RESPONSE TO THE PROPOSED DIRECTIVE ON CORPORATE SUSTAINABILITY DUE DILIGENCE

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Executive remuneration today is driven by incentives that may no longer align with shareholder interests or reflect broader societal responsibilities.

Reward Value Foundations' mission is to support the development of remuneration policies that contribute to long-term sustainable and inclusive value creation. The Foundation seeks to further the debate on executive remuneration with investors, business schools, and the business community at large to develop evidence-based, long-term, sustainable, and stakeholder-inclusive executive remuneration policies.

Reward Value Foundation is a not-for-profit research initiative. Reward Value can be reached by email (contact@rewardvalue.org). For more information on Reward Value please visit our website www.rewardvalue.org.

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On the 23rd of February 2022, the long-awaited outcome of the European Commission's Sustainable Corporate Governance Initiative was made public. The new draft Directive on Corporate Sustainability Due Diligence (CSDD; the Directive)[2] has already received a first wave of feedback and criticism. With this short article, Reward Value Foundation (RVF) seeks to provide commentary on some of the aspects of the proposal that have been the subject of debate and analysis in the past month. This first condensed reaction will later be followed-up by a more comprehensive, in-depth analysis on the entire text of the Directive.[3]

RVF welcomes the CSDD as an important next step towards a sustainable and inclusive economy. We recognise the Commission's effort to introduce and prioritize sustainability in European corporate governance and, in particular, we appreciate the strengthening of the role of human rights and environmental concerns in light of companies' contribution to the sustainable development and sustainable transition of economies. The strengthening of corporate responsibility in the areas of human rights and climate change is an important milestone. Moreover, the CSDD reflects the EU's intention to further align with international standards like the UN Guiding Principles on Business and Human Rights (UNGPs), to increase awareness and accountability in relation to human rights and environmental harm, and to foster the inclusion of stakeholder-value in corporate governance. In these regards, the CSDD represents an important achievement. However, as remarked by several commentators, there is room for improvement. [4]

Despite the positive aspects, judging by the immediate feedback of various stakeholders that had provided input for the creation of the proposal, many seem to feel as though the final result was 'watered-down'.[5] There is a sense that the European Commission (EC) has taken a step back from its initial intentions, potentially having lost confidence in its goals during the consultations, perhaps also due to the critical reaction to the background studies used for the construction of the consultation questionnaires.[6]

As Reward Value Foundation, we join the chorus and encourage the EC to reconsider certain key parts of the CSDD in order to unlock what we believe is its full potential as a transformative and influential instrument for sustainable corporate governance. Reward Value Foundation explicitly wants to stress the importance of proactive intervention in the area of sustainable executive remuneration and the introduction – and definition – of a *long-term time horizon* perspective in European corporate governance. As expanded upon in our background note series, we believe that, since sustainability in itself is a long-term concept, such time orientation should be better reflected in corporate governance.[7] Moreover, we support the leveraging of executive remuneration to incentivize behavioural changes in corporate governance practices.[8]

Although the CSDD will generate important progress and developments in areas like HRDD which we support, in light of this context we feel the need to point out a few areas of potential improvement.

[2] European Commission (2022) Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, 2022/0051 (COD), COM(2022) 71 final (CSDD).

[3] The follow up background note will address in greater depth issues and implications related to the scope of application, the relationship between the CSDD and CSRD, implications of the terminology used in the CSDD, Article 25 CSDD's implications on director's duties, and more.

[4] On the note of areas of improvement for the CSDD see also: Lara Wolters (2021) Report with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL).

[5] See for example: ETUC (2022), Commission delivers "bare minimum" on Corporate Sustainability Due Diligence; ShareAction (2022) EU presents watered-down rules on Corporate Sustainability Due Diligence; ECCJ (2022) Dangerous gaps undermine EU Commission's new legislation on sustainable supply chains; ActionAid (2022) EU's gender-blind corporate due diligence proposal risks leaving women behind; Human Rights Watch (2022) EU: Disappointing Draft on Corporate Due Diligence; etc.

[6] See for example: ECLE (2020) EC Corporate Governance Initiative Series: Comment by the European Company Law Experts Group on the European Commission's Consultation Document 'Proposal for an Initiative on Sustainable Corporate Governance'.

[7] Reward Value Foundation (2021) Managerial and Capital Market Short Termism.

[8] Reward Value Foundation (2020) Green Paper - Reward Value.

THE DIFFICULT CASE OF THE SCOPE OF APPLICATION

Firstly, a few considerations can be made regarding Article 2 of the Directive, on the scope of application. It appears that the Commission has taken a cautious approach, excluding small and medium enterprises (SMEs) from the HRDD duty.[9] Although it has been widely criticised for unduly restricting the scope – and therefore the effectiveness – of the CSDD,[10] this choice addresses the fear of overly heightened compliance costs for SMEs while still encompassing businesses of important size in the EU market. Targeting the 1% of big corporations could also push industry leaders to become an example that, in time, can be followed by smaller companies, considering also that this exemplary behaviour will directly impact the SMEs participating in these larger companies' value chains.

For EU-based companies, whether the Directive applies is determined by calculating global turnover.[11] For non-EU companies, only turnover generated in the Union is relevant.[12] This approach is an attempt to create a level playing field within the EU market. At the same time, this approach could generate a competitive disadvantage for EU companies on the global market, as very few non-EU companies of big size satisfy the requirements of the scope of application.[13] A stated goal in the explanatory memorandum is to propagate a spill-over effect of sorts and contribute to HRDD practices on a global scale,[14] however, this goal is similarly hindered by the limited scope.

Overall, the Commission's approach to the scope of application has warranted some criticism, but the compromises and strategic choices the EC had to make in this regard, should be taken into account. Against this backdrop, there is room for further consideration and a deeper assessment of the practical implications that Article 2 will have on the effectiveness and normative relevance of the CSDD, the creation of the spill-over effect and the reality of the level playing field. Such consideration will all be addressed in depth in our follow-up background note.

THE UNFULFILLED POTENTIAL OF SUSTAINABLE EXECUTIVE REMUNERATION

In the larger context of the CSDD, the goals and impact of sustainable executive remuneration could have been leveraged more effectively to underscore corporate responsibility. Despite having been a substantial topic in the consultation document, executive remuneration receives very little attention in the final draft of the CSDD, and its scope of application has similarly been substantially reduced.

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[9] CSDD 'Explanatory Memorandum' p. 14.

[10] E.g. "the scope of application of the current proposal is limited and not fully aligned with the UN Guiding Principles" Business & Human Rights Resource Centre (2022) UN Working Group on Business and Human Rights preliminary assessment of EU draft due diligence directive; "The limited scope of the Commission's proposal is insufficient" PRI (2022) PRI statement: European Commission proposal on Corporate Sustainability Due Diligence; "The draft comes amid heavy corporate lobbying to weaken and dilute its scope and regulatory reach." Human Rights Watch (2022) EU: Disappointing Draft on Corporate Due Diligence; "The proposal deviates from international due diligence frameworks, that emphasise the need for all businesses to avoid and address negative impacts of their operation." ShareAction (2022) EU presents watered-down rules on Corporate Sustainability Due Diligence; "Such a limited scope would allow human rights and environmental risks in value chains to go undetected and unaddressed." Investor Alliance for Human Rights (2022) Investor Alliance for Human Rights Responds to EU Directive on Corporate Sustainability Due Diligence etc.

[11] See: CSDD Article 2 'Scope'.

[12] "The EU turnover criterion for third-country companies creates a link to the EU. Including only turnover generated in the Union is justified since such a threshold, appropriately calibrated, creates a territorial connection between the third-country companies and the Union by the effects that the activities of these companies may have on the EU internal market, which is sufficient for the Union law to apply to third-country companies." CSDD 'Explanatory Memorandum' p. 15.

[13] "While the Directive will cover about 13 000 EU companies, based on the estimations of the Commission, it will only cover about 4 000 third-country companies" CSDD 'Explanatory Memorandum' p. 16.

[14] "large third-country companies having a high turnover in the Union have the capacity to implement due diligence and will benefit from the advantages coming with due diligence also in their operations elsewhere" CSDD 'Explanatory Memorandum' p. 16.

The only reference to 'variable remuneration' can be found in Article 15 of the Directive (and the relative paragraph of the Explanatory Memorandum).[15] The article recites:

Article 15

Combating climate change

1. Member States shall ensure that companies referred to in Article 2(1), point (a), and Article 2(2), point (a), shall adopt a plan to ensure that the business model and strategy of the company are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement. This plan shall, in particular, identify, on the basis of information reasonably available to the company, the extent to which climate change is a risk for, or an impact of, the company's operations.

2. Member States shall ensure that, in case climate change is or should have been identified as a principal risk for, or a principal impact of, the company's operations, the company includes emission reduction objectives in its plan.

3. Member States shall ensure that companies duly take into account the fulfilment of the obligations referred to in paragraphs 1 and 2 when setting variable remuneration, if variable remuneration is linked to the contribution of a director to the company's business strategy and long-term interests and sustainability.

A few annotations can be made on this article:

Firstly, it appears that the concept of 'sustainable' executive remuneration has been applied very narrowly: the wording of paragraph 3 explicitly links 'variable remuneration' to the obligations referred to in the paragraphs 1 and 2, which are entirely centred on the topic of climate change, and specifically refer to the '1.5°C metric' of the Paris Agreement. Although the reference to 'transition to a sustainable economy' in paragraph 1 could be interpreted as broadening the scope of the article to other sustainability factors (notably 'sustainability' or 'sustainable economy' are not defined by the Directive), the sections of the Explanatory Memorandum dedicated to Article 15 seem to confirm the intention of limiting its scope to climate change and emission reduction.[16]

By taking this approach, the CSDD not only disconnects the concept of responsible executive remuneration from the broader interpretation of sustainability which includes human rights, governance, social factors and environmental concerns outside emissions reduction (concepts which are otherwise very much represented in other parts of the Directive), but it comes across as actively seeking to shut down this part of the conversation. Outside of the articles pertaining to HRDD, the CSDD projects a level of adversity to the juxtaposition of corporate governance and 'sustainability' at large, preferring to keep a very narrow focus on specific environmental metrics. Interestingly, in the entire text of the Directive no reference is made to

[15] See: CSDD Article 15 'Combating climate change' and 'Explanatory Memorandum' p. 41.

[16] "(50) In order to ensure that this Directive effectively contributes to combating climate change, companies should adopt a plan to ensure that the business model and strategy of the company are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement. In case climate is or should have been identified as a principal risk for or a principal impact of the company's operations, the company should include emissions reduction objectives in its plan.
(51) With a view to ensure that such emission reduction plan is properly implemented and embedded in the financial incentives of directors, the plan should be duly taken into account when setting directors' variable remuneration, if variable remuneration is linked to the contribution of a director to the company's business strategy and long-term interests and sustainability." CSDD 'Explanatory Memorandum' p. 41.

Environmental, Social and Governance (ESG) metrics, which is surprising considering that these metrics have become increasingly popular and commonly used in the realm of corporate governance and finance.

Secondly, the wording of paragraph 3 restricts the relevance of sustainable remuneration even further, by implying that companies should take into account these environmental parameters ***only if and when*** variable renumeration ***is linked*** to 'the contribution of a director to the company's business strategy and long-term interests and sustainability'. It is easy to see how the effectiveness of this requirement leaves much to be desired, especially considering the larger ambitions for sustainable reform that the CSDD was supposed to stand for.

Overall, the CSDD makes little attempt at establishing a comprehensive framework for sustainable remuneration and provides very little guidelines thereof. On the contrary, it seems to have taken several steps backwards, by limiting themselves to the application of only one sustainability variable (and by failing to integrate ESG).

This overly cautious approach to executive remuneration seems puzzling. Some explanation could be found in the consultation findings.[17] Apparently, half of the consultation respondents avoided answering the question on 'mandatory sustainable remuneration measures', with companies and business associations being particularly reluctant to express an opinion.[18] It seems that the lukewarm response of market practitioners to the topic, might have led the Commission to refrain from taking a stronger stance on this topic. However, the active attempt to separate remuneration from broader sustainability factors like human rights, social welfare, and other environmental concerns, which are otherwise held in high regard in other parts of the text, feels like an unexpected outcome and insufficiently supportive of the purpose of the Directive.

MISSING THE TIME-HORIZON ELEMENT: THE SPECTRE OF 'SHORT-TERMISM'

The issues with the limited inclusion of sustainable remuneration are further complicated by the fact that, throughout the Directive, the concept of 'long-term interest' is mentioned, but never defined. There is a sense that the 'time horizon' element, both when it comes to remuneration, and in the broader context of corporate governance, could have gotten lost.

When comparing the Directive to the consultation document something stands out: the CSDD has very distinctly dropped the concept of 'short-termism' and seemingly walked back on many foundational assumptions that had led to the identification of key issues related to it. This reaction is no doubt linked to the backlash of the background studies originally used to form the consultation. However, when looking at the proposal, one wonders whether the pendulum has swung in an overly cautious direction, now risking losing substance and missing the opportunity to define a cohesive, actionable framework for sustainability in these key areas.

CONCLUDING THOUGHTS: ROOM FOR IMPROVEMENT

In this first short response to the CSDD proposal, we wish to take note of the positive achievements and progressive elements of the Directive, especially in the area of HRDD. At the same time, we would like to make a call for further improvements.

[17] European Commission (2021) Sustainable corporate governance initiative: Summary report – public consultation, Directorate-General Justice and Consumers, Directorate A, Unit A3: Company law.
[18] *Id ibid.* p. 8.

Throughout their communications and proposals, the Commission has demonstrated their intention to become a leader and pioneer in the transition to a sustainable and inclusive economy. We believe that there is room for improvement on the subject of executive remuneration as well as the element of time horizon in pursuit of sustainable long-term value creation, and that the CSDD should more confidently embrace its potential to become a tool for necessary structural changes in the realm of corporate governance.

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