

Tomasz Wiatrak, Chairman and CEO of ORLEN Unipetrol, highlighted that today customer expectations are driving companies to take action on sustainability.

Whatever is expected by the customers will be implemented by the business, but whatever is pushed by legislation will be delayed, will be somehow implemented in a not logical or effective way.

Tomasz Wiatrak, Chairman and CEO of ORLEN Unipetrol

A likely practical issue for companies will be finding people with the experience and skills to help them implement the requirements of the directive. Data is also a problem as many companies do not have the data they need to report effectively.

Giving a not-for-profit perspective, Anaïs Berthier, Head of the Brussels office for environmental law charity ClientEarth, questioned whether the CSDDD is ambitious enough. She argued that a company's whole value chain should be covered by the law, as well as by the due diligence obligation.

From an investor viewpoint, it's not entirely clear from the CSDDD proposal whether some of the due diligence obligations extend to the process of investment and, by extension, potentially shareholding rules and responsibilities, noted Carey Evans, Managing Director, Global Public Policy, at BlackRock. He pointed out that shareholders of public listed companies can only act based on publicly available information, which limits their capacity to perform comprehensive due diligence. He added that there "tends to be an overestimation of the influence that even large minority shareholders can have on the business operations of companies".

Evans said that investors were very concerned about sustainability as well as long-term value creation. Nevertheless, board composition and quality are also extremely important and investors would be concerned if accountability obligations on directors deterred highly qualified people from taking on board roles.

Connecting remuneration policy with ESG

Executive remuneration is key to driving more sustainable business conduct. Businesses are more likely to deliver on their sustainability objectives if the reward of their senior leaders is directly linked to the achievement of those objectives. Examples of possible objectives include reduction in carbon dioxide emissions, biodiversity-related targets relating to pollution and water usage, employee reskilling and retention targets, and diversity, such as increasing the number of women in management teams.

Another obvious target is the attainment of a specific ESG rating by a recognized rating agency. Nevertheless, a challenge for companies today is the lack of consistency among rating agencies in terms of the criteria they use. Kateřina Bohuslavová, Chief Sustainability Officer and Head of the ESG Office at Czech energy company ČEZ Group, said that different rating agencies measure different criteria and rely on different data. She noted: "Not always is their methodology clear, sometimes you have to guess". It was noted during the conference that neither rating agencies, nor the proxy advisory firms that provide research and data to institutional investors, are regulated or supervised.

Over the past few years, the EU has made a number of moves to more directly connect executive remuneration with ESG. Under the revised Shareholder Rights Directive, which came into force in 2017, listed companies are required to publish a remuneration policy and to give shareholders a vote on that policy (what is known as "Say on Pay"). But it is down to individual Member States to decide whether the vote should be binding or advisory only.

The Shareholder Rights Directive states that the remuneration policy "should contribute to the business strategy, long-term interests and sustainability of the company and should not be linked entirely or mainly to short-term objectives". It adds: "Directors' performance should be assessed using both financial and non-financial performance criteria, including, where appropriate, environmental, social and governance factors."

Another significant piece of EU legislation is the proposed Corporate Sustainability Reporting Directive (CSRD). The CSRD will require companies within scope to report on a wide range of sustainability issues that are relevant to their business, including information on any sustainability-related incentive schemes offered to administrative, management and supervisory boards. Additionally, under the proposed CSDDD, directors who benefit from variable remuneration must be incentivized to develop corporate strategy that helps to combat climate change.

Giving the investor perspective, George Dallas, Policy Director for International Corporate Governance Network, an investor-led network, said that the link between ESG and remuneration is well established, growing and supported by the investor community. He explained that investors view remuneration as a way to help ensure "long-term, sustainable value preservation and creation".

Nevertheless, tying executive remuneration to ESG is hard to do well, not least because of the lengthy time horizons involved. The practice can also come with unintended consequences. Dallas warned that, in some cases, remuneration metrics could potentially be "false proxies" that reward behaviors that "are not necessarily consistent with either the goals of sustainability or good profitability". Additionally, it is important to consider how the financial objectives of a compensation plan are balanced with ESG objectives to ensure that executives do not receive a substantial share of their bonus if they perform very well on one set of objectives but poorly on the other.

Alice Machová, Climate Change and Sustainability Services Leader at Ernst & Young Audit s.r.o. in the Czech Republic, pointed out that an absence of robust data is currently an obstacle to the development of remuneration strategies that are effectively linked to ESG. Many companies do not yet haveaccess to data that is sufficiently reliable for them to base remuneration on it. This is likely to change as a result of the CSRD, however, since companies will need to collect more non-financial data to comply with their reporting requirements and also get limited assurance on the information they report.

Impact of the Corporate Sustainability Reporting Directive

The CSRD will come into force from January 2024 onwards, in a phased approach. Companies that are required to report under the directive will use a set of sustainability reporting standards (ESRS) that have been developed by EFRAG. In total there will be 12 standards: two "cross-cutting standards" that cover general principles and disclosure requirements plus five environmental standards, four social standards and one governance standard.

One of the cross-cutting standards, ESRS 2 *General Disclosures*, requires disclosures about general governance topics such as the role of the AMSBs[1], the information provided to them, sustainability aspects covered by remuneration schemes and the sustainability due diligence statement, as well as the risk management and internal controls over sustainability reporting. The governance standard, ESRS G1, focuses on business conduct and covers topics such as business ethics, corporate culture, late payments, anti-corruption and bribery.

Board oversight will be needed for reporting that is undertaken in line with the CSRD. Fredré Ferreira, Senior Technical Manager at EFRAG, said that boards should ensure that they're prepared for the directive to come into force. This involves knowing where the relevant data will come from, what data controls are in place, how the company will meet the auditing requirements, and which material risks and opportunities their company should be reporting on under the standards. It was important not to try to report on everything covered by the ESRS, she warned, or companies risk providing information overload, which is not useful.

Another important consideration for boards is establishing whether the company has sufficient sustainability expertise. It may be necessary to recruit external experts as well as undertake some internal reskilling. When it comes to data collection, it is important to draw on the expertise of the financial reporting team, which will have useful existing knowledge of how data flows within the organization.

[1]Administrative, management and supervisory bodies

Review of the G20/OECD Principles of Corporate Governance

The G20/OECD Principles of Corporate Governance are a set of principles that help policy makers to evaluate and improve the legal, regulatory and institutional framework for corporate governance, with the aim of supporting economic efficiency, sustainable growth and financial stability. First issued in 1999, the Principles are currently being reviewed, with the revised Principles set to be issued in 2023. The conference panel discussion on this topic was moderated by Carmine Di Noia, Director for Financial and Enterprise Affairs at the Organisation for Economic Co-operation and Development (OECD), who has overseen the review.

The review is taking into consideration a range of priority areas, including the management of environmental, social and governance risks. Accordingly, the revised Principles will have a new chapter (chapter six) on sustainability and resilience, which will bring together guidance on corporate governance matters related to sustainability, addressing not only disclosure but also the role of shareholders, boards and stakeholders.

Odile de Brosses, President of the European Corporate Governance Codes Network and a member of the EuropeanIssuers Policy Committee, said that while she generally agreed with the content of the revised Principles, she was concerned by the "suspicious tone" in relation to group structure and the implication that groups existed to enable tax evasion. She pointed out that groups have existed for over 100 years and their purpose is not to organize tax evasion, but to allow companies to operate in a more efficient manner.

A further concern was raised by Pascal Durand-Barthez, Vice-Chair of the Corporate Governance Committee, Business at the OECD and a member of ecoDa's Advocacy Committee. He said that the revised Principles give "a little too much attention" to listed companies given that unlisted companies are also very important and vital to the economy of most countries. He pointed out that family companies, in particular, tend to be highly focused on sustainability since they take a long-term perspective.

Durand-Barthez also noted that sustainability is not only about managing risks, it is also about seizing opportunities. Companies can thrive from seizing the opportunities that sustainability presents. Furthermore, he emphasized the importance of regulatory stability, saying that companies become fatigued as a result of complex regulations that change all the time.

Massimiliano Turconi, Chief Audit Executive for Italian communications group TIM and vice president of the European Confederation of Institutes of Internal Auditing, commented that it was crucial to distinguish between the role of internal audit and external audit in the corporate governance model. In certain countries, internal auditors are even requested to express an independent opinion on the adequacy and effectiveness of the governance model for the board.

Concluding, Di Noia said that well-designed corporate governance policies "support the sustainability and resilience of corporations and, in turn, contribute to the sustainability and resilience of the broader economy".

Summary

Overall, the conference underlined the vital role that boards can play in accelerating the transition to a more sustainable economy. They can set the right tone at the top by ensuring that their companies understand the impact of their activities on the world around them, and take society and the environment into account when making decisions. They can also encourage their companies to see sustainability as a strategic opportunity, and not just as a risk, and ensure that sustainability targets are specific, measurable and publicly available. Remuneration policies are a useful tool for promoting a sustainable approach to business. To fulfil their governance role effectively, boards should educate themselves on sustainability and understand their obligations under both the CSRD and the proposed CSDDD.

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EYG no. 001403-23Gbl
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