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European Commission
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By email: salla.saastamoinen@ec.europa.eu, just-cleg@ec.europa.eu

Consultation Document Proposal for an Initiative on Sustainable Corporate Governance ("the Consultation")

Dear Ms Saastamoinen

EY Europe welcomes the opportunity to comment on the Consultation.

The purpose of this letter is to set out how some suggestions on how companies and their governance may be usefully supported by the European Commission in their sustainability transformations.

Our comments are backed by our recent research "*Will there be a 'next' if corporate governance is only focused on the 'now'?*" ("the Research") which sought the views of over 100 C-suite members around Europe. It explores how organizations might refresh their corporate governance to accelerate the deployment of critical long-term approaches and strategies.

Because the Research goes beyond the topics discussed in the Consultation, we have chosen to respond by letter rather than submitting a completed questionnaire.

Our role and commitment to a sustainable future

EY is committed to long term value and a more sustainable world through our purpose, our NextWave strategy, our adoption of long-term value metrics as part of our own annual reporting¹, and our commitment in 2021 to be carbon negative; having become carbon neutral in 2020².

Our commitment is further demonstrated by our founding membership of the Embankment Project for Inclusive Capitalism using our Long-Term Value approach,³ our full contribution to the WEF/IBC initiative "*Toward Common Metrics and Consistent Reporting of Sustainable Value Creation*"⁴, and our annual Global Institutional Investor Survey^{5,6}.

Lastly, we work with boards and directors across Europe as auditors of more than 50,000 companies, including just over 1000 public interest entities. We also have a team of nearly 650 sustainability professionals providing either advice to companies about their sustainability strategies or independent

¹ "How common metrics can drive long-term value creation", 2021, EY, <https://www.ey.com/en_uk/long-term-value/how-common-metrics-can-drive-long-term-value-creation>

² EY Global review 2020, 2020, EY, <https://www.ey.com/en_vn/global-review-2020>

³ Embankment Project for Inclusive Capitalism, 2018, Coalition for Inclusive Capitalism, <<https://www.coalitionforinclusivecapitalism.com/epic/>>

⁴ "Toward Common Metrics and Consistent Reporting of Sustainable Value Creation", 2020, World Economic Forum, <<https://www.weforum.org/whitepapers/toward-common-metrics-and-consistent-reporting-of-sustainable-value-creation>>

⁵ Global Institutional Investor Survey, 2020, EY, <https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/assurance/assurance-pdfs/ey-global-institutional-investor-survey-2020.pdf>

⁶ On 23rd January 2021, executives of over 60 large companies announced their adoption of the WEF/IBC's new reporting framework of ESG metrics

assurance on matters like non-financial reporting including environment, social, governance and other factors.

Context

Companies today are performing a difficult balancing act. They are handling the severe – and, in certain cases, existential – short-term challenges unleashed by COVID-19, while simultaneously driving the pursuit of long-term value for all their stakeholders.

Yet despite having to navigate the most testing trading environment that most of us have experienced, many companies have managed this balancing act. They have addressed their short-term challenges while making great progress in terms of realigning their strategies toward long-term value creation; strategies which in many cases pre-dated COVID-19.

The ways in which they have done this include reconnecting with their purpose and values, setting environmental targets, and focusing on employee wellbeing. Seeing the devastating impact of COVID-19 on society has only strengthened their determination to reorient their businesses around the long term.

According to our latest EY Europe Attractiveness Pulse survey⁷ a majority (61%) of business executives believe that sustainability agendas going forward will give precedence to social priorities in line with the social impact of falling employment levels and the increased vulnerability in communities as welfare needs rise. Overall, 60% of respondents anticipate that a focus on sustainability and climate change is likely to accelerate significantly as a result of the pandemic.

Key points from the research

So, while great progress has been made, the gravity of the social and environmental issues we face mean that organizations can and must do more to meet the ever-rising expectations of their own stakeholders and society more broadly. In the Research, we explore how organizations can refresh their corporate governance to accelerate the deployment of critical long-term approaches and strategies.

The Research highlighted five key success factors for boards looking to drive long-term value and meet the long-term interests of their organization's stakeholders including shareholders:

- ▶ Attributes: Board dynamics, including skills, diversity and values⁸
- ▶ Risk: Risk governance, oversight and public reporting⁹
- ▶ Reward: Remuneration schemes to incentivize a focus on long-term value and the central role of ESG-driven metrics¹⁰
- ▶ Engagement: Defining key stakeholders and building an end-to-end engagement strategy that includes a feedback loop
- ▶ Authenticity: Transparent and authentic reporting disclosures on progress against long-term value goals and KPIs, showing clear accountability for achievement of KPIs¹¹

⁷ EY Europe Attractiveness Survey 2020, 2020, EY <https://www.ey.com/en_nz/attractiveness>

⁸ The Research revealed the following top ranked attributes: (1) A board that has enough trust to be honest, debate openly and have healthy disagreement; (2) A board that engages and considers the interests of all stakeholders when making decisions and a board that implements management remuneration schemes linked to long-term value goals; and (3) a board that proactively identifies and engages potential investors focused on long-term value.

⁹ When we asked executives what would likely deter their board from pursuing an initiative that was expected to improve long-term value but diminish near-term financial performance, the top two factors were: (1) a high degree of uncertainty that the initiative will succeed; and (2) a risk framework and appetite that is geared toward short-term shareholder return rather than long-term, inclusive growth.

¹⁰ As an internal challenge to long-term value orientation the greatest portion of respondents in the Research chose the following: "CEO and executive compensation are tied to short-term performance."

¹¹ In the Research, 80% of executives said it would be helpful to have globally consistent frameworks and standards for long-term value-focused corporate reporting.

More detail can be found in the full Research attached to this letter and also found [here](#)¹².

Other comments

Directors Duties

Although there are nuances in some countries, generally speaking the directors' primary duty is to the company. A duty to promote the success of the company can be fulfilled through appropriate reconciliation of stakeholders' interests and the impact of board's decisions on sustainability and other matters.

While we are fully supportive of the Consultation's objectives, we believe there are valuable alternative measures to changing directors' legal duties and creating direct enforcement rights for stakeholders; alternatives that will avoid unintended consequences and allow the flexibility that business sorely needs to reflect differences in size, ownership, business model, sector etc. They are as follows:

1. *The ability to bring about positive change is already in the control of boards*

The Research confirms the case for corporate governance as a lever for long-term value creation. It also reveals that boards can make more progress by addressing internal barriers and misalignments in the governance arena. Such change is entirely within the board's and does not require the law on director's duties to be changed.

2. *Allow other initiatives in the Sustainable Finance Action Plan to take effect first*

In the Research, our survey results show that a significant external challenge for companies is short terms earnings pressure. From this, it is reasonable to assume that the respondent companies are strongly influenced by the behaviour of investors.

Under the Green Deal, the Commission is seeking to align the EU's capital markets and financial services sector with sustainability objectives through initiatives such as the EU Taxonomy, the Sustainable Finance Disclosure Regulation and the review of the Non-Financial Reporting Directive. Their aims are to:

- ▶ Reorient capital flows towards sustainable investment
- ▶ Mainstream sustainability into risk management
- ▶ Foster transparency and long-termism in financial and economic activity

We fully support these initiatives and believe that time should be given to allow them to take effect. We anticipate they will do much to incentivise the sustainability-focussed behaviours of investors, lenders and boards that the Commission is looking for and, in the latter case, without the need to change directors' duties in law. Of course, it should be recognised that these desired behaviours already exist in ESG-focussed investors (see [here](#)) and in many companies as shown by the Research. This is about these beliefs and behaviours becoming mainstream.

¹² "Will there be a 'next' if corporate governance is focused on the 'now'?", 2021, EY, < https://www.ey.com/en_gl/long-term-value/sustainable-corporate-governance >

3. Focus on ensuring companies have high-quality risk management and internal controls

EY has long been an advocate for strong accountability in the financial ecosystem, including management, directors and audit committees, because collectively they are responsible for the assets entrusted to them and the accuracy of corporate information on which shareholders and other stakeholders rely.

Although not currently part of the Consultation, we believe there would be merit in the Commission (DG FISMA and DG JUST collectively) considering how it would like boards and audit committees to approach risk management and internal controls in terms of how they can best contribute to company resilience or the quality of both financial and non-financial information. The robustness of these governance mechanisms will be important to help realise the Commission's ambitions for sustainable finance including the review of the Non-Financial Reporting Directive. We say this for the following reasons:

Boards have always fulfilled an important function to understand and mitigate business risk – and the pandemic has brought that responsibility into sharp focus. It has highlighted the interconnectedness of risks and the velocity at which the landscape can change.

Successfully managing challenges like climate change, demographic shifts, globalisation, technological disruption, not to mention pandemics, requires a new way of thinking about risk. For too long, risk management has focused mainly on downside risk and managing well-established areas such as compliance.

Important though these approaches are, particularly for ensuring that the company is resilient now, long term success will also depend on embracing the upside risks that come with rapidly changing markets and having a more sophisticated understanding of external risks like climate change that are beyond an organisation's direct control.

This is complex and requires specialist skills and approaches. Boards will struggle to do this without robust and increasingly sophisticated risk management and internal controls frameworks in place to support them¹³.

Strong and effective audit committees have a key leadership role to play here too which includes overseeing the robustness and reliability of risk information both used by boards to make decisions and provided to stakeholders so they can understand the effects on the company's future prospects and cashflows. However if one looks at EU law on audit committees, it is focussed on their role in the preparation of historical financial statements; an important function but only part of their role; when looking forward and risk management takes up increasingly more of their time.

4. Placing an expectation on companies to declare a corporate purpose, choose their key stakeholders and communicate publicly how they have taken their interests into account in achieving that purpose and pursuing their strategy

It is impossible for directors to make a decision which treats the interests of all stakeholders equally. All decisions involve trade-offs. To do otherwise puts companies in an invidious position. There is a real risk that imposing duties on directors to all stakeholders with direct rights of enforcement, as the Commission is considering, could have unintended consequences such as decision paralysis, unnecessary risk aversion and vexatious litigation.

¹³ See comments of Professor Rajna Gibson Brandon, page 29 of the Research.

Instead, if the Commission is committed to implementing change in the company law and corporate governance arena, we believe an alternative approach may be drawn from EY's Long-Term Value methodology.

It envisages that directors should set out a corporate purpose and strategy and then those stakeholders who are key to the company meeting that purpose and achieving strategic success.

A company might then describe publicly, at least annually, information such as:

- ▶ its purpose and strategy
- ▶ those stakeholder outcomes that are necessary to meet the purpose and prosecute the strategy successfully ("Key Stakeholders"): for example, product quality; employee development; health, safety & wellbeing; limiting environmental impact; respecting laws and regulations, etc¹⁴
- ▶ how the company has interacted with the Key Stakeholders
- ▶ how the board has taken their interests into account; and
- ▶ how board specific decisions have been influenced as a result

Such reporting would describe specifically what the board has done during the year and would avoid boilerplate. Through this mechanism, stakeholders should be able to assess how their interests are being considered and whether the company is meeting its stated purpose. They should also be able to exercise their existing powers to hold companies to account e.g., purchasing power of customers or rights that already exist in law like health and safety. It will also help shareholders and investors specifically to assess the company's future prospects.

The above approach will also benefit the market generally in that best practices will be transparent and could be adopted by other companies.

Such information could sit well alongside the ambit of the Non-Financial Reporting Directive (e.g., respect for human rights) and future EU Non-Financial Reporting Standards. As such information increases in quality and reliability, it will become as important as financial information for an assessment of a company's future prospects. As that happens, existing quality enforcement mechanisms at the Member State level already applied to financial reporting might logically be applied to such non-financial information.

Supply Chain Due Diligence

We would make the following comments in relation to the Commission's questions about supply chain due diligence:

- ▶ Supply chain due diligence plays an important part of a company's ability to grow safely and with resilience as well as contributing to its sustainability efforts.
- ▶ Generally speaking, to provide for the flexibility necessary to reflect company specifics, principles for supply chain due diligence at an EU level are preferable to prescriptive requirements in matters such as governance and identification, prevention and mitigation of risk.
- ▶ However, the experience of supply chain due diligence law in markets like France suggests that, to cut complexity and mitigate against a free rider problem, more prescriptive requirements may be useful in areas such as risk universe definition, risk assessment methodology (including stakeholder engagement)

¹⁴ KPIs/metrics to demonstrate progress towards outcomes on ongoing basis would also be relevant here - see footnotes 3 and 4 above for further details.

and control frameworks.

This can also help companies to understand how to set up supply chain due diligence programs quickly and in a way that is more likely to generate long term value. In this respect, clear references to existing standards like the International Labour Organization conventions and OECD principles would also be helpful to foster awareness and understand of the benefits of due diligence for more profitable, resilient and sustainable supply chain ecosystems.

- ▶ While we fully acknowledge that addressing some fundamental risks like modern slavery should be mandated for all companies, we do not currently see value in having sector-specific requirements – the key risks apply to all companies.
- ▶ Certified public corporate disclosures about supply chain risk management systems may also be useful to drive accountability; subject to protections around commercially sensitive information. Assurance from an independent third party on those systems could also be procured. It is for the Commission and other stakeholders to assess whether this additional comfort would be of value.
- ▶ The question of SME coverage is complex. It is difficult to argue that they should be considered differently because (1) there is a need to ensure a level playing field within the Single Market; and (2) in the aggregate, they have a major impact on economy, society and environment. However, we suggest the Commission might also identify ways to support SMEs in their sustainability efforts (e.g facilitating sustainable marketplaces of suppliers).

Conclusion

We hope you find our comments useful. We wish the Commission every success in its important work on Sustainable Finance and the Green Deal.

Should you wish to discuss the contents of this letter or if we can assist further, please contact me or

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Yours sincerely

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