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# SMART REPORT:

# Securing the future of European business: SMART reform proposals

We study the barriers and drivers for market actors' contribution to the UN Sustainable Development Goals within planetary boundaries, with the aim of achieving Policy Coherence for Development.


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## Executive summary

Achieving sustainability, and implementing the SDGs, requires reform of EU laws, policies and practice concerning business. The contribution of business is vital to achieving sustainability, and yet we know that business-as-usual currently undermines sustainability goals. To change this, reform is necessary to ensure sustainable value creation within planetary boundaries. This entails reforms that enable business to positively contribute to transitioning our societies to a *safe* and *just* space for humanity, while at the same time constraining and mitigating the environmental, social and economic harms caused by business. This is fundamental to securing the foundation for human dignity and protecting vulnerable people within Europe and contributing to doing so in low-income countries outside of Europe.

Our reform proposals aim to improve sustainability measures already taken by the EU in the context of trade and investment, and to make these more coherent and credible. We also aim to contribute to facilitating respect for the concerns of policy actors in third countries as well as those in the EU, particularly those who experience challenges relating to development. We advocate that the EU take regulatory action to shape business conduct in trade and investment as in other facets of their operations, and propose changes also to the EU regulatory framework for European businesses, so that it facilitates the shift to sustainability.

As a key issue in our reform proposals, we aim to mitigate the pressure on decision-makers in business to maximize financial returns. We propose to redefine the purpose of business and the duties of the board, to ensure that sustainable value creation is integrated throughout the business. This enables business to move away from linear, unsustainable business models of overproduction and overconsumption. It also mitigates the fragmentation of responsibility across numerous legal entities organized in groups and networks and across global value chains, an important characteristic of the structure of trade and investment. These proposals are supported by our proposals for a comprehensive and reliable reporting framework.

Business must shift to sustainable business models and be encouraged to innovate sustainably. To achieve this, the purpose of business needs to be redefined towards sustainability, to protect the decision-makers in business against the pressure to maximize financial returns. To make sure that it is operationalised properly, we also need to integrate this into the duties of business decision-makers – requiring them to pursue sustainable value within the limits of our planet, and integrating this goal throughout their global value chains.

For far too long, the disconnect between business and finance, on the one hand, and humanity and the stability of the biosphere of this planet on which we all depend, on the other, has informed an unsustainable pursuit of profit that is based on environmental degradation and exploitation of people. There is an emerging understanding of the financial risks of continued unsustainability, but it tends to be limited to climate risks.

The proposals presented in this report are interconnected with the proposals in the reports on Finance and on Products. The proposals concerning business are prerequisites for the proposals concerning finance and products, forming the basis also for more sustainable investments and lending, and more sustainable private and public consumption. In turn, the proposals concerning finance and products may act as enforcers and drivers for the timely and successful implementation of the changes we suggest in the way business operates. We welcome comments on all three reports as we work to finalise them. [1]

[1] Comments may be submitted by this online form or by e-mail to smart-admin@jus.uio.no.

# 1. Introduction

## 1.1 The EU's commitment to sustainability – and the SMART approach

There is increasing high-level policy commitment to sustainability in the EU. The European Commission 2019-2024 emphasises its prioritisation of sustainability, launching a European Green Deal, with a 'just transition' that leaves 'nobody behind', refocusing the coordination of economic policies across the EU to integrate sustainability.[2] Executive Vice-President, Frans Timmermans, underlines the need for an 'ambitious Green New Deal for Europe, which shapes the future for our children and ensures their health, prosperity and security on a green and thriving planet'.[3]

The EU's commitment to sustainability is anchored in the EU Treaties.[4] Sustainability is an overarching objective of the European Union and meant to be the guiding principle for the EU's policies and activities within Europe and in its relations with the rest of the world, to promote 'peace, its values and the wellbeing of its peoples'.[5] This is set out in the Treaty on the European Union (TEU) Article 3(3) and 3(5), and underlined as concerns what the EU denotes as developing countries, in Article 21 TEU. Article 11 of the Treaty on the Functioning of the European Union (TFEU) requires the implementation of environmental protection requirements in all EU policies where necessary to achieve sustainability.[6] Policy coherence for development (PCD) is set out as an EU legal norm in Article 208 TFEU, requiring that any area of EU law and policy must not work against developmental policies, also with the sustainability aim of 'leaving no-one behind'.[7]

The adoption of the United Nations Sustainable Development Goals (SDGS) in 2015, together with the Paris Agreement on Climate Change in the same year, has given a new impetus to the public discourse concerning what we need to do to achieve sustainability. The EU's commitment to implementing the SDGs is elaborated on in the EU's 2017 Consensus on Development.[8] Among the

[2] With reference to the UN Sustainable Development Goals; see 'A Union that strives for more. Political guidelines for the next European Commission', by then President-Elect van der Leyen, https://ec.europa.eu/commission/sites/beta-political/files/political-guidelines-nextcommission_en.pdf.

[3] European Commission, Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions: The European Green Deal, 11.12.2019, COM(2019) 640 final. Quote from: 'Green Deal branded as 'hallmark' of new European Commission', Euractiv, 11 Sep. 2019, https://www.euractiv.com/section/energy-environment/news/green-deal-branded-as-hallmark-of-neweuropean-commission/.

[4] ADD ref.

[5] Article 3(1) of the Treaty of the European Union (TEU), [ADD full reference to the TEU], with the values set out in Article 2: 'respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities'.

[6] [ADD full reference to the TFEU]. B. Sjåfjell, 'The Legal Significance of Article 11 TFEU for EU Institutions and Member States' in B. Sjåfjell, A. Wiesbrock (eds.), The Greening of European Business under EU Law: Taking Article 11 TFEU Seriously, (Routledge, 2015) p. 11.

[7] Clair Gammage, working paper on policy coherence (draft on file with current authors). See the 2030 Agenda for Sustainable Development, https://ec.europa.eu/europeaid/policies/european-development-policy/2030-agenda-sustainable-development_en.

[8] European Commission, Commission Staff Working Document '2019 EU Report on Policy Coherence for Development' SWD(2019) 20 Final of 28 January 2010, 6. Joint Statement by the Council and the representatives of the governments of the Member States meeting within the Council, the European Parliament and the Commission on 'The new European Consensus on Development, Our World, Our Dignity, Our Future', Official Journal, (2017/C 210/01) , paras 9 and 10.

positive initiatives from the EU are the Sustainable Finance Initiative, including its Action Plan action 10 on the role of boards and corporate governance,[9] and the Green Deal, including its plan for new Circular Economy Action Plan.[10]

However, a lot of the EU's emphasis on how to achieve sustainability is concentrated on mitigating climate change, as we see in the slogan for the EU Green Deal with its aim of Europe being the 'first climate-neutral continent by 2050'. There is emphasis on other environmental issues, including ambitions of preserving and restoring ecosystems and biodiversity and reduce pollution such as microplastics.[11] The EU Green Deal refers to key environmental reports,[12] and on its website presenting the Green Deal, the Commission states that 'Climate change and environmental degradation present an existential threat to Europe and the world'.[13] Yet, there is no reference in the EU Green Deal Communication to the planetary boundaries or the 'limits of our planet'.[14] Further, sustainability as an overarching commitment of the EU encompasses the social dimension, including the protection of human rights, social policy and policy coherence for development. This has a clear Treaty basis. Yet, in the important initiative of the EU Green Deal, the emphasis on Just Transition and leaving nobody behind is limited to ensuring justice in the transition to sustainability within the EU Member States.[15] References to those 'most vulnerable' does not appear to encompass vulnerable people and communities outside of the European Union.[16] On the one hand, this is a natural emphasis in the context of changing Europe, but on the other hand, it is important in a broader perspective to recognize and encompass social justice impacts in other countries. Notably, there is no mention in the EU Green Deal communication of indigenous peoples, in Europe or in the rest of the world. Yet, these are amongst the most vulnerable, exposed to exploitation by business, while central to protection of biodiversity.[17] The vulnerability of workers across global value chains is exacerbated through 'business model(s) based on exploitation and abuse of human rights'. And

[9] European Commission, Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions: Action Plan: Financing Sustainable Growth (8.3.2018, COM/2018/097 final), Section 4.2.

[10] The latter, with its focus on Sustainable Products, is discussed further in E. Maitre-Ekern, M. van der Velden and M.B. Taylor 'Towards a Sustainable Circular Economy: SMART Reform Proposals', SMART report, draft on file with current authors.

[11] *Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions. The European Green Deal. COM/2019/640 final*. Sections 2.1.7 and 2.1.8.

[12] Sources cited in the European Green Deal footnote 1: (i) Intergovernmental Panel on Climate Change (IPCC): Special Report on the impacts of global warming of 1.5°C; (ii) Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services: 2019 Global assessment report on biodiversity and ecosystem services; (iii) The International Resource Panel: Global Resources Outlook 2019: Natural Resources for the Future We Want; (iv) European Environment Agency: the European environment — state and outlook 2020: knowledge for transition to a sustainable Europe; COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS The European Green Deal, Brussels, 11.12.2019 COM(2019) 640 final.

[13] https://ec.europa.eu/neighbourhood-enlargement/news_corner/news/european-green-deal-sets-out-how-make-europe-first-climate-neutral-continent-2050_en

[14] 'Living well, within the limits of our planet', General Union Environment Action Programme to 2020 (7th EAP), Luxembourg: Publication Office of the European Union, 2014, DOI: 10.2779/68165; for more information, see https://ec.europa.eu/environment/action-programme/.

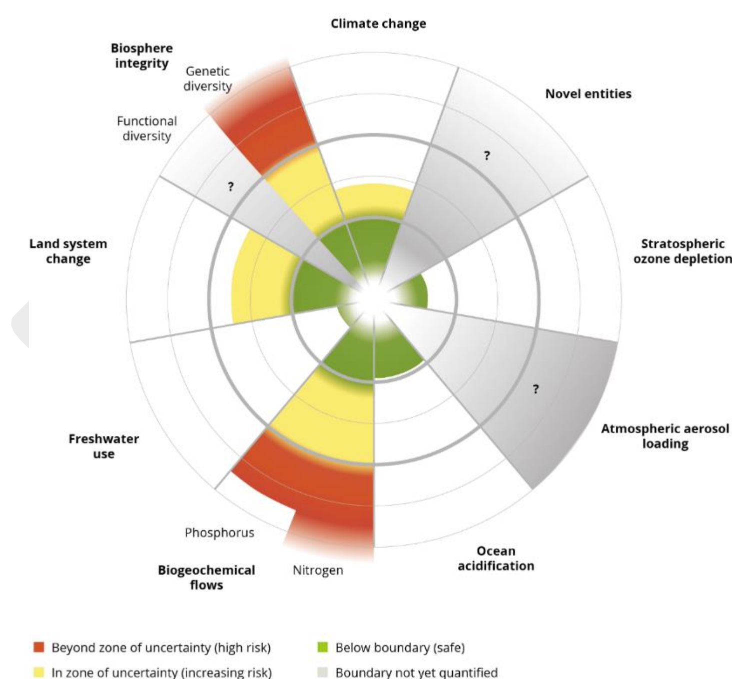
[15] EU Green Deal Communication, Section 2.2.1.

[16] Ibid.

[17] K. Swiderska, 'Protecting indigenous cultures is crucial for saving the world's biodiversity'.

within and beyond Europe, there is a long history of exploitation of indigenous peoples, from colonialization by states to neo-colonisation by business.[18]

In the SMART Project, we see the recognition of planetary boundaries framework as crucial to an evidence-based understanding of sustainability. Planetary boundaries, as a term used for the limits of our planet, is the result of the work of an international multidisciplinary group of environmental scientists, who, in 2009, pooled their knowledge of different Earth system processes to inform the world about the space for sustainable action within planetary boundaries.[19] Their work reflects the growing scientific understanding that life and its physical environment co-evolve. This pioneering effort brought together evidence of rising and interconnected global risks in several different contexts where environmental processes are being changed by human activities. The planetary boundaries framework flags a set of sustainability-critical issues. It presents policy makers with a dashboard of issues which arise from the collective impacts of humanity, impacts that are changing profoundly the fundamental dynamics of the Earth system upon which humans rely for our lives and livelihoods.[20]



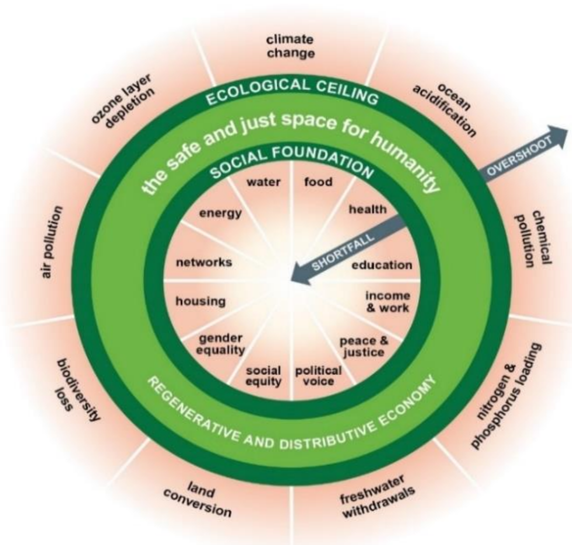

[18] G. Christensen, 'What Does It Mean to be Sustainable? Regulating the Relationship between Corporations and Indigenous Peoples', in B. Sjåfjell and C.M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Ch. 30.

[19] J. Rockström, W. Steffen, K. Noone, Å. Persson, F. S. I. Chapin, E. Lambin, T. Lenton, M. Scheffer, C. Folke, H. J. Schellnhuber, B. Nykvist, C. de Wit, T. Hughes, S. van der Leeuw, H. Rodhe, S. Sörlin, P. Snyder, R. Costanza, U. Svedin, M. Falkenmark, L. Karlberg, R. Corell, V. Fabry, J. Hansen, B. Walker, D. Liverman, K. Richardson, P. Crutzen, and J. Foley, 'Planetary Boundaries: Exploring the Safe Operating Space for Humanity' (2009) 14 *Ecology and Society*; W. Steffen, K. Richardson, J. Rockström, S. E. Cornell, I. Fetzer, E. M. Bennett, R. Biggs, S. R. Carpenter, W. de Vries, C. A. de Wit, C. Folke, D. Gerten, J. Heinke, G. M. Mace, L. M. Persson, V. Ramanathan, B. Reyers, and S. Sörlin, 'Planetary boundaries: Guiding human development on a changing planet' (2015) 347 *Science* 1259855.

[20] S. Cornell, 'Planetary Boundaries and Business: putting the operating into the Safe Operating Space for Humanity' (draft paper on file with current authors).

*Figure 1: planetary boundaries. Source: Steffen et al. (2015).*[21]

Through the planetary boundaries work it is estimated that humanity has already transgressed or is at risk of transgressing at least four of the currently identified nine planetary boundaries, including climate change, biosphere integrity (biodiversity), biogeochemical flows, and landsystem integrity.[22] At least two of these planetary boundaries, climate change and biodiversity, are what may be denoted as core boundaries, where transgression of each of them may in itself be sufficient to bring the Earth system out of the relatively stable state of the past few millennia, which the planetary boundaries scientists refer to as a 'safe operating space for humanity'.[23]




Further, in the SMART Project, we fully incorporate social issues in the concept of sustainability which we employ as our framework.[24] Such a broader perspective is crucial in our focus on the global value chains connecting EU business and finance with other parts of the world, including low-income countries falling within the EU's definition of 'developing' or 'least-developed' countries.[25] We employ the broadly recognised definition of sustainability as securing the social foundation for humanity now and in the future within planetary boundaries – encapsulated in the goal of a safe and just space for humanity (Figure 2).[26]

[21] This planetary boundaries image is from the European Environment Agency Report 'The European environment — state and outlook 2020: knowledge for transition to a sustainable Europe', see https://www.eea.europa.eu/soer-2020 under Selected visuals.

[22] The other five being global freshwater use, ocean acidification, atmospheric aerosol loading, stratospheric ozone depletion, and cycling of the impact of novel entities; Steffen, Richardson, Rockström, Cornell, Fetzer, Bennett, Biggs, Carpenter, Vries, Wit, Folke, Gerten, Heinke, Mace, Persson, Ramanathan, Reyers, and Sörlin, 'Planetary boundaries'. As more expert communities worldwide engage with putting the concept into practice, discussions continue (and become scientifically better evidenced) about the best control variables and the best placing of a truly precautionary boundary, as we see in this report, which indicates that the freshwater boundary is also transgressed, B. Campbell, D. Beare, E. Bennett, J. Hall-Spencer, J. Ingram, F. Jaramillo, R. Ortiz, N. Ramankutty, J. Sayer, and D. Shindell, 'Agriculture production as a major driver of the Earth system exceeding planetary boundaries' (2017) 22 *Ecology and Society*.

[23] Rockström, Steffen, Noone, Persson, Chapin, Lambin, Lenton, Scheffer, Folke, Schellnhuber, Nykvist, de Wit, Hughes, van der Leeuw, Rodhe, Sörlin, Snyder, Costanza, Svedin, Falkenmark, Karlberg, Corell, Fabry, Hansen, Walker, Liverman, Richardson, Crutzen, and Foley, 'Planetary Boundaries'.

[24] B. Sjåfjell, 'How Company Law has Failed Human Rights – and What to do About it' (2020) *Business and Human Rights Journal*; B. Sjåfjell, T. Häyhä, and S. Cornell, *A Research-Based Approach to the UN Sustainable Development Goals. A Prerequisite to Sustainable Business and Finance* (2020).

[25] See https://ec.europa.eu/europeaid/sectors/economic-growth/trade/global-value-chains_en (under Overview)

[26] This is elaborated on in the SMART Report D2.4, 'Obstacles to Sustainable Global Business. Towards EU Policy Coherence for Sustainable Development', *University of Oslo Faculty of Law Research Paper* No. 2019-02,

*Figure 2: The safe and just space for humanity. Source: Raworth 2017.*

For us, this encompasses a recognition that those most vulnerable, including workers across value chains in slavery-like conditions,[27] and traditional and indigenous communities whose land and other resources are exploited, are not always encompassed in sustainability initiatives.[28] To change this, it is not sufficient for experts to merely assess what is good for vulnerable people. Instead there need to be inclusive and participatory processes (as envisaged by SDG 16) which enable them to have access to justice and representative participation in the crafting of measures that affect their well-being.[29]

## 1.2 Why change is necessary – and beneficial to European business

A number of initiatives, from policymakers, from thought leaders in business and finance, and from civil society, have contributed to an emerging change in public perception of what is necessary and what is feasible. As indicated above, high-level policy-makers in the EU are increasingly speaking about the necessity of integrating sustainability into decision-making and there are number of promising developments. [30] This is echoed in civil society movements including the school strikes 'Fridays for future' and Extinction Rebellion.[31]

The emerging recognition especially of the financial risks of climate change is evident also in business and finance and society at large. Examples include statements by Mark Carney, the governor of the Bank of England, emphasising the unacceptability of ignorance of climate change in business.[32] Yet,

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available at SSRN: https://ssrn.com/abstract=3354401 or http://dx.doi.org/10.2139/ssrn.3354401. See M. Leach, K. Raworth, and J. Rockström, 'Between social and planetary boundaries: Navigating pathways in the safe and just space for humanity' World Social Science Report 2013, (OECD Publishing, 2013), pp. 84–90. See also 'Living well, within the limits of our planet', General Union Environment Action Programme to 2020 (7th EAP), Luxembourg: Publication Office of the European Union, 2014, DOI: 10.2779/68165; for more information, see https://ec.europa.eu/environment/action-programme/. .

[27] 'New ITUC report exposes hidden workforce of 116 million in global supply chains of fifty companies'. 18 January 2016, https://www.ituc-csi.org/new-ituc-report-exposes-hidden.

[28] T. Novitz, 'Supply chains and temporary migrant labour: The relevance of trade and sustainability frameworks' in D. Ashiagbor (ed.), Re-imagining Labour Law for Development : Informal Work in the Global North and South, (2019), pp. 191–211; G. Christensen, 'What Does It Mean to be Sustainable? Regulating the Relationship between Corporations and Indigenous Peoples' Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability, (Cambridge: Cambridge University Press, 2019); C.-Y. Yu, 'An Application of Sustainable Development in Indigenous People's Revival: The History of an Indigenous Tribe's Struggle in Taiwan' (2018) 10 *Sustainability* 3259.

[29] For discussion, see T. Novitz, 'Engagement with Sustainability at the International Labour Organization and Wider Implications for Worker Voice' (2020) *International Labour Review,* forthcoming**.**

[30] 'A Union that strives for more. Political guidelines for the next European Commission', by then President-Elect van der Leyen, https://ec.europa.eu/commission/sites/beta-political/files/political-guidelines-next-commission_en.pdf. See also *Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions. The European Green Deal. COM/2019/640 final*. Section 2.2 'Mainstreaming sustainability in all EU policies', albeit with the limitations mentioned above (mostly environmental focus, and especially climate change mitigation).

[31] See about Fridays for future, https://www.fridaysforfuture.org/, and Extinction Rebellion, https://rebellion.earth/, and see e.g. 'Climate activist Greta Thunberg urges MEPs to put words into action', European Parliament News, 16 April 2019, https://www.europarl.europa.eu/news/en/press-room/20190410IPR37531/climate-activist-greta-thunberg-urges-meps-to-put-words-into-action.

[32] 'Firms ignoring climate crisis will go bankrupt, says Mark Carney', *The Guardian*, 13 Oct. 2019, https://www.theguardian.com/environment/2019/oct/13/firms-ignoring-climate-crisis-bankrupt-mark-carney-bank-england-governor.

as we discuss in Section 2 below, there are limitations already in the approach to climate risk such as that promoted by the Task Force of Climate-Related Financial Disclosure, and the broader sustainability elements of other planetary boundaries and of social, economic and governance issues included in the social dimension of sustainability are not covered. These are important to bring out into the public debate and to include in discussions of reform of company law and corporate governance.

The international trend of lawsuits against companies and states for environmental and human rights harms are indications of the growing lack of acceptance of status quo. [33] The response from business, inter alia to the EU Commission's study on human rights diligence, shows that business increasingly is positive to legislative reforms that can give business a level playing field in the transition to sustainability.[34] That is what the SMART project aims to do. For far too long, the competitive advantage has been with unsustainable business. Businesses attempting to transition to sustainable business models and be open about their sustainability impacts and attempts at dealing with these, are forced to compete with their sustainability information in a sea of noise of greenwashing and SDG-washing. The unrealised potential of the EU's so-called Non-Financial Reporting Directive is amply illustrated through the Alliance for Corporate Transparency's study of 1000 companies' reports, which show very limited follow-up.[35] This shows clearly that barriers to sustainable business remain, which must be dismantled if the potential to achieve sustainability, is to be realised.

Global commerce operates within and across regulatory spaces at the national, regional and international levels. In the context of international trade and investment, difficulties arise from the fragmentation of the hire of labour and apportionment of responsibility for corporate conduct across borders. The connection between international trade and investment law and European business law and financial market law is rarely considered. We argue for a more unified and holistic approach, in accordance with an agreed aim of policy coherence, which reflects the synergies identified in Agenda 2030 and SDG 17.14, and accords with the desirability of coherence and consistency in the EU's actions and institutions.[36] A challenge is also to achieve more effective and unified means of enforcement of any trading standards which relate to environmental or social sustainability.

A core problem is the externalization by business of its negative environmental, social, economic governance impacts, with fragmentation of enterprises across corporate groups, networks and global value chains.[37] Global value chains of European business far too often encompass exploitation of people and environmental degradation,[38] and an undermining of local economies within the EU and in third countries.[39] These include those that the EU defines as developing countries.[40]

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[33] Mark B. Taylor, 'The Revolution Will not be Litigated - towards a theory of corporate accountability in the Anthropocene, paper presented at the SMART Project Conference 'Social Justice, Business and the Pursuit of Sustainability' (December 2019).

[34] L. Smit et al, 'Study on due diligence requirements through the supply chain', final report, 20 Feb 2020. https://op.europa.eu/sv/publication-detail/-/publication/8ba0a8fd-4c83-11ea-b8b7-01aa75ed71a1/language-en

[35] http://www.allianceforcorporatetransparency.org/

[36] See TEU, Article 11(3) and Article 13(1) respectively.

[37] B. Sjåfjell, J. Mähönen, A. Johnston, and J. Cullen, *Obstacles to Sustainable Global Business. Towards EU Policy Coherence for Sustainable Development* (2018).

[38] Add refs

[39] Add refs

[40] As Jason Hickel shows, shows, aid to developing countries is insignificant in light of all the value that is extracted from developing countries by European trade and business actors, J. Hickel, *The Divide* (2017).

We have further identified as a barrier to achieving sustainability the entrenched economic beliefs supporting the pressure for short-term maximisation of returns, and a still persistent belief in the self-correcting ability of fully-informed markets.[41] We also found that there is a lack of relevant, reliable and verified information on sustainability impacts of business, which undermines the potential of a number of sustainability-oriented initiatives including the Sustainable Finance Initiative and the 2014 reform of the Public Procurement Directives.[42] The emergence of legislative initiatives on Member State level illustrates the recognition of the need for change and reinforces the need for harmonisation on EU level.[43] A reform is needed, for the sake of securing the future of European business, to give them a level playing field and legal certainty – and to ensure the contribution of business to sustainability. The financial risks of unsustainability make this a necessity.

### 1.3 The structure of the report

Section 2 of this draft report presents key elements of a broader, comprehensive understanding of the financial risks – i.e. the potential negative impacts on business and finance – of continued unsustainable economic behaviour.

Section 3 outlines the connections between the EU's role as a global actor in trade and investment, and European business activities across global value chains. This shows the importance of analysing international trade and investment law together with EU business legislation, and prepares the ground for explaining the elements of our reform proposals.

Section 4 presents the EU law framework for the proposals. Section 5 discusses important elements of the reform proposals, while Section 6 presents the proposals, ending with a brief discussion of other elements that should be included in a possible comprehensive EU law reform, to realise the full potential of the reform proposals.

Section 7 concludes with some reflections on the way forward.

## 2. The financial risks of unsustainability

### 2.1 A (limited) recognition of climate change risk

The financial risks of climate change understood as the potential for negative impacts from climate change on business profitability or survival, have received a lot of attention. The recommendations of the Financial Stability Board's Task Force on Climate-Related Financial Disclosure[44] highlight the potential financial impacts of climate-related risks and opportunities that they think are significant, drawing on 'member expertise, stakeholder engagement, and existing climate-related disclosure regimes'.[45] This was complemented by the report, also in 2017, from Cicero Centre for International Climate and Environmental Research in Oslo: *Shades of Climate Risk* for investors,[46] which is also

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[41] Sjåfjell, Mähönen, Johnston, and Cullen, *Obstacles to Sustainable Global Business. Towards EU Policy Coherence for Sustainable Development*.
[42] Ibid. ADD ref to Alliance for Corporate Transparency report.
[43] We describe some of these initiatives and problems associated with them in Section 4 below.
44 Task Force on Climate-Related Financial Disclosures, Final Report: Recommendations of the Task Force on Climate-Related Financial Disclosures (June 2017) <https://www.fsb-tcfd.org/publications/final-recommendations-report/>.

[45] Ibid. p. iii.
[46] Christa Clapp et al, *Shades of Climate Risk. Categorizing Climate Risk for Investors* (2017) <http://hdl.handle.net/11250/2430660>.

directly relevant and applicable for decision-makers in the non-financial industry, such as corporate boards.[47]

Although laudable for contributing to awareness-raising of the significance of climate change for business and finance, both initiatives have short-comings when analysed in the SMART Project's holistic sustainability perspective. Even limiting the scope to climate change, important aspects are excluded in the two reports.

Firstly, although both reports discuss the acute and chronic physical risks of climate change, the financial risks in the form of risk to humans relevant to the business, including that of increased risk for spread of diseases and of unmanageable heatwaves, are explored only to a very limited extent.[48] The reference to impacts on humans is limited in the Cicero report to brief mention of risks to 'health and labour productivity' and 'worker unavailability' in its tables, and an even briefer mention is made of negative impacts on 'workforce' from acute physical risks in the Task Force report.[49]

Secondly, the reports stop short of explaining the potential severity of the financial risks of climate change. The Task Force report mentions the danger of 'catastrophic environmental and social consequences' in its introduction[50] and the Cicero report states that 'the potential for catastrophic change is not well understood'.[51] However, neither of the reports spell out what climate change, insufficiently mitigated, may entail in the form of global catastrophic risks of even existential risk for humanity.[52]

Thirdly, neither of the reports speak about the societal risks, including risk of societal breakdown. These are all relevant as financial risks, as we will show below.

## 2.2 From climate change risk to a systemic approach to Anthropocene risks

The financial risks of other aspects of unsustainability besides climate change, warrant attention. In the SMART Project we take such a broader approach, including other risks of unsustainability, concentrating on risks caused by unsustainable economic activity. In sustainability science literature, the terminology *Anthropocene risks* is employed, referring specifically to risks that: 'emerge from human-driven processes; interact with global social–ecological connectivity; and exhibit complex, cross-scale relationships'.[53] The annual Global Risks Report from the World Economic Forum, drawing on surveys of perceptions of global risks amongst respondents in business, government, and civil

[47] The growing recognition of the importance of environmental risks and emphasis on climate change is also illustrated through the Global Risk Report 2020, see the press release: https://www.weforum.org/press/2020/01/burning-planet-climate-fires-and-political-flame-wars-rage
[48] The Cicero Report states that 'We exclude some important social risks such as ecological disruption and disease that are addressed in other research' p. 11 (without further references), although they do thereafter actually mention the climate change related risk of disease, e.g. risk of increased 'increases vulnerability to pests and disease' in Central and South America, p. 38, referring to the risk of disease in the coffee trees.
[49] The Cicero Report, eg. [add page numbers], and the Task Force report, p. 10.
[50] Task Force, page 1 (Background).
[51] Shades of Climate risk, Executive Summary.
[52] See e.g. S. D. Baum and I. C. Handoh, 'Integrating the planetary boundaries and global catastrophic risk paradigms' (2014) 107 *Ecological Economics* 13–21.
[53] P. W. Keys, V. Galaz, M. Dyer, N. Matthews, C. Folke, M. Nyström, and S. E. Cornell, 'Anthropocene risk' (2019) 2 *Nature Sustainability* 667–73. This article also illustrates the interconnectivity in ways that we can only briefly touch upon in this report.

society, increasingly also takes such a broader approach, emphasising in their 2017 report that a systemic approach is necessary.[54]

Climate change, albeit a crucial issue, is just one of the hitherto identified *planetary boundaries* (see figure 1 above in Section 1.1). In Table 1 below, we include *biodiversity loss* and *novel entities* as examples of other environmental categories that should be included. Biodiversity is, like climate change, a core boundary. This means that transgressing this one boundary is regarded as sufficient to bring the Earth system out of the relatively stable state it has been the last 11,000 years.[55] Novel entities, including nanomaterials, microplastics and various forms of chemical pollution, is another potential core boundary.[56] The boundary is not yet quantified, so as opposed with climate change and biodiversity, we do not yet know whether and how far we have gone beyond any kind of safe limits.[57]

Further, we also include risks concerning the *social foundation*. Securing the social foundation within planetary boundaries, namely a safe and just space for humanity, is the definition of sustainability that we use as our framework.[58] This is presented in figure 2 in Section 1.1 above, and discussed further in Section 5 below.

As examples of the undermining of the social foundation, we have in Table 1 included *human rights violations*, l*ack of decent work* and *tax evasion*. As illustrated in Table 1, all of these bring with them financial risks.

The Task Force report divided climate-related risks into two major categories: (1) transition risks, i.e. risks related to the transition to a lower-carbon economy and (2) physical risks, i.e. related to the physical impacts of climate change. We have added *business model change* to the transition risks, and *global catastrophic risk* to the physical risks. We have also added a third major risk category: *Societal risks,* including risk of unrest, risk of authoritarianism, and societal breakdown risk.

We describe these risks below, and what this entails for business, with the emphasis that these are just examples. In Table 1, red dots indicate direct risks and orange dots indirect risks connected to environmental degradation and the undermining of the social foundation. A full and comprehensive assessment of the financial risks of unsustainability, with grading of the risks in each category, is yet to be undertaken.

[54] [Add full ref].
[55] Steffen, Richardson, Rockström, Cornell, Fetzer, Bennett, Biggs, Carpenter, Vries, Wit, Folke, Gerten, Heinke, Mace, Persson, Ramanathan, Reyers, and Sörlin, 'Planetary boundaries'.
[56] P. Villarrubia-Gómez, S. E. Cornell, and J. Fabres, 'Marine plastic pollution as a planetary boundary threat – The drifting piece in the sustainability puzzle' (2018) 96 *Marine Policy* 213–20.
[57] Include a footnote about precaution.
[58] Leach, Raworth, and Rockström, 'Between social and planetary boundaries: Navigating pathways in the safe and just space for humanity'.

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**Table 1: Financial Risks of Unsustainability**[59]

| | | ***Planetary Boundaries – example categories of unsustainability*** | | | ***Social foundation – example categories of unsustainability*** | | |
|---|---|---|---|---|---|---|---|
| **Risk categories** | | Climate change | *Biodiversity* | *Novel entities* | *Human rights violations* | *Lack of decent work* | *Tax evasion* |
| **Transition risks** | Policy risk | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 |
| | Liability risk | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 |
| | Reputation risk | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 |
| | Market risk | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 |
| | Technology risk | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 | N/A |
| | *Business model change risk* | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 |
| **Physical risks** | Acute risks | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 | 🟠 |
| | Chronic risks | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 | 🟠 |
| | *Global catastrophic risks* | 🔴 | 🔴 | 🔴 | N/A | N/A | 🟠 |
| ***Societal risks*** | *Risk of unrest* | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 | 🟠 |
| | *Risk of authoritarianism* | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 | 🟠 |
| | *Societal breakdown risk* | 🔴 | 🔴 | 🔴 | 🔴 | 🔴 | 🟠 |

*The red circles indicates that environmental degradation or social harm (unsustainability categories in vertical columns) entails direct financial risks within the various financial risk categories (categories in horizontal rows). The orange circles indicate indirect financial risk, while N/A explains that the category of unsustainability (horizontal columns) is not assumed to involve the specific risk category (vertical rows).*

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[59] Italics in the table denotes new categories compared to the two cited reports on financial risks of climate change.

## 2.3 Transition risks

The category of transition risks are financial risks for businesses that are not taking part in the transition to sustainability, which we have begun to see the contours of, or not transitioning quickly enough. The risks are caused by action or expected action from other actors or institutions: policy makers, victims of environmental harm or human rights violations, investors or other financiers, or competitors.

### 2.3.1 Policy risks

Policy risks concern the 'risk' of changes in policy, which will impact in varying degrees on different sectors and individual corporations. Anticipating and adapting to changes to the regulatory environment through policy-making is clearly also a part of the financial risk management of the corporation. Policy risks are a part of traditional risk management for EU businesses, within Europe and for globalised business activities. Typically the latter may concern the risk of nationalisation or regulatory change, perceived as market-related risks including contractual risks and enhanced definitions of net loss, business interruption, license cancelation coverage, and contingency risks[60] as well as political risks of a project.[61] Political risks are often defined as the possibility of 'government actions which deny or restrict the right of an investor/owner (i) to use or benefit from his/her assets; or (ii) which reduce the value of the firm'.[62]

The context of climate change broadens the perception of policy risks beyond the traditional one outlined above, and opens up the possibility – the risk – of policy-makers in Europe heavily taxing, limiting or forbidding activities that directly or indirectly generate greenhouse gas emissions. Such action is increasingly called for and may be necessary and also more likely now than it has ever been previously. In our broader context of sustainability, the policy risk also concerns policies with other environmental aims, besides climate change mitigation, and with social aims. They include the possibility of European policy-makers legislating to internalise environmental and social costs of globalised business within European business entities with influence over global value chains.

Businesses taking the more cynical approach of betting against relevant policy changes, may be making a correct judgment call in that respect, although the increasing societal pressure and other drivers for sustainability may be changing this picture. Businesses calculating with a low political risk will need to see this in connection with other aspects of the financial risks of unsustainability, including other transition risks as well as the physical and societal risks. These risks will tend to increase if policy risks are low; i.e. if policy-makers do not regulate efficiently to support the transition to sustainability and to mitigate impacts of unsustainability.

On the aggregate level of business lobbying, a more active approach to policy risk —promoting policies that will support the transition to sustainability — may accordingly be the best financial risk management.[63] Such an active approach may also be beneficial in the sense that this may give the corporate decision-makers a higher degree of certainty about upcoming changes in laws and policies.

[60] Add ref to James, 2001

[61] Add ref to Peinhardt & Allee, 2016

[62] Add ref Gordon, 2008, p. 92

[63] The support for changes in EU law, reported by Salla Saastamoinen, in her presentation at The 24th European Corporate Governance Conference: Company Law and Climate Change? 12 December 2019 Helsinki may be seen in this light.

Conversely, when corporations work against necessary policies, as is discussed by Cushman in relation to ExxonMobil,[64] the financial risk in the form of liability risks rises.

### 2.3.2 Liability risks

The international increase in lawsuits against corporations, including parent corporations, for environmental or social harm allegedly caused by their subsidiaries, and against lead corporations for negative environmental or social impacts in their global value chains, shows that the liability risk of unsustainability is materialising.[65] While many cases are rejected for procedural reasons, and many lost, some are likely to be won, and the sheer multitude of cases makes them a driver for change in themselves. They underline the financial risk of ignoring sustainability.

Liability risks take the form of investors suing either corporations or the board members directly for loss of profit arising from failure to anticipate and adapt to climate change or other environmental degradation. This includes law suits alleging that corporate decision-makers failed to adequately factor in the risk of policy changes and regulation by governments reacting to climate change. Liability risks also takes the form of lawsuits brought against the corporation or the board members directly for damage caused to people or communities by the corporation's contribution to climate change or other environmental degradation. This further applies to harm caused by the corporation through violation of human rights or complicity in corruption — the social and broader governance dimensions of sustainability.[66] While who will have standing to sue, and the likelihood of a lawsuit's success, will vary with the procedural rules across jurisdictions, such lawsuits entail a varying degree of financial risk for the corporation. The risks arise from the lawsuit itself — the costs associated with lawyer's fees, time spent, possible damages that have to be paid and negative reputational impacts — which may lead to lower profit caused by negative reactions from potential customers, contractual parties and investors.

The financial risk of carrying on with mainstream governance models through corporate groups or global value chains is also illustrated through these cases. The Anthropocene imposes new social and environmental realities on all of humanity, including business. Failing to recognize the significance to a business of these new constraints increases the likelihood that a company will be involved in contributing to transgressing planetary boundaries or undermining the social foundation in a manner that gives rise to liability for the company. Already the courts in a number of countries are being asked to treat such breaches as causes of action in civil (tort) claims or, in some cases, as criminal

[64] See, eg, John H Cushman, 'Harvard Study Finds Exxon Misled Public about Climate Change', *Inside Climate News* (online), 22 August 2017 <https://insideclimatenews.org/news/ 22082017/study-confirms-exxon-misled-public-about-climate-change-authors-say>.

[65] M. B. Taylor, 'Litigating Sustainability – Towards a Taxonomy of Counter-Corporate Litigation' (2020). See also Michal Nachmany et al, *Global Trends in Climate Change Legislation and Litigation: 2017 Update* (Grantham Research Institute on Climate Change and the Environment, May 2017) <http://www.lse.ac.uk/GranthamInstitute/wp-content/uploads/2017/ 04/Global-trends-in-climate-change-legislation-and-litigation-WEB.pdf>.

[66] For a list of cases see 'Legal Case Map', Business and Human Rights Resource Centre, <https://www.business-humanrights.org/en/corporate-legal-accountability>. See also Jennifer Zerk, *Corporate Liability for Gross Human Rights Abuses — Towards a Fairer and More Effective System of Domestic Law Remedies. A Report Prepared for the Office of the UN High Commissioner for Human Rights* (OHCHR, 2014) <https://www.ohchr.org/Documents/ Issues/Business/DomesticLawRemedies/StudyDomesticeLawRemedies.pdf>.

violations.[67] While corporate law may start from the supposition that a parent corporation is not responsible for its subsidiaries' actions, and even less so a lead corporation for that of its global value chains, modern financial risk management will increasingly need to take a broader — arguably a life-cycle-based — approach including the full impacts throughout the global value chains. This is what the SMART reform proposal presented in this report facilitates.

### 2.3.3 Reputation risk and market risk

If a business is involved or perceived to be involved in unsustainable behaviour, there may be a reputation risk in the form of customers or clients choosing not to purchase products or services from the business, employees and jobseekers looking for work elsewhere, and contractual parties, private and public, not wishing to renew or sign up with the business. With social norms and expectations gradually changing,[68] there is an indication of a shift in consumer preferences,[69] as well as in the preferences of job-seekers.[70] This leads to an increasing reputational risk for business involved in unsustainable activities. Media also plays an important role here, in revealing unsustainable business activities, including those related to tax evasion.[71]

The related market risk concerns changes in demand and preferences for goods and services. This can be due to a changing physical environment, such as, less demand for winter sports gear, or changes in demands for agricultural goods. This can also be due to increased interest in and emphasis on the sustainability impacts, for example, preference for more environmentally friendly goods with good working conditions, or goods of higher quality that are repairable and long-lasting, rather than single-use products. Changes in procurement regimes, such as through the EU's increased emphasis on sustainable public procurement,[72] may increase the market risk for business not transitioning or not transitioning quickly enough.

Similarly, changes in the financial markets involve a market risk for only getting financing at a higher premium or not all, as institutional investors and banks increasingly wish to shift to sustainable investment and lending objectives.[73] The drive to divest from coal and increasingly also from oil and gas, is a case in point here.[74]

The reputation and market risks are assumed to be drivers for sustainability when policymakers adopt various forms of sustainability reporting regimes, and when voluntary initiatives for similar reporting is advocated. However, together with the liability risk, this also functions as a disincentive for relevant and honest reporting, especially in a regime where there is a lack of stringency and of assurance. This entails the danger that honest and sustainability-oriented businesses suffer reputational risk associated with being open about challenges in their transition to sustainability, in comparison with competitors who choose to greenwash (or SDG-wash).

This underlines the importance of stringent reporting regimes with assurance and enforcement, providing a level playing field. Similarly, the same considerations indicate the necessity for credible

[67] Taylor, 'Litigating Sustainability – Towards a Taxonomy of Counter-Corporate Litigation'.
[68] B. Sjåfjell and M. B. Taylor, 'Clash of Norms: Shareholder Primacy vs. Sustainable Corporate Purpose' (2019) 13 *International and Comparative Corporate Law Journal* 40–66.
[69] 'Consumer Preferences Continue to Shift Toward Sustainability, Market Research Shows'. However, limitations of relying on 'consumer power' are well-established [add ref.]
[70] ADD REF.
[71] ADD REF
[72] ADD ref to SMART procurement report.
[73] ADD Ref
[74] ADD ref

and coherent trade and investment conditionality, alongside effective mechanisms for their enforcement. This is discussed further below in Sections 5 and 6.

The EU's Sustainable Finance Initiative, which we through our SMART reform proposals seek to broaden and strengthen,[75] has the potential for increasing the market risk for unsustainable business. However, also here, there is a need to secure a level playing field, so that the financial market risk is channelled in a sustainability-promoting manner.

### 2.3.4 Technology risk and business model change risk

Further related to the above, is the technology risk. The risk of 'stranded assets' — assets that no longer have value — to any corporation involved in exploiting fossil fuels is the obvious example here. The shift from fossil fuels to renewables presents a great financial risk to corporations planning to profit in the long run from oil, gas or coal.[76] However, this risk is also borne by corporations indirectly relying on these resources, such as manufacturers of fossil-fuelled cars.

The technology risk is not limited to climate change. For example, with the emerging recognition of the impact of increasing biodiversity loss, business continuing with products that either are based on exploitation of biodiversity resources that are becoming scarce, may find themselves outcompeted by products developed in new ways.

The broad shift from unsustainable linear business models to the sustainable circular model[77] involves financial risk for corporations not anticipating and adapting to this shift. The idea of *technology change* is insufficient to capture this risk — *business model change* (or even *systems change*) is more appropriate, and therefore included as a category here.

## 2.4 Physical risks and societal risks

These two broad risk categories distinguish themselves from the transition risks category above, in that they affect businesses also seeking to transition to sustainability, and quickly. The severity of the risks depends on the speed with which we as a global society transition to sustainability, and will, of course, have local variations. This emphasises the importance for business to work together to mitigate the physical and societal risks as far as possible, both through lobbying for and not against necessary legislative and policy reforms, and, without waiting for legislation, through transitioning in their businesses and whole sectors towards sustainability. It also places the onus on government at national levels as well as on the European Union to act to evade risks to citizens which are physical and social.

### 2.4.1 Physical risks

The physical risks of climate change are those that a changing climate entails, such as sudden and gradual changes to our natural environment, including warmer, wetter and wilder weather, floods and landslides, sea level rise, droughts and heat stress. Ignoring these predictions may lead businesses to make financially risky investments, for example in property that will not be possible to

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[75] Ref to SFI and to SMART Finance report.

[76] Beate Sjåfjell, Heidi Rapp Nilsen and Benjamin J Richardson, 'Investing in Sustainability or Feeding on Stranded Assets. The Norwegian Government Pension Fund Global' (2017) 52 *Wake Forest Law Review* 949.

[77] A linear business model is one that takes responsibility for, eg, a product, only until it is sold, and typically does not encompass the supply chain of the product and all its components. Conversely, a circular business model takes responsibility for a product from cradle to cradle, encompassing each stage from design to recycling/upcycling or management of the waste.

develop, or to fail to put in place necessary measures, for example the fortification of factories against the changing physical environment.

A similar picture may be drawn for other environmental issues, including loss of biodiversity and novel entities such as various forms of pollution, as well as ocean acidification, deforestation and other land change, and pressure on fresh water. These are complex, interconnected processes, with environmental degradation of one type increasing the associated also with others.

Environmental degradation may bring physical risks to humans also in the form of increase in disease, changes in which diseases occur where, through insufficient food, water, and through unmanageable increase in temperature, suddenly or over time. This translates into financial risks for businesses through employees or other workers not being able to come to work or work as well, and it may similarly affect the customers or suppliers of a business.[78]

Human rights violations and lack of decent work may similarly bring physical risks for the work force, undermine the ability or willingness of them to carry out the work. Such risks can also undermine the future potential of worker, for example child labour can lead to harms which stunt their capabilities in the labour market, but also in other aspects of their lives.[79] It may also undercut the ability of other businesses which do not engage in such exploitative conduct to compete fairly in markets for goods and service, making physical risk a business norm.

Tax evasion, or other forms of undermining the economic basis for good welfare societies,[80] may negatively impact on the relevant societies' ability to protect their population against physical risks due to environmental degradation, human rights violations and lack of decent work, thereby causing the physical risks to materialise or to be strengthened. Similarly, lack of economic resources in a country undermines its possibility to put into place relevant measures to adapt to environmental change.

The physical risks of unsustainability may have direct financial consequences for corporations in various sectors, and decision-makers lacking in awareness or knowledge about these issues may increase the financial risk for the corporation through the decisions it makes or fails to make.

There are (at least) two levels on which the physical risk of environmental degradation and undermining of the social foundation, represents financial risk for businesses. The first is on the level of the individual corporation which needs to anticipate and adapt to physical changes in the natural environment and for example, increase in risk of disease, as far as possible. This may involve changes in insurance levels, in investments, in relocating factories, or in the very business model of the corporation.

The second is on the aggregate level of the sector, in a country, a region or globally. In addition to anticipating and adapting to physical risks, a corporation or an aggregate of corporations may more actively mitigate environmental degradation, exploitation of people and undermining of the societal

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[78] Add ref to Galaz et al 2014, Global networks and global change-induced tipping points. While we do not have reason to believe that the coronavirus is caused or reinforced by unsustainable economic activities, the economic and financial impacts are indicative of the risks involved in, e.g., environmental degradation leading to an increase in the spread of disease. See e.g. https://www.theguardian.com/news/2020/feb/10/will-the-coronavirus-outbreak-derail-the-global-economy

[79] Otto, Hans-Uwe, and Melanie Walker, eds. *Capability-promoting policies: Enhancing individual and social development*. Policy Press, 2017; Manley, R., 2019. Trade Law and the Capability Approach. *Journal of World Trade*, *53*(6), pp.1041-1062.

[80] Refer to Hickel and other work

bases' for welfare, to ensure the continued viability of the corporation's business. To take just one example linked to biodiversity loss, an agricultural sector dependent on bees, wasps and other pollinators, may collectively work to reduce the use of pesticides and mitigate other threats to pollinators. Not doing so, while continuing with the same line of business, involves the financial risk of reduced crops. Anticipating and adapting to unavoidable change, and contributing to the transition to sustainability to mitigate negative changes, are therefore intrinsic aspects of the risk management in the core financial sense.

Of course, the involvement of the individual business in unsustainable behaviour leading to physical risks, increases the liability risks, reputation and market risks, as well as the risk of being outcompeted by sustainability business through a materialisation of the technology risk and the business model change risk.

Ultimately, the physical risks go beyond that which can be managed through anticipation and adaption. This is reflected through changes in insurance premiums for certain areas, 'with some insurers simply withdrawing from the market'.[81] Unmitigated environmental degradation and continued overshoot of planetary boundaries brings with it global catastrophic risks (discussed also in Section 3.3 of the Finance Report), defined as the risk of a scenario which takes 'the lives of a significant portion of the human population, and may leave survivors at enhanced risk by undermining global resilience systems'.[82] The financial risks to most, if not all, businesses in global catastrophe scenarios are existential.[83] This is closely linked to the 'societal collapse' risk below.

### 2.4.2 Societal risks

Societal risks include risk of social unrest caused by social inequality and the corporate undermining of the economic basis of our welfare systems.

Tax evasion is a part of an undermining of the economic bases for our societies, the increasing inequality between and within countries, and the rise of populism and the risk of societal instability that this entails. Some of the most disturbing trends in major industrialised countries reflect such a lack of social stability, and corporations and associated financial markets have a role in this.[84]

Social precarity and vulnerability has led to a significant increase in the disparity of income levels between the wealthy and the poor, but also between capital, managers and those dependent on working for a living.[85] International Monetary Fund (IMF) reports recommend re-regulation of labour markets, for example through worker voice in the form of trade union representation.[86] The motivation is not only the protection of workers' human rights or decent work, but that growing inequalities of income also affect consumer potential and, ironically, undermine capitalism as a whole. This is also arguably reflected in concern expressed by the World Bank and OECD Reports on

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[81] ADD ref to Finance report section 3.3. ADD ref to Global Risk Report 2020 or earlier.

[82] S. Avin, B. C. Wintle, J. Weitzdörfer, S. S. Ó hÉigeartaigh, W. J. Sutherland, and M. J. Rees, 'Classifying global catastrophic risks' (2018) 102 *Futures* 20–26.

[83] See also Global Risk report.

[84] See further B. Sjåfjell and C. M. Bruner, 'Corporations and Sustainability' in B. Sjåfjell, C. M. Bruner (eds.), The Cambridge handbook of corporate law, corporate governance, and sustainability, (Cambridge: Cambridge University Press, 2019), p. Ch. 1.– on which this paragraph is based.

[85] Thomas Piketty, *Capital in the Twenty-First Century* (Harvard University Press, Cambridge Mass., 2014). See for further discussion, T. Novitz, 'The perils of collective begging: The case for reforming collective labour law globally and locally too' (2020) NZERR forthcoming.

[86] Florence Jaumotte and Carolina Buitron, *Inequality and Labor Market Institutions*. IMF staff discussion note (Washington: IMF, 2015). Available at https://www.imf.org/external/pubs/ft/sdn/2015/sdn1514.pdf.

*The Changing World of Work* and *New Forms of Work* (respectively).[87] Within this context, sustainability is creating added momentum to enhance the scope of representation and voice of all those at work (or in the world of work), rather than those who merely meet the current threshold requirements of protection in a standard employment relationship. [88]

Moreover, social precarity and vulnerability arguably do not only have implications for the consumer base in global capitalism, but also for the quality of democratic engagement.[89] Precarity limits the scope to find energy for political activity and campaigning, which are becoming again a preserve of the elite. As capital gains in wealth, many employers become ever more influential in political life.

Powerful vested interests can hijack political advertising, not just through conventional media (as was the case with the Rupert Murdoch press in the 1980s and 1990s which had to be wooed by political leaders), but through less tangible forms of communication which can involve attempts at intervention in the democratic process (the google and Facebook scandals).[90] This may also be linked to the attempt to blame others even more vulnerable for conditions of scarcity, prompting resort to forms of nationalism and even neo-fascism.[91]

There are a number of scenarios that can lead to global catastrophic risks, including climate change and other environmental degradation.[92] If we do not manage to reposition our economies and societies within planetary boundaries and in a way that secures a safe and just operating space for everybody now and in the future, there is a risk of societal collapse, which may be caused by a combination of the factors discussed here.

## 2.5 Beyond business case

The global catastrophic risk and the risk of societal collapse, underlines that that we cannot settle for a mainstream 'business case' approach. Recognising the financial risks of unsustainability does not mean that it is sufficient to only internalise environmental, social and broader governance issues to the extent that a clear cause-and-effect line can be drawn from ignoring an issue to the financial risk it entails for the corporation. Identifying the financial risk is not intended as a boundary of what issues are relevant to corporate sustainability. The point is to challenge the dichotomy of profits versus sustainability and show that, however little a business may care about 'ethics' and 'corporate

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[87] World Bank, *World Development Report 2019: The Changing Nature of Work* (World Bank, 2019) (online report, 24 April 2019) <https://openknowledge.worldbank.org/handle/10986/30435> (hereafter *World Development Report 2019*); OECD n.12.

[88] Nicola Countouris, *Defining and Regulating Work Relations for the Future of Work* (Geneva, ILO, 2019); Tonia Novitz, 'Tripartism as Sustainable Governance' in George Politakis, Tomi Kohiyama and Thomas Lieby (eds), *ILO100 - Law for Social Justice* (Geneva : International Labour Office, 2019), 337 – 354 available at: https://www.ilo.org/global/about-the-ilo/how-the-ilo-works/departments-and-offices/jur/law-for-social-justice/WCMS_730958/lang--en/index.htm.

[89] Buitron and Osario n.(84 – for now) observe at 27 that: 'Inequality could also hurt society by allowing top earners to manipulate the economic and political system.'

[90] Daniel Kreiss and Shannon C. McGregor, "Technology Firms Shape Political Communication: The work of Microsoft, Facebook, Twitter, and Google with campaigns during the 2016 US presidential cycle" (2018) 35(2) Political Communication 155-177; Carole Cadwalladr and Emma Graham-Harrison, "Revealed: 50 million Facebook profiles harvested for Cambridge Analytica in major data breach" *The Guardian* (2018).

[91] See Karl Polanyi, *The Great Transformation: The Political and Economic Origins of our Time* (Beacon Press, 2001, 2nd paperback ed), 245 and 256. Cf. Ronald Inglehart and Pippa Norris, 'Trump and the Populist Authoritarian Parties: The silent revolution in reverse' (2017) 15(2) *Perspectives on Politics* 443; see also Pippa Norris and Ronald Inglehart, *Cultural Backlash: Trump, Brexit, and Authoritarian Populism* (Cambridge University Press, 2019).

[92] Ibid.

social responsibility', (un)sustainability will sooner or later, in one way or another, affect most businesses. This is the grand challenge facing our economies, including business, and more broadly, our societies.

There has never been a stronger case for all partners working together for a better system. The EU as a global actor and as European policymaker and legislator has a crucial role here to ensure that the international and European regulatory framework for business mitigates these risks as far as possible. The risks of continuing on an unsustainable path of business as usual are enormous. The possibilities for securing good lives and sustainable prosperity are too.

## 3. Europe's role in international trade, investment and globalised business

EU-based businesses are involved in global value chain activities that violate both environmental and social aspects of sustainability. These can also have economic development implications when they displace wealth from the country that is a site of production or the origin of services. In terms of both trade in goods and trade in services, the EU's engagement in free trade agreements (FTAs) has been (and will continue to be) made conditional on sustainability and good governance in the State concerned.[93] Indeed, we see the EU as a leader in this field, noting that the EU's modern FTAs now include sustainable development chapters that explicitly link the three dimensions of sustainability: economic, social and environmental.[94] In its preferential trading arrangements, such as the Generalised System of Preferences (GSP), the EU has long made provision for withdrawal of preferences in breach of environmental and labour standards and now includes an added incentive arrangement for sustainable development and good governance (GSP+),[95] which requires beneficiaries to respect 27 international conventions relating to human rights, labour standards, environment, and good governance. However, at present it seems that neither sustainability chapters in FTAs nor GSP conditionality are securing effective implementation of the international legal norms that they endorse. More needs to be done to secure effective enforcement.

There is also a danger of undermining of sustainability goals through the investment provisions of EU FTAs. Modern EU-FTAs, like the Comprehensive Economic and Trade Agreement (CETA), now include an Investment Court (including an appellate structure). This may overcome many concerns raised to date regarding the problems with standard investment arbitration, within which the protection of investor interests has the capacity to override environmental and social measures. We also note the EU's attempt to encourage the adoption of a multilateral treaty establishing an investment court through UNCITRAL mechanisms. Inclusion of a right to regulate in investment chapters within FTAs further prevents the potential anti-democratic effects of State obligations to investors to guarantee 'fair and equitable treatment' and 'non-discrimination', to protect 'legitimate expectations' and to guard against 'expropriation' whether direct or indirect. Nevertheless, there is a lack of joined up

[93] Communication from the Commission 'The European Green Deal' COM(2019)640 final, 11.12.2019, 21; Commission Communication, 'A Strong Social Europe for Just Transitions' COM(2020) 14 final, 12: 'Every new comprehensive bilateral agreement will have a sustainable development chapter and the highest standards of climate, environmental and labour protection, with a zero tolerance policy on child labour, in order to ensure the appropriate level playing field with our trading partners.'

[94] C. Gammage, 'Social Norms in EU-Free Trade Agreements: Justiciable or not?' in C. Gammage and T. Novitz, *Sustainable Trade, Investment and Finance: Towards Responsible and Coherent Regulatory Frameworks* (Cheltenham: Edward Elgar, 2019).

[95] Initially set out in Council Regulation 732/2008 and maintained in the current incarnation of the GSP under Council Regulation 978/2012.

thinking, such that the relationship between trade, investment and sustainability chapters (whether concerning environmental issues or labour standards) remains unclear. We argue for greater policy coherence internally within FTAs, regarding their content and implementation. To this end, we present in a separate report, our SMART guidelines for improved policy coherence for development, positioned within the broader context of sustainability.[96]

We also envisage a greater role for the EU to promote multilateral agreement and action for the promotion of sustainability objectives in trade and investment, which respects representative participatory engagement with those affected by any policy shifts and EU trade and investment decisions. We see this as necessitated by SDG 16 which seeks to 'Promote peaceful and inclusive societies for sustainable development, provide access to justice for all and build effective, accountable and inclusive institutions at all levels'. This entails, at a minimum, the realisation of genuine 'access to justice for all' under target 16.3 and 'responsive, inclusive, participatory and representative decision-making at all levels' under target 16.7.

On this basis, we argue that it is imperative to reflect in FTAs, the dynamic synergies between SDGs, namely the economic, social and environmental aspects of sustainable development, all encompassed in a planetary boundaries approach. This means reconsidering the position and use of SD chapters, which we propose be foregrounded and integrated throughout chapters of an FTA, rather than being placed at the tail end. Moreover, to enhance access to justice and inclusive participatory engagement in policy-making, we recommend enhancement of the domestic advisory group (DAG) process under FTAs and non-disputing parties engagement in investment arbitration (ISDS). We also consider that this participatory principle of enhancing voice to ensure no one is left behind requires action, not just at the point of enforcement, but prior to adopting new EU legislative initiatives which will have social, economic or environmental impacts on developing countries. Inclusive consultation (including policy actors in developing countries in the global South) will therefore be vital to the success of proposals for further elaboration on sustainable finance and product liability initiatives. Moreover, there may need to be cooperation within the Commission, prior to entry into an FTA, to ensure that aid and support suitable for ensuring developing countries in the global South can achieve the sustainability objectives set out in any sustainability chapter.[97]

At the heart of the unsustainability of globalised business is the social norm of shareholder primacy in limited liability companies: this norm results in pressure on decision-makers in those companies to maximise returns for investors, especially shareholders. This acts as a systemically entrenched barrier to corporate sustainability. Denoting shareholder primacy as a barrier of such significance is a short form for a complex mix of perceived market signals and economic incentives, informed by path-dependent corporate governance assumptions and postulates from legal-economic theories. While especially strong in listed companies, it affects also non-listed companies, and has knock-on effects on other business forms without personal liability of their members. This is contrary to the goals of European company law[98] and of the values and overarching objectives set out in the Treaties of the EU, and to the achievement of the SDGs.

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[96] See C. Gammage, S.E. Stave, H. Ahlström and B. Sjåfjell, *SMART Guidelines: Making Policy Coherence for Development Fit for Purpose*, SMART report, draft on file with current authors.

[97] See further in Section 6.1 below.

[98] B. Sjåfjell, A. Johnston, L. Anker-Sørensen, and D. Millon, 'Shareholder Primacy: The Main Barrier to Sustainable Companies' in B. Sjåfjell, B. J. Richardson (eds.), Company Law and Sustainability: Legal Barriers and Opportunities, (Cambridge University Press, 2015), pp. 79–147; C. M. Bruner and B. Sjåfjell, 'Corporate Law, Corporate Governance and the Pursuit of Sustainability' in B. Sjåfjell, C. M. Bruner (eds.), The Cambridge

The core role of EU secondary legislation regulating business, notably company and financial market law, is perceived to be the promotion of economic development notably by acting as a vehicle for market integration, through facilitating and enabling cross-border business and promoting investment in the European financial markets, and to protect the interests of the involved parties – both to promote business and facilitate integration and as an objective in its own right. Increasingly these area of EU law and policy are explicitly recognised to have a role in achieving the overarching sustainability objectives of the EU. However, the existing regulatory framework tends either to be neutral to the purpose and direction of business, leaving then space for the social norm of shareholder primacy, or is directly shareholder-primacy informed. The combination of this with the market pressure for maximisation of returns, and the distance between business decisions and unsustainable impacts, leads to unsustainability.

In this report, we present proposals for changes to the EU's trade and investment policies, as well as detailed proposals for changes in EU's legislative framework for business. Our proposals encompass the transnational activities of EU business through global value chains, connecting EU business law with EU's trade and investment framework.

## 4. The EU law framework for the reform proposals

Any area of EU law and policy is as a matter of EU law meant to contribute to the overarching objectives of the EU as set out in the EU Treaties. To reinforce this, we have crosscutting rules such as the environmental integration rule in Article 11 TFEU, requiring that environmental protection requirements must be integrated in all policies and activities of the EU with the aim of securing a sustainable development.[99] The inclusion of respect for human dignity and human rights, social policy, minority peoples and rights of the child in the EU's values and objectives, together with the legal requirement for PCD, requiring that any area of EU law and policy must not work against developmental policies,  strengthen the sustainability aim of 'leaving no-one behind'.[100]

The subsidiarity principle of the EU, entails that it shall only act if action on an EU level is necessary. The transnational nature of business and its unsustainability makes it clear that action on EU level indeed is necessary. The problematic issues with individual initiatives by Member States is clearly illustrated through the innovative French vigilance law, including the questions concerning scope.[101] In this section, we outline the legal basis for EU action, from the international trade level and down to the regulation of European business.

The EU enjoys exclusive competence in respect of its common commercial policy (Article 3 TEU) although this can be limited by the principles of conferral and proportionality (Article 5 TEU). Article 4 TEU sets out the areas, including environment, where the EU and its Member States have shared competence. The EU's common commercial policy is set out under Article 207 TFEU, which the EU enjoys the exclusive competence to adopt binding legislation and regulations in respect of trade in goods, services and commercial aspects of intellectual property while Opinion 2/15 on the conclusion

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Handbook of Corporate Law, Corporate Governance, and Sustainability, (Cambridge: Cambridge University Press, 2019), p. Ch. 50.

[99] Sjåfjell, 'The Legal Significance of Article 11 TFEU for EU Institutions and Member States', p. 11. [Add refs to Grimeaud, 2000; Durán and Morgera, 2012; Solana, 2019.]

[100] C. Gammage, 'The EU's Evolving Commitment to Promoting Sustainability in its External Actions: Policy (In)Coherence for Development?', SMART working paper on file with current author.

[101] ADD REF

of the EU-Singapore FTA[102] confirmed that foreign direct investment also falls within the exclusive competence of the EU. All other aspects of investment fall under the shared competence of the EU and its Member States. Where the Treaty is silent on an issue, the EU may enjoy implied competence to act on behalf of the Member States. Most modern FTAs are 'mixed agreements' and will require the consent of the EU, its institutions and its Member States prior to ratification and implementation.[103]

Development cooperation has been a part of the Union's external action. Development objectives were first codified into primary law in the Maastricht Treaty (1992) and most recently in Article 208 of the Lisbon Treaty. Article 208 TFEU provides that development cooperation 'shall be conducted within the framework of principles and objectives of the Union's external action' and this brings it under the general scope of the common commercial policy and the EU's exclusive competence. As a legal obligation, Article 208(1) TFEU provides that 'development cooperation shall have as its primary objective the reduction and, in the long term, the eradication of poverty'. Furthermore, Article 208(2) TFEU requires that the EU and its Member States 'comply with the commitments and *take account* of the objectives they have approved in the context of the United Nations and other competent international organisations'.

External action in relation to development cooperation finds its legal base in Article 209 TFEU, which provides that 'the Union may conclude with third countries and competent international organisations any agreement helping to achieve the objectives referred to in Article 21 of the Treaty on the European Union and in Article 208 of this Treaty'. As such, development cooperation and trade policy are not merely incidental to one another.[104]

Further, under TEU, Art 21(2)(d) and (f), the EU will 'foster the sustainable economic, social and environmental development of developing countries, with the primary aim of eradicating poverty' and 'help develop international measures to preserve and improve the quality of the environment and the sustainable management of global natural resources, in order to ensure sustainable development'. This is consistent with the more general objectives in Article 3(5) TEU which states that: 'In its relations with the wider world, the Union shall uphold and promote its values and interests and contribute to the protection of its citizens. It shall contribute to peace, security, the sustainable development of the Earth, solidarity and mutual respect among peoples, free and fair trade, eradication of poverty and the protection of human rights, in particular the rights of the child, as well as to the strict observance and the development of international law, including respect for the principles of the United Nations Charter.'

After the Single European Act 1986, Article 130r(2) of the EC Treaty stated that: 'Environmental protection requirements shall be a component of the Community's other policies'. Now Article 11 of the TFEU) makes it clear that: 'Environmental protection requirements must be integrated into the definition and implementation of the Community policies and activities.' Article 3(3) of the TEU states that: 'The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection

[102] Opinion 2/15 on the Conclusion of the EU-Singapore FTA [2016] ECLI:EU:C:2016:992.

[103] See Clair Gammage, 'EU International Relations Law: The Power To Conclude International Trade Agreements' Chapter 3 in Sangeeta Khorana & Maria Garcia (eds), *Handbook on the EU and International Trade* (Cheltenham, Edward Elgar: 2018).

[104] Case C-377/12 *Commission v Council* [2014] ECLI:EU:C:2014:1903.

and improvement of the quality of the environment. It shall promote scientific and technological advance.' All three dimensions of sustainability are reflected here.

The EU regulation on company law, accounting law and auditing law is based on Article 50 of the TFEU, especially 50(1) stating: 'In order to attain freedom of establishment as regards a particular activity, the European Parliament and the Council, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, shall act by means of directives.' The provision is complemented by Article 50(2)(g) stating that the European Parliament, the Council and the Commission shall carry out the duties devolving upon them under the preceding provisions, in particular 'by coordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 54 with a view to making such safeguards equivalent throughout the Union. With this provision, the scope of Article 50(1) is enlargened to all profit-making legal persons, both public and private, including cooperatives:

> Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.
>
> 'Companies or firms' means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making.[105]

Article 50 is the basis of major European company, accounting and auditing legislation, such as the Company Law Directive, the Accounting Directive, the Transparency Directive, and the Shareholder Rights Directive I and II. Article 50 does not set other limitations to the type, purpose of size of the undertaking except excluding entities with pure non-profit purpose. Article 54 mentions explicitly cooperatives that have an economic purpose.

As regards securities law, the Treaty contains no reference to securities markets. However, the facilitation of the financial markets (including the securities market) has been linked to the provisions on Article 114 [Disclosure Regulation (Art 114), Prospectus Directive (Art 114)].

# 5. Important elements of the reform proposals

## 5.1 Reforming international trade and investment

The EU as a global actor can contribute to international trade and investment being a force for achieving sustainability in accordance with Article 3(5) of the EU Treaty. Our proposals are geared towards recognizing the synergies between the SDGs, which we outline here.

The SDGs have been framed around 'purposive alliteration': People, Planet, Prosperity, Peace and Partnership.[106] Starting with the idea of 'People', it is not surprising that (given a focus on 'development'), the first SDG is 'to end poverty' and the second is to end 'hunger' for humans. Crucial to protection of people is arguably SDG 3 (concerning health and well-being), SDG 5 (empowering women and girls) and SDG 8 (decent work), as well as the overarching objectives of SDG 10 (reducing inequality within and between countries). Also significant is the phraseology. For

[105] Article 54 TFEU.

[106] See Tonia Novitz and Margherita Pieraccini, 'Agenda 2030 and the Sustainable Development Goals: "responsive, inclusive, participatory and representative decision-making"?' in M. Pieraccini and T. Novitz (eds), *Legal Perspectives on Sustainability* (Bristol: Bristol University Press. 2020).

example, there is to be water and energy 'for all' (see SDGs 6 and 7); this is a claim all have by virtue of being human. As one would expect numerous environmental objectives on the 'Planet' are highlighted, concerning agriculture (SDG 2), water (SDG 6), climate change (SDG 13), oceans and seas (SDG 14), as well as ecosystems and biodiversity on land (SDG 15) and energy (SDG 7). Mention of '*Prosperity*' reflects a past UN focus on the achievement of economic objectives in the context of sustainable development. For example, SDG 8 is not only concerned with 'decent work' (as promoted by the ILO) but also 'sustained, inclusive and sustainable economic growth'.[107] '*Peace*' is arguably concerned with intra-generational distributive justice and can be linked to some over-arching SDGs concerned not only with specific concrete outcomes, but as much with overcoming barriers to achievement to other SDGs. An example is SDG 16, which aims to: 'Promote peaceful and inclusive societies for sustainable development, provide access to justice for all and build effective, accountable and inclusive institutions at all levels'. This is concerned with promotion of inclusive participatory mechanisms for multi-level decision-making and also protection from harm through effective judicial and other mechanisms (see especially SDG 16.3, and 16.7). [108]

Finally, crucial to achievement of all the SDGs is '*Partnership*' written into SDG 17, which seeks to: 'Strengthen the means of implementation and revitalize the Global Partnership for Sustainable Development'. This is to be achieved by 'finance', 'technology', 'capacity-building' and 'trade' all of which feature as further targets under this heading. Further, the SDGs end with subheadings (in SDG17) on 'policy and institutional coherence', 'multi-stakeholder partnerships' and 'data, monitoring and accountability', under each of which further targets are listed. This is important because, as digital and technological innovations increase the pace of globalisation, making the business of doing trade faster, easier and more efficient, the trading system become riddled with complexities and fragmentation. For example, trade often takes place through complex supply chains and global value chains where corporate actors can exert significant influence over the adoption of private standards and influence norm preferences across the chain.[109] The complexities of global value chains also have a notable labour dimension. Complex supply chains typically mean complex ownership patterns and it can be difficult to identify who is the employer or business accountable for pollutants. This, in turn, makes enforcement of labour and environmental standards more difficult. Similarly, eco-labelling schemes may be used as 'greenwashing' and lower levels of protection under the moral guise of saving the planet. Where regulatory gaps and inconsistencies exist, there is greater risk of protectionism, exploitation and a 'race to the bottom' in terms of social and environmental protections. This is why the policy coherence advocated under SDGs targets 17.13 and 17.14 are so important to the operation of any 'global partnership'. In this context, the EU will need to 'continue to lead international efforts and … build alliances with the like-minded',[110] but will need to do so in ways that are consistent with international consensus and the connections between the SDGs.

[107] Here we point again to our concern that economic growth may not however per se be an unqualified human good. See the SMART Report D2.4, 'Obstacles to Sustainable Global Business. Towards EU Policy Coherence for Sustainable Development', *University of Oslo Faculty of Law Research Paper* No. 2019-02, at 17.

[108] T. Novitz, 'Engagement with Sustainability at the International Labour Organization and Wider Implications for Worker Voice' (2020) *International Labour Review,* forthcoming**.**

[109] O. Herrnstadt, 'Are International Framework Agreements a path to corporate social responsibility?' (2007-8) 10 *University of Pennsylvania Journal of Business and Employment Law* 187.

[110] 'The European Green Deal' n. 1 above, 2.

In terms of the coherence of these goals, it is already evident that they are connected potentially in a variety of ways. The preamble to the UN (in para. 5) describes the SDGs as 'integrated' and 'interdependent'. An International Labour Organization (ILO) Report on SDG 8 has, for example, described these as 'dynamic interlinkages'.[111] SDGs 16 and 17 have self-evidently the greatest capacity to affect the interpretation, application and significance of other SDGs.

Trade plays a central role in the attainment of *all* the SDGs, as is acknowledged in SDG 17 and target 17.10 which seeks to 'promote a universal, rules-based, open, non-discriminatory and equitable multilateral trading system under the World Trade Organization, including through the conclusion of negotiations under its Doha Development Agenda' and SDG target 10.A which aims to 'implement the principle of special and differential treatment for developing countries, in particular least developed countries, in accordance with World Trade Organization agreements'. As the Commission itself has observed in December 2019, 'the EU can set standards that apply across global value chains' and can 'facilitate trade in environmental goods and services, in bilateral and multilateral forums, and in supporting open and attractive EU and global markets for sustainable products'.[112] In this respect, we are not surprised by the continued commitment for sustainable development to feature prominently in free trade agreements (FTAs). Our recommendations concern how this might best be done, considering scope for the improvement of current practice.

We regard it as essential that, not only the norms in each chapter of any FTA cohere, but also the modes of dispute settlement provided for the FTAs be rationalized to promote coherence. We argue that this can be achieved within processes preceding adoption of FTAs, which may also require liaison between different Commission DGs, so that aid strategy supports new trade relations. Moreover, we recommend navigating SDG implementation through engagement with civil society voices, including environmental NGOs and trade unions, including those of developing countries, as envisaged in Agenda 2020. This would also entail greater scope for non-disputing parties to intervene in investor-state dispute settlement (ISDS) under agreements concluded by the EU.

## 5.2 Mitigating shareholder primacy

Shareholder primacy is a systemically entrenched barrier to the contribution of business to sustainability. Denoting *shareholder primacy* as a barrier of such significance is a short form for a complex mix of perceived market signals and economic incentives, informed by path-dependent corporate governance assumptions and postulates from legal-economic theories.[113] Shareholder primacy should be distinguished from the legal norm denoted *shareholder value*, which we find notably in the UK.[114] That this distinction often is not made is symptomatic of the dominance of the shareholder primacy thinking, also in corporate law doctrine.[115] Shareholder value is on the one end of the spectrum with a pluralistic approach to the interests of the company on the other, as we have

[111] ILO International Labour Office, *Time to Act for SDG 8: Integrating Decent Work, Sustained Growth and Environmental Integrity* (Geneva: ILO, 2019).
[112] 'The European Green Deal', n. 2 above, 22.
[113] Sjåfjell et al, 'Shareholder Primacy: The Main Barrier to Sustainable Companies'.
[114] In earlier work, David Millon uses 'radical' and 'traditional' shareholder primacy to distinguish between the social norm and the legal norm; D. Millon, 'Radical Shareholder Primacy' (2013) 10 *University of St. Thomas Law Journal* 1013. On UK law, see A. Johnston, 'Market-led sustainability through information disclosure: the UK approach', in B. Sjåfjell and C.M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge University Press, 2019), Ch. 15.
[115] B. Sjåfjell, et al., 'Shareholder Primacy: The Main Barrier to Sustainable Companies'.

seen in multi-jurisdictional comparative analyses.[116] No company system insists on boards focusing only on returns for shareholders, and certainly not requiring that returns be maximised. In addition to the obvious point that jurisdictions expect boards to ensure legal compliance, corporate law provides – across this spectrum – a large latitude to the board and by extension the management to shape business in a sustainable manner.[117] However, as is also evident from the state of unsustainability we are in, boards in aggregate do not predominantly choose sustainability-enhancing options even within the realm of the business case, let alone challenge the outer boundaries of the scope to pursue profit in a sustainable manner by going beyond the business case.[118]

The shareholder primacy drive combined with a lack of understanding of the scope the law gives the board, and by extension management, has given rise to legal myths inspired by law-and-economics postulates, dictating that the board and senior managers are the 'agents' of the shareholders and must maximize returns to shareholders as measured by the current share price.[119] The capital markets function to funnel and exacerbate the shareholder primacy drive, supported by securities regulation and stock exchange rules that have as their primary aim to protect investors, not the various other interest affected by corporate activity.[120] The normative impact of the shareholder primacy drive goes beyond the listed corporations, and is exacerbated by the chasm between corporate law's approach to corporate groups and the dominance and practice of such groups,[121] and the extensive use of global value chains, and other non-equity modes of control,[122] allowing for an intensified externalisation of environmental, social and economic costs.

We see it as necessary, as key in the SMART reform agenda, for company law to take back the power to define what the purpose of the company, or more broadly: the undertaking, is, and what the duties of the board are in Europe. This has to be done in a way that not only pushes back against the legal myth that shareholder primacy has developed into, to clarify that the purpose of business and the duty of the board is actually not to maximize returns for shareholders.[123] In light of the

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[116] Ibid. Bruner and Sjåfjell, 'Corporate Law, Corporate Governance and the Pursuit of Sustainability'.

[117] Ibid. This is supported for the institutional investors e.g. by the report 'Resource Efficiency and Fiduciary Duties of Investors', Final Report, ENV.F.1/ETU/2014/0002, DG Environment, produced by Ernst & Young Cleantech and Sustainability Services (France) on behalf of the European Commission.

[118] The lack of cases challenging the boundaries for how far corporate boards can go in promoting long-term sustainability in their decision-making, is a striking feature in the multijurisdictional comparative analysis presented in Sjåfjell, et al., 'Shareholder Primacy: The Main Barrier to Sustainable Companies'.

[119] Along with that of shareholders owning corporations, which they as a matter of corporate law clearly do not; e.g. P. Ireland 'Company Law and the Myth of Shareholder Ownership' (1999) 62 no. 1 *Modern Law Review* 32-57; L. Talbot, *Critical Company Law* (Abingdon: Routledge, 2nd ed., 2015).

[120] J. Cullen and J. Mähönen, 'Taming unsustainable finance: the perils of modern risk management', in B. Sjåfjell and C.M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge University Press, 2019), Ch. 8; C.M. Bruner, 'Corporate Governance Reform in a Time of Crisis' (2011) 36 no. 2 *Journal of Corporation Law* 309.

[121] B. Clarke and L. Anker-Sørensen, 'The EU as a potential norm creator for sustainable corporate groups', in B. Sjåfjell and C.M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge University Press, 2019), Ch. 14.

[122] J. Salminen, 'Sustainability and the move from corporate governance to governance through contract', in B. Sjåfjell and C.M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge University Press, 2019), Ch. 5.

[123] B. Sjåfjell, 'Dismantling the Legal Myth of Shareholder Primacy: The Corporation as a Sustainable Market Actor' in N. Boeger, C. Villiers (eds.), Shaping the Corporate Landscape. Towards Corporate Reform and

convergence of crises we face, a legislative reform is also required to facilitate and ensure that business partakes in the transition to sustainability. The financial risks of unsustainability, directly impacting on the productivity of business, underline that this is necessary also from a conservative economic point of view.[124] We know it is inadequate to rely solely on the strengthening of compartmentalised specific legislation on environment, product safety and labour, both national and international,[125] or on sustainability reporting as a driver for change.[126] We also know that competing social norms are insufficient,[127] and we cannot rely on self-regulation or voluntary improvement.[128] Rather we draw on international 'soft law' norms, notably the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles for Business and Human Rights as best practice for what legislative reform should contain.[129]

A law reform must find a balance between being principles-based and open and at the same time firm enough, with clear boundaries within which a continuous improvement process can take place, with room for development based on new scientific knowledge as well as best practice evolving amongst business. It must attempt to encompass the complexity and opacity of business through locating responsibility for systems of business within single legal entities of companies. It must go beyond permissiveness to duties and beyond mere reflexive regulation to public enforcement.

It must accordingly go beyond clarifying the scope that corporate law, with variations across jurisdictions, gives the corporation to shape its own purpose and direction.[130] More or less expressly formulated permissive regulation – typically allowing the corporate decision-makers to take other interests than those of the shareholders 'into account'[131] – are insufficient in the face of the shareholder primacy drive. More innovative reforms such as the South African Social and Ethics Committee arguably illustrate, through the struggle of recognition of this as a committee on board level,[132] that instead of add-ons it is time to reform the very core of the corporate law, which shapes corporate governance: the purpose of the corporation and the role and duties of the corporate board.

The urgency of a harmonised legislative reform in Europe, is underlined by the unfortunate acceptance of the legal myth of shareholder primacy, which in some cases informs counterproductive legislative initiatives. For example, the Commission-appointed Informal Group of Company Law Experts a few years ago suggested that EU law should be changed to allow Member States to allow businesses to include in their articles of association that boards can have a long-term

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Enterprise Diversity, (Shaping the Corporate Landscape. Towards Corporate Reform and Enterprise Diversity, 2018).

[124] See Section 2 above.

[125] [Add ref re the limitation of external regulation]

[126] [Add ref re limitation of reporting.]

[127] Sjåfjell and Taylor, 'Clash of Norms'.

[128] Add refs

[129] Add refs.

[130] Sjåfjell, Johnston, Anker-Sørensen, and Millon, 'Shareholder Primacy'; Bruner and Sjåfjell, 'Corporate Law, Corporate Governance and the Pursuit of Sustainability'.

[131] Or 'have regard to' them, as is mandated in the UK Companies Act s. 172, which simultaneously subordinates these other interests to shareholder interests; see A. Johnston, 'Market-Led Sustainability through Information Disclosure' The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability, (Cambridge University Press, 2019).

[132] T.H. Mongalo, 'The Social and Ethics Committee: Innovating corporate governance in South Africa', in B. Sjåfjell and C.M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge University Press, 2019).

and broad perspective.[133] The implication then is of course that this is not allowed today, which is contrary to European company law properly interpreted.

A further example of counterproductive legislative initiatives, is the rise of B Lab informed initiatives. Informed by a wrongful perception that shareholder primacy is the law in a number of countries, the B Lab movement is actively seeking to change legislation around the world to facilitate a specific legal form – the benefit corporation. It has succeeded to do so in Canada, where the benefit corporation now enacted in company law is a legal form that provides less support for a shift to sustainable business than ordinary companies do.[134] In Europe, it has also succeeded in doing so in Italy,[135] and is working to lobby legislators in other European countries too. The benefit corporation is a much too weak regulatory initiative to achieve the desired result of transitioning business towards sustainability. More broadly, while social entrepreneurship may offer some interesting examples of alternative approaches to business,[136] if we do not also reform mainstream company law, we risk that the attention to social enterprises serves as a deflection device away from the necessity to reform mainstream companies – and especially when this is done in a way that tends to reinforce the social norm of shareholder primacy.[137]

## 5.3 Sustainable value creation within planetary boundaries

To transition towards sustainability requires innovate solutions, informed by transdisciplinary and transnational perspectives, in order to achieve a transformation of business. Corporate sustainability requires more than resource-efficiency and recyclability, and a minimalist 'do no harm' business respect of human rights; the full cycle of products, processes and services of business must be designed and carried out with the aim of contributing to staying within planetary boundaries and securing the social basis for people and communities across global value chains. This includes issues such as living wages and not undermining the economic bases of welfare states, whether they are well-established or weak.[138]

The challenge is to encompass as much as possible of this in a company law reform. Just as the dominance of shareholder primacy shows what we must explicitly regulate to push back against, knowledge about the existential risk we all share, our vulnerability as humanity interconnected in complex socio-ecological systems, and the systemic reasons for extreme variations in resilience in space and time, indicate what and who we must explicitly regulate to protect.

Based on our research, in the redefinition of the corporate purpose and the role and duties of the board, the two key concepts should be 'sustainable value' and 'planetary boundaries'. Accordingly,

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[133] [Add ref.]
[134] C. Liao, 'B.C. MLAs should recognize "benefit corporation" is an American branding exercise', *The Globe and Mail*, 21 Oct. 2018, www.theglobeandmail.com/business/commentary/article-bc-mlas-should-recognize-benefit-corporation-is-an-american/.
[135] A. Bartolacelli, 'The Unsuccessful Pursuit for Sustainability in Italian Business Law' (December 2019).
[136] See C. Liao, 'Social enterprise law: friend or foe to corporate sustainability?', in B. Sjåfjell and C.M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Ch. 46; V. Pönkä, 'The cooperative as a platform for sustainable business operations', in B. Sjåfjell and C.M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Ch. 48.
[137] Also, even if social enterprises do become influential enough, there is a danger that they may be corporatized, as the argument is that cooperatives have been, although this trend may now be shifting, see H. Henrÿ, 'Trends and Prospects of Cooperative Law', in D. Cracogna, A. Fici and H. Henrÿ (eds.), *International Handbook of Cooperative Law* (Heidelberg: Springer, 2013), pp. 803-823.
[138] S. Darcy, '"The Elephant in the Room": Corporate Tax Avoidance & Business and Human Rights' (2017) 2 *Business and Human Rights Journal* 1–30. See further below in Section 5.4.

corporate purpose as a legal concept could be formulated as creating 'sustainable value within planetary boundaries'. In the articles of association or equivalent documents a more detailed purpose, specific to the business of the undertaking may be formulated, within the overarching purpose as expressed in the above paragraph.

Sustainable value creation is an emerging concept in corporate law and corporate governance,[139] which in the context of a corporate law reform needs to engage with a research-based concept of sustainability. Strong, or real, sustainability is an integrated, dynamic, interconnected and complex aim.[140] The goal of creating 'sustainable value', as a redefinition of corporate purpose, must reflect the multifaceted and interconnected environmental, social, cultural, economic and governance aspects of securing the social foundation for humanity. Translated into the governance of business, this encompasses issues such as fair treatment of employees as well as of workers and local communities across global value chains, with respect for international human rights and core ILO conventions as a minimum,  ensuring a 'living wage' and safe working conditions. This further entails supporting democratic political processes and as a minimum not undermining these through engaging in corporate capture of regulatory processes. It also entails contributing to the economic basis of the societies in which the business interacts by not engaging in so-called aggressive tax planning and outright evasion.

Transplanting the concept of planetary boundaries into company law and thereby into corporate governance has the potential of significance on three levels: firstly and most importantly, it brings to the forefront that there are ecological limits (conversely, that being perceived as 'environmentally friendly' is totally inadequate).

Secondly, it highlights the complex interaction between planet-level environmental processes and that for example climate change, however topical (and difficult to mitigate), is only one aspect of the convergence of crises we are heading directly into.

Thirdly, it continuously reminds us that state-of-the-art natural science must continue to inform our decisions on a work-in-progress-basis. For corporate decision-makers it therefore should stress the

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[139] Examples include: the 2017 revision of the Australian Council of Superannuation Investors (ACSI) Governance Guidelines, emphasising board oversight of 'sustainable, long-term value creation'; V. Schnure Baumfield, 'The Australian paradox: conservative corporate law in a progressive culture', , in B. Sjåfjell and C.M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Ch. 12; the German Corporate Governance Code on the duty of the Management Board to manage the company 'in the best interests of the company … with the objective of sustainable value creation'; A. Rühmkorf, 'Stakeholder value versus corporate sustainability: company law and corporate governance in Germany', in B. Sjåfjell and C.M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Ch. 17; the increased emphasis in the 2016 revision of the Dutch Corporate Governance Code on acting 'in a sustainable manner by focusing on long-term value creation'; A. Lafarre and C. Van der Elst, 'Corporate sustainability and shareholder activism in the Netherlands', in B. Sjåfjell and C.M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Ch. 19. Also the new Belgian corporate governance code is based on sustainable value creation, see Corporate Governance Committee, The 2020 Belgian Code on Corporate Governance. A majority of stewardship codes also describe stewardship as connected to 'the creation of long-term sustainable value', D. Katelouzou, 'Shareholder stewardship: a case of (re)embedding institutional investors and the corporation?', in B. Sjåfjell and C.M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*,  Ch. 41.

[140] Sjåfjell and Bruner, 'Corporations and Sustainability', in B. Sjåfjell and C.M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Ch. 1.

unacceptability of ignorance in the face of these severe environmental risks and the necessity of a knowledge-based precautionary approach.

As a matter of company law, the corporate board has a crucial role in determining the strategy and the direction of the undertaking, and supervising how this plays out.[141] As also the European Commission has observed also earlier, boards have a 'vital part to play in the development of responsible companies'.[142] To operationalize the proposed redefined purpose it would therefore need to be integrated into the duties of the board, which should clarify the board's duty to adopt and implement a system for this purpose that encompasses all of the company's areas of business and the full life impacts of its products, services and processes. This should be done in a principle-based manner, while being specific enough on the aspects where correction from the current trajectory is most needed. This will include a duty to commit to the overarching purpose of sustainable value creation within planetary boundaries, adjusting the business model of the undertaking, where necessary, and develop a strategy to implement the purpose throughout the business and its internal control and risk management systems, including, where relevant, its global value chains.

We further propose that the board shall ensure that a stringent sustainability assessment is undertaken at regular intervals (e.g. every three years), including sustainability due diligence – encompassing environmental, social and governance impacts – and including open and participatory processes with affected communities and persons. This would give a basis for rectifying lack of legal compliance and for a continuous improvement process towards the overarching purpose, on which the undertaking annually shall report as a part of the management report. We propose that the regular assessment be subject to assurance requirements and the annual reporting be subject to full audit.

Through these requirements, which we suggest to be enforced through both public and private means, the potential of sustainability reporting as a driver for change can be realized, through a significant improvement in the relevance and reliability of the reported information.

We also propose Commission guidelines on assessment and reporting, assurance and audit, which would replace the current separate two sets of Commission guidelines on 'non-financial' reporting. We suggest changes to other parts of the EU secondary legislation to support and reinforce the reform proposal above and remove other barriers to change. For SMEs we will suggest a scalability of the board duties. For the listed companies, we will propose changes in securities legislation to reinforce the suggested changes in company law and remove barriers to the shift to sustainability, including changes to the 2004 Directive on Takeover Bids and the 2017 Directive on Shareholder Rights.

## 5.4 Sustainable value creation to contribute to securing the social foundation

The basis for the social foundation, the minimum requirement, is that of securing fundamental human rights. Yet, the criticism against the human rights movement may indicate that it has not

[141] The 'board' is used in this report as a general term encompassing both levels of boards in countries where there is a supervisory board and a management board, such as the German *Aufsichtsrat* and *Vorstand*.

[142] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, *A renewed EU strategy 2011-2014 for Corporate Social Responsibility*, COM(2011) 681 final, at 5-6.

done enough to mitigate the most detrimental impacts of global business.[143] Discussing human rights in the context of sustainability, of securing the social foundation of humanity, gives rise to the question of whether protecting human rights – including socio-economic rights – is sufficient.

Employing the planetary boundaries framework does not mean that sustainability is merely about safeguarding the ecological limits of a *safe* space for humanity. It is also about 'questions of justice and inequality relating to global patterns of consumption and production, resource allocation, benefit distribution, and so on'[144] – in other words, securing a *just* space for humanity. While planetary boundaries is a science-based environmental ceiling, the basis for the social foundation as launched by Kate Raworth, is the political consensus of which aspects were important in the adoption of the United Nations Sustainable Development Goals.[145] As also Raworth emphasises, the minimum requirement intrinsic in securing the social foundation of humanity now and in the future is that of ensuring the realization of basic human rights.[146] Human rights as set out already in the Universal Declaration of Human Rights of 1948, include the right to life (and thereby to sufficient water, food and medicine); the right to not be held in slavery or servitude; the right to equality and not to be discriminated against; and the right to work and to 'just and favourable conditions' of work, including remuneration ensuring for workers and their families 'an existence worthy of human dignity'.[147] According to Samuel Moyn, the United Nations through this milestone document 'consecrated the democratic welfare state … It thereby did more than simply enshrine the ideal of *distributive sufficiency* that the declaration explicitly defined in its series of basic entitlements; it also reflected the ambitious political enterprise of *distributive equality*'.[148] However, socio-economic rights have remained in the shadow of civil and political rights, together with the emphasis on distributive equality as an intrinsic element of social justice that Moyn emphasised as linked to the post World War II idea of the welfare state.[149]

Turning to the UNGPs, [150] we see that 'internationally recognised human rights' as the 'benchmarks against which other social actors assess the human rights impacts of business enterprises',[151] refer as

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[143] E.g. L. J. Kotzé, 'The Anthropocene, Earth system vulnerability and socio-ecological injustice in an age of human rights' (2019) 10 *Journal of Human Rights and the Environment* 62–85. At 73-75.
[144] L. J. Kotzé and R. E. Kim, 'Earth system law: The juridical dimensions of earth system governance' (2019) *Earth System Governance* 100003., pp. 7-8.
[145] United Nations General Assembly resolution 70/1, *Transforming Our World: The 2030 Agenda for Sustainable Development*, A/RES/70/1 (25 September 2015), available at: www.undocs.org/A/RES/70/1. K. Raworth, 'A safe and just space for humanity: can we live within the doughnut' (2012) *Oxfam Discussion Papers*; M. Leach, K. Raworth, and J. Rockström, 'Between social and planetary boundaries: Navigating pathways in the safe and just space for humanity', in *World Social Science Report 2013: Changing Global Environments* (Paris: OECD Publishing, 2013), pp. 84–90.
[146] Raworth, 'A safe and just space for humanity'; 'Human Rights and the 2030 Agenda for Sustainable Development', United Nations Human Rights Office of the High Commissioner (undated), www.ohchr.org/en/issues/SDGS/pages/the2030agenda.aspx.
[147] The Universal Declaration of Human Rights (UDHR), proclaimed by the United Nations General Assembly in Paris on 10 December 1948 (General Assembly resolution 217 A), Articles 3 and 25, 4, 2 and 7, and 23, respectively [CHECK whether I should cite more of these]. For an analysis of the SDGs from a human rights perspective, see L.M. Collins, 'Sustainable Development Goals and human rights: challenges and opportunities', in D. French and L.J. Kotzé (eds.), *Sustainable Development Goals. Law, Theory and Implementation* (Cheltenham: Edward Elgar 2018), pp. 66-90.
[148] S. Moyn, *Not enough: human rights in an unequal world* (The Belknap Press of Harvard University Press, 2018). pp. 13-14. Emphasis added.
[149] Ibid.
[150] UNGPs Principle 12.
[151] UNGPs Principle 12, commentary.

a minimum to those expressed in the International Bill of Human Rights. These include the Universal Declaration of Human Rights and its main instruments of codification: the International Covenant on Civil and Political Rights and the International Covenant on Economic, Social and Cultural Rights,[152] as well the principles concerning fundamental rights set out in the eight ILO core conventions as set out in the International Labour Organization's Declaration on Fundamental Principles and Rights at Work.[153]

In a similar way as the science basis for the concept of planetary boundaries must continuously evolve in light of new understanding of what is 'safe', attempts at defining and pursuing the social foundation must be rigorously interrogated in light of what is 'just', which cannot be exhaustively defined by the SDGs nor by a minimalistic approach to human rights. We therefore must look also beyond human rights in defining the social foundation, albeit also arguably to the roots of human rights: to 'human dignity', as intrinsic to a *just* space for humanity.

Securing the social foundation for humanity is accordingly a range of interconnected issues. Amongst the pivotal aims must also be that of 'decent work', advocated in the ILO 2008 Declaration.[154] This is reiterated and expanded on in the ILO 2019 Global Commission Report,[155] which resists the 'commodification of labour by seeking to revitalise the voice of everyone, regardless of the types of work they do or how they are hired'.[156] This is relevant for workers employed by large businesses as it is for small- and medium-sized entrepreneurs across the global value chains.

The interconnectedness between environmental, social, cultural, economic and governance aspects of sustainability merits emphasis:

> [C]ommon social justice issues such as crumbling neighborhood infrastructure and poor access to open space and fresh food are environmental issues from the perspective of residents living in corroding and toxic neighborhoods, but these issues have traditionally

[152] UNGPs Principle 12, commentary.

[153] UNGPs Principle 12, commentary. These eight conventions are: Convention Nos. 87 and 98 on freedom of association and collective bargaining (1948 and 1949); Conventions Nos. 29 and 105 on the elimination of all forms of forced and compulsory labour (1930 and 1957); ILO Convention No. 138 on the minimum age for admission to employment (1973); and ILO Conventions Nos. 100 and 111 on the elimination of discrimination in respect of employment and occupation (1957 and 1958), and the 1999 ILO Convention No. 182 on the worst forms of child labour. These have been criticised as merely promoting 'civil and political rights (and even just a selection of these), while moving away from insistence on broader socio-economic entitlements', Novitz, 'Past and Future Work at the International Labour Organization', with further reference.

[154] In a Polanyian analysis, the ILO Declarations may be said to reflect 'countermovement to market dominance', i.e. as a part of a 'continued attempt to navigate (and reconcile insofar as this is ever possible) conflicting market and social pressures', Novitz, 'Past and Future Work at the International Labour Organization' at p. 1 and 3, with further references. T. Novitz, 'Engagement with sustainability at the International Labour Organization and implications for worker voice' (Fothcoming) *International Labour Review*. T. Novitz, 'Engagement with sustainability at the International Labour Organization and implications for worker voice', *International Labour Review* (forthcoming).

[155] International Labour Organization (ILO) Global Commission on the Future of Work, *Work for a brighter future* (ILO, 2019), Report issued 22 January, 2019, which repeatedly emphasises that labour 'is not a commodity' with reference to the aim of sustainability and advocating 'sustainable work'; Novitz, 'Past and Future Work at the International Labour Organization'.

[156] Novitz, 'Past and Future Work at the International Labour Organization'.

> been overlooked by a sustainability agenda that tends to focus on 'green' issues of ecosystem conservation rather than 'brown' issues of urban inequality.[157]

There are tensions inherent in global society's goal of sustainability, including the risk that the most marginalized groups will not be sufficiently included in participatory processes, [158] notably excluding indigenous peoples[159] and other vulnerable groups. An emphasis on vulnerability arguably resonates with the Commentary to the UNGPs Principle 12, cited above, which emphasises that business 'may need to consider additional standards'. These concern, according to the Commentary, the human rights of 'specific groups or populations that require particular attention', elaborated on in United Nations instruments regarding the 'rights of indigenous peoples; women; national or ethnic, religious and linguistic minorities; children; persons with disabilities; and migrant workers and their families'.[160] However, employing a vulnerability lens in the Anthropocene entails understanding that we are all vulnerable but not all equally resilient, that vulnerabilities will shift through 'destabilization processes we are witnessing in the Anthropocene and its changing socio-ecological conditions',[161] and that this calls for an analysis that addresses also the 'causally interdependent structural causes of socio-ecological justice globally', and that is 'more inclusive and attentive refusing to shut out complexities and connections that might otherwise go unaccounted for'.[162]

The social inequality within and across countries is a fundamental sustainability challenge. The economic basis of our societies (of our welfare states) is also crucial to securing the social foundation, and this pertains both to the possibility of ensuring 'distributive sufficiency', to the basis of good lives, and to 'distributive equality'. This underlines that a 'safe and just' social foundation for humanity within planetary boundaries is not something that is here now, which we (merely) need to protect. It is something that we must transition towards, with appropriate policy measures informed by interconnected complexities of the social-ecological systems of our Earth.

As an intrinsic element of the transition must be included participatory aspects of the social foundation,[163] of workers, regarding of their labour law status, and of affected communities,

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[157] R.H.W. Boyer, N.D. Peterson, P. Arora and K. Caldwell, 'Five Approaches to Social Sustainability and an Integrated Way Forward' (2016) 8 *Sustainability* 878.

[158] Achieving sustainability 'requires exploration of and debate about which combinations of pathways to pursue at different scales', and this process 'will need to be as open and inclusive as possible, giving voice to the knowledge, values and priorities of women and men who are marginalised, so that they are able to challenge powerful groups and interests'. Leach, Raworth and Rockström, 'Between social and planetary boundaries', at 88.

[159] That the cultural rights of indigenous peoples often are ignored is also a long-term criticism against sustainable development. See e.g. D. Weissbrodt and M. Rumsey (eds.), *Vulnerable and Marginalised Groups and Human Rights* (Cheltenham: Edward Elgar, 2011); Collins, 'Sustainable Development Goals and human rights' at 87-88; R. Madden and C. Coleman, 'Visibility of indigenous peoples in sustainable development indicators', working paper presented at 16th Conference of the International Association of Official Statisticians (IAOS) OECD Headquarters, Paris, France, 19-21 September 2018, www.oecd.org/iaos2018/programme/IAOS-OECD2018_Madden-Coleman.pdf.

[160] UNGP Principle 12, Commentary. Also, in cases armed conflict, the Commentary emphasises that business should respect the 'standards of international humanitarian law', ibid.

[161] Kotzé, 'The Anthropocene, Earth system vulnerability and socio-ecological injustice in an age of human rights'. p. 77.

[162] Ibid.

[163] T. Novitz, 'Engagement with sustainability at the International Labour Organization and implications for worker voice', *International Labour Review* (forthcoming). Concerning some of the challenges involved, see also I. Scoones, 'The Politics of Sustainability and Development', *Annual Review of Environment and Resources* Vol. 41:293-319 (Volume publication date November 2016).

including indigenous peoples and ensuring that all affected are fully involved. And yet, we must avoid merely replacing the 'shareholder' in shareholder primacy with 'stakeholder'. While involving affected communities, trade unions, and civil society is crucial, a mere canvassing of 'stakeholder interests' and given priority to the ones that make themselves heard the most is insufficient. The backdrop must always be the interconnected complexities and the vulnerability of the often unrepresented groups (whether invisible workers deep in the global value chains, indigenous communities, or future generations), and the aim of the 'safe and just' space for humanity, now and in the future, within planetary boundaries.

## 5.5 Taking sustainability reporting seriously

The EU's 'Non-financial' reporting directive of 2014[164] (through which Article 19a was added to the Accounting Directive of 2013[165]) was an important follow up to open the space for a discourse on how to report on the sustainability impacts of business. It aimed to ensure that the largest listed companies disclose 'the impact of [their] activity, relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters',[166] also with the view to facilitating responsible investment. The EU perceived this reporting as 'vital to managing change towards a sustainable global economy by combining long-term profitability with social justice and environmental protection'.[167]

At the same time provisions in Article 19 of the Accounting Directive on management report remained intact. The EU introduced already in 2003 requirements in the Fourth and Seventh Directive of information relating to environmental and employee matters, now in Article 19(1)(3) of the Accounting Directive.[168] Rules in Article 19 are however also weak, requiring information only 'to the extent necessary for an understanding of the undertaking's development, performance or position' and 'where appropriate'.

The lack of stringency in both Article 19 and Article 19a, as well as lack of verification requirements (for the non-financial statement leaving the choice for verification requirements to Member States) have meant that it has remained difficult for businesses attempting to be sustainable, to show this to

[164] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups.
[165] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC.
[166] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC as amended by Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, Article 19a.
[167] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, Recital 3.
[168] Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings.

their potential contractual parties and society at large.[169] Further, by not confronting the social norm of shareholder primacy, the chasm remains between the perceived role and duty of the board and management (to maximise returns for shareholders), and these 'non-financial' issues that boards and management are asked to report on. This chasm constitutes a barrier to the internalisation of environmental, social and economic sustainability in the corporate decision-makers.

It has also remained possible for unsustainable businesses to greenwash – or now, SDG-wash. That the unsustainable businesses thereby still often have the competitive advantage is especially detrimental for European companies who have the potential of becoming the market-leaders of tomorrow if they have a regulatory framework that support their attempts at creating value in a sustainable way. The recent assessment of sustainability reports form 1000 companies across the EU by the Alliance for Corporate Transparency shows clearly the insufficiency of non-financial reporting.[170]

The researchers in the SMART project have assessed the reporting by allegedly sustainability-oriented businesses done inter alia on the basis of the Global Reporting Initiative[171] and Integrated <IR> Framework, and we have found massive shortcomings in the reporting. [172] This confirms the results of previous analyses.[173]

Member States could have taken the opportunity that the 2014 Directive gave them to strengthen sustainability reporting requirements. Instead, it led to an unfortunate reversal of requirements, with for example Norway (as an EEA country) removing pre 2003 Directive sustainability reporting requirements that it already had in place for all companies expect for the largest ones, and for Finland to remove the auditing requirement that it had for management reports.[174] These two examples only illustrate the necessity of harmonisation of stringent and clear requirements on the EU level.

Our reform proposals connect the purpose of the undertaking with the duties of the board and further with its reporting requirements, bridging the chasm that for too long has undermined the potential of sustainability reporting. We also suggest changes that will ensure assurance of the information provided by business by broadening the scope of legal auditing, as we believe it is time that we take issues concerning the treatment of people, the protection of the environment and the safeguarding of the economic bases of our societies as seriously as we for decades, if not centuries, have taken financial issues in the narrow sense.

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[169] See C. Villiers and J. Mähönen, 'Article 11: Integrated Reporting or Non-Financial Reporting?' in B. Sjåfjell and A. Wiesbrock (eds), *The Greening of European Business under EU Law - Taking Article 11 TFEU Seriously* (Abingdon: Routledge, 2015), pp. 118–143; J. Mähönen, 'Integrated Reporting and Sustainable Corporate Governance from European Perspective (2020) *Accounting, Economics and Law: A Convivium*, https://doi.org/10.1515/ael-2018-0048.

[170] ADD REF

[171] https://www.smart.uio.no/news/textile-companies-lack-information-about-their-var.html [add full ref].

[172] See C. Villiers and J. Mähönen, 'Article 11: Integrated Reporting or Non-Financial Reporting?' in B. Sjåfjell and A. Wiesbrock (eds), *The Greening of European Business under EU Law - Taking Article 11 TFEU Seriously* (Abingdon: Routledge, 2015), pp. 118–143; J. Mähönen, 'Integrated Reporting and Sustainable Corporate Governance from European Perspective (2020) *Accounting, Economics and Law: A Convivium*, https://doi.org/10.1515/ael-2018-0048.

[173] ADD ref

[174] See Auditing Act of 2015 § 3:1 (1141/2015) repealing Auditing Act of 2007 § 3:1 (459/2007)

As we outline in Section 2 above and in the Finance Report, neglecting these issues pose serious financial risks to the businesses themselves, thereby closing the loop. The EU has had in its accountancy law had rules since 2003 concerning the inclusion of financial risks of environmental and social issues in the financial accounts of business, without the desired effect. This further underlines the need for mandatory, comprehensive and clear rules.

## 5.6 Competitiveness and scalability for SMEs

We suggest not to limit the reform to companies but also to include all forms of undertakings. The EU has the competence to harmonise national company laws to attain freedom of establishment (Article 50 of the TFEU) or approximate legislation to ensure the proper functioning of the internal market (Article 114 of the TFEU), including financial institutions, domiciled in a EU or EFTA Member State, with limited liability for its members. Similarly, our proposal applies to undertakings of all sizes, including small and medium-sized enterprises (SMEs). Besides companies, our proposa encompasses also cooperatives and other undertakings with limited liability for the members.

We are not proposing exemptions based on the size of the undertaking or of its market position (listed or non-listed), or based on sectors or industry, such as institutional investors and other financial market participants,  insurance or banking, as it is in the present company law regulation, eg. in Company Law Directive or Accounting Directive. We believe that including size, market or industry based thresholds for which undertakings should be subject to the rules we propose will be detrimental for three reasons:

Firstly, large businesses are often organised across a network of small, medium-sized and large legal entities, whether through corporate groups or various types of other networks and platforms, or contractually including through value chains. We do not want to make proposals that will encourage further a fragmentation of responsibility across such business enterprises. To the contrary, what we are proposing is that a life-cycle based approach is taken which entails a parent company or lead company should consider its business enterprise as a whole when following up on the new company law and accounting law regime that we are proposing. The role of smaller legal entities in a corporate group, for example, will then be to contribute to the sustainability assessment and sustainability due diligence of the parent company. The same applies to members in a value network, as subcontractors, compared to the controlling entity in the network. This is comparable to what controlled entities do in the context of consolidated management reports, but is wider, and not so vulnerable to decoupling activities to escape liabilities.[175] For its regulatory weaknesses, the approach of consolidation is not sufficient to capture all types of control across business enterprises,[176] and we do therefore not wish to promote such formal distinctions either. Rather, by making the duties we propose applicable to all business entities, we expect those that are working together, whatever the formal connection, will contribute to facilitating the sustainability assessment and the sustainability due diligence, and give a basis for meaningful sustainability reporting.

Secondly, excluding undertakings under a certain threshold would mean taking opportunities away from SMEs, which constitute a significant part especially of the European economy.[177] Due to their vast number, a majority of *importers and exporters* in the EU are SMEs and within the group of SMEs the majority are micro-sized enterprises, followed by small and then by medium enterprises. For

[175] ADD refs
[176] ADD refs to Anker-Sørensen.
[177] J. Mähönen, SMART working paper on SMEs. Draft on file with current authors.

example, in Germany, SMEs are referred to as the *Mittelstand* and they are considered to be the backbone of the German economy.[178] Achieving a Just Transition in Europe entails channelling the potential of entrepreneurship across Member States. SMEs must then be included with sufficient resources dedicated to facilitating the transition of all of European business to sustainability. That is how European businesses, including the smallest of them, can be in the market and
from SMEs, which constitute a significant part especially of the European economy.[179] Due to their vast number, a majority of *importers and exporters* in the EU are SMEs and within the group of SMEs the majority are micro-sized enterprises, followed by small and then by medium enterprises. For example, in Germany, SMEs are referred to as the *Mittelstand* and they are considered to be the backbone of the German economy.[180] Achieving a Just Transition in Europe entails channelling the potential of entrepreneurship across Member States. SMEs must then be included with sufficient resources dedicated to facilitating the transition of all of European business to sustainability. That is how European businesses, including the smallest of them, can thrive in the market and promote sustainable production and consumption, both private and public.

Thirdly, thresholds would disincentivise SME-driven innovations for sustainability. A correlation between sustainable social organisation and innovation is characteristic for SMEs and that is what makes them special. Collective 'social capital' is important to sustainable businesses regardless of the economic sector in which they develop or the philosophy that drives their development. Sustainable enterprises are built slowly by groups of people who collaborate over many years and not through the deliberate agency of visionary or 'charismatic' leaders or entrepreneurs.[181] In its Reflection Paper on harnessing globalization, the European Commission emphasised the quality of goods and services as the competitive edge of exporting European SMEs that count over 80 per cent of European exporting firms in numbers.[182] The societal importance of SMEs for Europe is crucial too: they employ the most of European workers and contribute to local economies through their supply chains and tax payments.[183] We therefore propose fully including the SMEs and rather scaling the duties while proposing that the EU provides resources directed specifically to the SMEs in the transition.

# 6 The reform proposals

## 6.1 Shifting trade and investment towards sustainability

To ensure that international trade and investment contributes to and does not prevent sustainable business, we make the following six proposals:

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[178] 'German lessons: Many countries want a *Mittelstand* like Germany's. It is not so easy to copy', *The Economist*, 12 July 2014 (available at: http://www.economist.com/news/business/21606834-many-countries-want-mittelstand-germanys-it-not-so-easy-copy-german-lessons) (accessed 22 November 2017
[179] J. Mähönen, SMART working paper on SMEs. Draft on file with current authors.
[180] 'German lessons: Many countries want a *Mittelstand* like Germany's. It is not so easy to copy', *The Economist*, 12 July 2014 (available at: http://www.economist.com/news/business/21606834-many-countries-want-mittelstand-germanys-it-not-so-easy-copy-german-lessons) (accessed 22 November 2017
[181] Ridley-Duff, 'Communitarian Perspectives', 383.
[182] European Commission, Reflection Paper on Harnessing Globalisation, COM(2017) 240 of 10 May 2017, p. 7, https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-globalisation_en.pdf.
[183] European Commission, Reflection Paper on Harnessing Globalisation, COM(2017) 240 of 10 May 2017, p. 7, https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-globalisation_en.pdf.

### 6.1.1 Implementing external trade policies in a sustainable way

We propose that the EU identifies the synergies between the different SDGs and seeks to implement its external trade policies in a manner that recognises the intersection(s) between the economic, social and environmental dimensions of sustainable development.

We note that the statement in the Commission Communication that a 'European Green New Deal' is to be 'an integral part of this Commission's strategy to implement the United Nations' 2030 Agenda and the sustainable development goals'.[184] This requires, we suggest, both an understanding of the synergies, namely the dynamic connections between SDGs within a planetary boundaries framework, and how this could affect the design and implementation of trade conditionality.

In our view, in the light of the dynamic interlinkages between the SDGs identified above (in part 6.1 of this Report) and the idea of 'policy coherence', stressed in SDG targets 17.13 and 17.14, it is not appropriate for any FTA to treat as entirely distinct economic, social and environmental objectives. There is a danger of the environmental and economic subsuming the social in chapter 3 of the 'European Green Deal', which is why the further Commission Communication on 'A Strong Social Europe for Just Transitions' is most welcome, and we note in that document, chapter 5 which relates to 'Promoting European values in the world'.[185] We would however prefer to see this as an instantiation of international values reflected in the SDGs, which genuinely ensures an 'appropriate level playing field' in trade. Strengthening dialogue not only with the Western Balkans but more generally (see below) would be helpful here.[186]

As a notion, policy coherence originates from the aid-effectiveness agendas of the EU and Organisation for Economic Cooperation and Development (OECD). Indeed, the principle has guided the actions of the EU for over two decades and is commonly understood to ensure that policies should not harm, but where possible contribute to international development objectives'. This also entails considering the negative spill-over effects of any policies. Article 208(1) of the Treaty on the Functioning of the European Union (TFEU) currently requires the Union and its institutions to 'take account of the objectives of development cooperation in the policies that it implements which are likely to affect developing countries'. Article 208(2) states that 'the Union and the Member States shall comply with the commitments and take account of the objectives they have approved in the context of the United Nations and other competent international organisations', which must be taken to include such as the SDGs, embedding their relevance in EU policy coherence for development (PCD). The difficulty is that the EU's history of 'policy coherence' has not always been so very coherent.

The first *European Consensus for Development* adopted in 2006,[187] stressing the EU's political commitment to PCD was clearly a significant initiative, reflecting the content of an earlier Commission Communication the previous year,[188] which had confirmed the determination of the EU to consider the extent to which PCD was achieved in certain key policy 'priority' areas: trade, the environment, climate change, security, agriculture, fisheries, the social dimension of globalisation, employment and decent work, migration, research and innovation, the information society, transport and energy. At this stage it was thought that 'the effective improvement in the coherence

[184] Communication from the Commission 'The European Green Deal' COM(2019)640 final, 11.12.2019, 2.
[185] Commission Communication, 'A Strong Social Europe for Just Transitions' COM(2020) 14 final, 12.
[186] Ibid.
[187] OJ C 46/1 24.2.2006.
[188] COM(2005)134 final, 3.

of developed countries' policies would put developing countries in a much better position' to achieve the Millennium Development Goals (MDGs) by 2015. But in 2009, a decision was taken to cluster these policy areas around only five 'PCD challenges': trade and finance, climate change, global food security, making migration work for development and strengthening links between security and development.[189] Decent work was gone, despite the recent ILO Declaration of 2008, with only limited work-related issues potentially arising in the sphere of migration. It is fortunate that since the advent of the SDGs (and SDG 8), decent work is receiving renewed protection in the new Consensus on Development was signed in June 2017.[190] The EU has since shifted its approach away from the five strategic PCD challenges and instead seeks to adopt a 'synergies approach' to the implementation of PCD in pursuit of the 2030 Agenda for Sustainable Development. The 'synergies approach' has been reinforced through the Better Regulation Agenda (2015) and the New Consensus on Development (2017). Nevertheless, there remain substantive and procedural issues relating to the process of PCD that have limited its effectiveness in practice.

To achieve human rights protections and sustainable development, labour and environmental standards need to be mainstreamed into the terms of trade. They need to operate as an ongoing limit on trade freedoms claimed by States and private actors. In this respect, a discrete chapter at the end of an FTA titled 'Sustainable Development' or 'Labour' is too weak a device. Instead, labour standards have to be foregrounded in a preliminary section, understood to inform all aspects of the agreement and be actionable by workers and their representatives (whether TUs or NGOs).

The inclusion of stand-alone (and tail-end) chapters on social and environmental issues is problematic for a number of reasons. First, the language used in these agreements is often ambiguous and vague. In the context of social clauses, EU FTAs could go further to clarify and enunciate the intersections between the chapters. Second, *even* where sustainable development is identified as a 'horizontal' commitment in the preambular recitals of FTAs, it is not clear how the concept of sustainable development is to inform the interpretation of the clauses and chapters. This could always be further clarified by a 'Joint Interpretative Instrument' such as that later appended to the EU-Canada Comprehensive Economic Trade Agreement (CETA). Third, systems of enforcement tend to vary considerably between chapters, as is discussed below and that inconsistency also needs to be addressed.

### 6.1.2 Enhancing enforceability of labour and human rights clauses in FTAs

We propose that the EU enhances the enforceability of labour and human rights clauses in FTAs in its further work on integrating sustainability into FTAs. The linkages between trade and other issues (like labour standards and environmental protection) are well known and the approach of EU FTAs is to use trade as a leverage to raise standards. However, the implementation of EU-FTAs does not always lead to an improvement of social and environmental standards. Mainstreaming trade to attain sustainable development is a priority of the EU and the WTO but strengthening compliance with sustainability clauses through the existing institutional frameworks established under the FTAs is needed.

[189] COM(2009) 458 final 15.9.2009.

[190] Available at: https://ec.europa.eu/europeaid/sites/devco/files/european-consensus-on-development-final-20170626_en.pdf. See also T. Novitz, 'Social Sustainability, Labour and Trade: Forging Connections' in Pieraccini and Novitz, n.2 above.

In the wake of the suspension of functioning of the World Trade Organisation (WTO) Appellate Body,[191] we agree with the Commission that it becomes imperative for the EU to take appropriate enforcement measures. We note the EU proposed interim appeal arrangements being offered to trading partners,[192] and the appointment of a Chief Trade Enforcement Officer to work under the Commissioner for DG TRADE in 2020.[193] Our suggestions relate in detail to how mechanisms for enforcement could be improved and made more efficacious, which we consider is related to both the idea of policy coherence in SDG 17 and the idea of meaningful participatory and representative engagement in SDG 16, especially access to justice under SDG target 16.3 and ‘responsive, inclusive, participatory and representative decision-making at all levels’ under target 16.7.

*Mechanisms for enforcement*

As noted above, systems of enforcement tend to vary considerably between chapters in free trade agreements (FTAs). In EU agreements, chapters concerning investment, trade and sustainability (whether concerning labour of the environment) contain very different dispute settlement clauses. An example is the Canada-EU Comprehensive Economic Trade Agreement (CETA) where investment disputes (which may raise issues for example of indirect expropriation regarding labour or the environment) are to be addressed under section F of Chapter 8. This can be contrasted with the remedies available to the parties in respect of unfair trade under Chapter 3 (which presumably may be unfair by reason of legitimate State concern with policy objectives listed under Article XX of the General Agreement on Tariffs and Trade (GATT) including labour and environmental issues). All these are also distinct from the provision for ‘dispute resolution’ in Chapter 23 (Trade and Labour) and Chapter 24 (Trade and Environment). Their relationship with the general provision for ‘dispute settlement’ in Chapter 29 could also further be clarified. It has been observed that human rights clauses in EU FTAs receive different treatment again.[194] Some homogenization of approach would enable policy coherence and more effective consistent attention to breach of the SDGs and synergies between sustainable development objectives within a planetary boundaries framework. For now, the process for (and likely success) of a dispute may well turn under which FTA chapter it is heard, regardless of the substantive merits of a case.

*Efficacy of enforcement and voice*

There are clear difficulties in assessing compliance with environmental and labour standards. For example, many countries ratify the ILO Conventions but do not comply with labour standards in practice.[195] The monitoring and implementation of clauses falling in the trade and sustainable development chapters of EU-FTAs tends to be influenced by a civil society mechanism, such as a Domestic Advisory Group (DAG) in the context of labour standards, and ultimately determined by a panel of experts that can examine any complaint and make recommendations to the parties.[196] Other

[191] Statement by Commissioner for Trade Phil Hogan on the suspension of the functioning of the WTO’s Appellate Body, 10.12.19. STATEMENT/19/6712.
[192] Ibid.
[193] Ursula von der Leyen, *A Union that strives for more: My agenda for Europe: Political Guidelines for the next European Commission 2019-2024* (Brussels: 2019), 17; ‘The European Green Deal’, n.2 above, 21; ‘A Strong Social Europe for Just Transitions’, n. xx above, 12.
[194] As discussed in F.C. Ebert, ‘Labour provisions in EU trade agreements: What potential for channelling labour standards-related capacity building?’ (2016) 155(3) *International Labour Review* 407, at 410-411.
[195] E Hafner-Burton*, Making Human Rights a Reality* (Princeton, New Jersey: Princeton University Press, 2013).
196 An exception to this type of arrangement is the EU-CARIFORUM EPA, for which the implementation of the entire agreement is overseen by the civil society mechanism.

parties may also intervene, including the ILO which offers technical assistance and expertise to ensure that contradictions in the application of national labour standards, labour provisions in FTAs, and multilateral obligations are avoided.[197]

There is evidence to suggest that the institutional frameworks to promote dialogue and cooperation in EU-FTAs are not as effective as they could be.[198] For example, in the context of the CARIFORUM-Economic Partnership Agreement the creation of the DAG was delayed while other FTAs, like EU-Korea and EU-Colombia-Peru, have failed to engage constructively with the recommendations of the civil society mechanisms. In the context of the EU-Colombia-Peru FTA[199] and the EU-Vietnam FTA[200] labour standards in the third country were *lowered* on the implementation of some bilateral agreements. To what extent the EU might be accountable for contributing to the lowering of labour standards very much hinges on the effectiveness of the civil society mechanism and the DAG. For this reason, as noted in the SMART Report on Policy Coherence for Development, we advocate addressing the systemic problems identified in respect of DAGs, which would involve: addressing delay in establishing DAGs, facilitating joint meetings between the EU DAG and the DAG in the third country, the need for the chairs of the DAGs to participate in the Trade and Sustainable Development (TSD) Committee meetings, more balanced representation of DAG members, sufficient funding to coordinate the work of the DAG in both the EU and partner country, as well as timely and consistent responses by the Commission to DAG concerns.[201]

### 6.1.3 Advance support for compliance with labour provisions

If FTAs are to be more readily enforceable, then third countries need to be capable of complying with their terms at the outset, namely at the point that they are entered into. We propose that the EU provides support and resources to ensure capacity for compliance with labour provisions prior to conclusion of FTAs with third countries, learns from the lessons of US Obama administrative action prior to conclusion of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

This shift towards overarching sustainability chapters has been controversial with fears that such an approach fails to recognise labour standards as human rights and loses social concerns in amidst the greater emphasis given to environmental concerns. [202] Certainly, there remain concerns with protecting labour standards, whether in discrete chapters like the 'Labour' chapter of the Comprehensive and Progressive Trans-Pacific Partnership Agreement (CPTPP)[203] or Chapter 23 of

197 International Labour Organisation, 'Labour-Related Provisions in Trade Agreements: Recent Trends and Relevance to the ILO' 29 September 2016 GB.328/POL/3.
198 Ebert, n.23 above.
199 A. Marx, B, Lein, & N. Brando, 'The Protection of Labour Rights in Trade Agreements: The Case of the EU-Colombia Agreement' (2016) 50(4) *Journal of World Trade* 587.
200 D. Sicurelli, 'The EU as a Promoter of Human Rights in Bilateral Trade Agreements' (2015) 11(2) *Journal of Contemporary European Research* 230.
201 Opinion of the European Economic and Social Committee on 'Trade and sustainable development chapters (TSD) in EU Free Trade Agreements (FTA)' by Raporteur Tanja Buzek, OJ 227 of 28 June 2018, para. 1.5 - 1.7
202 Lore Van Den Putte and Jan Orbie 'EU bilateral trade agreements and the surprising rise of labour provisions' (2015) 31(3) *International Journal of Comparative Labour Law and Industrial Relations* at 281-282; and Lorand Bartels, *Human rights and sustainable development obligations in EU Free Trade Agreements* (2012) Legal Studies Research paper Series, University of Cambridge Faculty of Law, Paper No. 24/2012 at 1. http://www.academia.edu/1902855/Human_rights_and_sustainable_development_obligations_in_EU_free_trade_agreements.
203 Full text and supplementary information available at: https://www.international.gc.ca/trade-commerce/trade-agreements-accords-commerciaux/agr-acc/cptpp-ptpgp/index.aspx?lang=eng.

CETA attached to an overarching sustainability framework. Our preliminary findings are that it is exceptionally difficult to enforce these chapters in a trade context, as is evident in the view of what 'affects trade' taken in the recent panel findings in the dispute between Guatemala and the US under the Central American Free Trade Agreement (CAFTA).[204]

Rather, as Franz Ebert has observed, it may be preferable to follow a US approach, which prioritises bringing states into compliance prior to brining the agreement into operation.[205] The TPP pre-ratification plans negotiated by the US with Brunei, Malaysia, and Vietnam may have had more effect than any attempt to enforce labour standards under chapter 19 after the fact. Further, he also observes the significance of redistributive aid which enhances capacity of states to engage in labour standard enforcement, so as to make labour provisions meaningful.[206] In this respect, we would support a greater role for DG DEVCO to liaise with DG TRADE, so as to facilitate in advance compliance with labour standards (and environmental protections) as a precursor to concluding an FTA which sought to secure sustainability protections. It may not be sufficient for example, merely to have a 'zero-tolerance approach to child labour',[207] but rather to work also in programmatic forms with non-compliant states to provide meaningful alternatives to the conditions that are drivers of child labour. Once again, we would advocate consultation with civil society in third countries to ensure such programmes are feasible. The ILO programme for the Elimination of Child Labour (IPEC) is illustrative of the ways in which this can be achieved.[208]

### 6.1.4 Explicit protection for non-disputing parties in investment proceedings

We propose that the EU elaborates, in its FTAs, the extent to which the terms in sustainability chapters affect the terms of investor protection in investment chapters. For example, there is scope to clarify further the relationship between Chapter 8 (Investment) and Chapters 22 (Trade and Sustainable Development), 23 (Trade and Labour) and 24 (Trade and Environment) of the Comprehensive Economic Trade Agreement between Canada and the EU. The EU has demonstrated a commitment to promoting and encouraging multi-stakeholder engagement in its consultative processes and has made references to 'corporate social responsibility' in its trade agreements. However, we propose that the EU provides explicit protection for non-disputing parties (such as environmental NGOs and trade unions) to intervene in investment proceedings regarding sustainability issues, offering also where appropriate sources of financial support, such as that provided in the context of WTO dispute settlement for developing countries.

*Clarification of how terms in sustainability chapters affect the terms of investor protection in investment chapters*

We have explained above how the EU could ensure that investment chapters set out in FTAs will in substantive terms and procedural terms ensure respect for sustainable development. To recap, this could be assisted by:

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[204] Final report: http://trade.gov/industry/tas/Guatemala%20%20–%20Obligations%20Under%20Article%2016-2-1(a)%20of%20the%20CAFTA-DR%20%20June%2014%202017.pdf. See for analysis of this case, T. Novitz, 'Rationales for Regulation of Posted Work: Options for a Post-Brexit Model' in Bernard Ryan (ed), *Migrant Labour and the Reshaping of Employment Law* (Oxford: Hart, 2020), forthcoming.
[205] Franz Ebert, 'Increasing the Social Sustainability of Trade Agreements Regarding Labour Standards: Insights from the TPP Experience' in Gammage and Novitz n.12 above.
[206] Ebert, n.23 above.
[207] 'A Strong Social Europe for Just Transitions', n.13 above, 12.
[208] https://www.ilo.org/global/about-the-ilo/how-the-ilo-works/flagships/ipec-plus/lang--en/index.htm.

- Ensuring that sustainability provisions are placed in a preliminary chapter which will apply to the other chapters of an FTA, rather than separately in a 'tail end' of the instrument;
- Unifying and rationalising dispute settlement procedures; and
- Enabling access to justice (SDG 16.3) and 'responsive, inclusive, participatory and representative' engagement (SDG 16.7)

We also note, in this respect, the significance of inclusion of 'a right to regulate' in EU FTAs, such as CETA and implicit restrictions on compensation for indirect expropriation (which may relate to compliance with labour or environmental standards).[209] However, more is possible. For example, we note Amy Man's suggestion that specific reference to sustainable development could be embedded in the text of bilateral investment treaties (BITs) or investment chapters as an explicit reminder that investment will only be protected when provided in a sustainable and equitable manner. She cites Article 10(1) of the China-Tanzania BIT which provides that 'it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures'.[210] Another potential opportunity has been offered by Shamila Dawood who argues for the statement of a principle of 'common but differentiated responsibilities' (CBDR),[211] or its use as an interpretative principle, which would apply to environmental and other social commitments undertaken by developing countries in the context of investment treaties.[212]

*Access of non-disputing parties to investment disputes*

In terms of investor-state arbitration, we note the significance of the CETA initiative for an appellate mechanism and the ongoing discussions taking place at UNCITRAL in this regard.[213] Rather than replicate the extensive attention which EU legal experts within and beyond the Commission have given to this issue, our proposals focus instead on access of non-disputing parties to participation in investment disputes. We note that in the context of the operation of a Sustainable Europe Investment Plan operating within the EU, the Commission acknowledges the importance of social dialogue and engagement with civil society;[214] this is also important in terms of EU engagement with the rest of the world.

To date, amicus curiae participation has been requested in ICSID proceedings[215] in 85 cases with just 14 requests pre-2015 and 71 requests since 2015. Permitting the participation of non-disputing

[209] C. Henckels, 'Protecting Regulatory Autonomy through Greater Precision in Investment Treaties: The TPP, CETA, and TTIP' (2016) 19(1) *Journal of International Economic Law* 27.
[210] A. Man, 'A Critique of the China-Ethiopia and China-Tanzania bilateral investment treaties' in Gammage and Novitz n. XX above, 168-9.
[211] D. French, 'Developing States and International Environmental Law: The Importance of Differentiated Responsibilities' (2000) 49 *International Law and Comp. Law Quarterly* 35; and C.D. Stone, 'Common But Differentiated Responsibilities in International Law' (2004) 98(2) *American Journal of International Law* 276. See also for contemporary perspectives, F. Baetens (ed), *Investment Law within International Law: Integrationist Perspective* (Cambridge: Cambridge University Press. 2013).
[212] S. Dawood, 'The Principle of "CBDR" in BITs to Promote Sustainable Development Strategies while Combating Environmental Degradation' in Gammage and Novitz, n. XX above.
[213] See https://uncitral.un.org/en/working_groups/3/investor-state.
[214] 'The European Green Deal', n.1 above, 16.
[215] https://icsid.worldbank.org/en/Pages/Process/Decisions-on-Non-Disputing-Party-Participation.aspx#

parties is a discretionary power of the tribunal[216] and in total, the tribunal has granted permission in just ten cases, denied permission in seven cases and provided no response to date in the remainder of cases. The request by non-disputing parties (NDPs) to participate in the case has increased since the landmark case of *Foresti v South Africa,*[217] where that ICSID tribunal first granted permission for NDPs to file submissions for consideration by the tribunal.

This was a response to new Rule 37(2) of the ICSID Rules which provides that:

'After consulting both parties, the Tribunal may allow a person or entity that is not a party to the dispute (in this Rule called the 'non-disputing party') to file a written submission with the Tribunal regarding a matter within the scope of the dispute. In determining whether to allow such a filing, the Tribunal shall consider, among other things, the extent to which:

> (a) the non-disputing party submission would assist the Tribunal in the determination of a factual or legal issue related to the proceeding by bringing a perspective, particular knowledge or insight that is different from that of the disputing parties;
>
> (b) the non-disputing party submission would address a matter within the scope of the dispute;
>
> (c) the non-disputing party has a significant interest in the proceeding.

The Tribunal shall ensure that the non-disputing party submission does not disrupt the proceeding or unduly burden or unfairly prejudice either party, and that both parties are given an opportunity to present their observations on the non-disputing party submission.'

This case concerned the legitimacy of positive discrimination measures in South Africa's post-apartheid Black Economic Empowerment (BEE) policies which were put in place to remedy the discriminatory practices of apartheid. New legislation required mining companies to divest themselves of a portion of their assets in order to increase indigenous ownership. The NDPs comprised a coalition of four non-governmental organizations (comprised of the Centre for Applied Legal Studies, the Center for International Environmental Law, the International Centre for the Legal Protection of Human Rights ('INTERIGHTS'), and the Legal Resources Centre (LRC), and a separate petition was made by the International Commission of Jurists. They sought clarification of the relationship between South Africa's human rights obligations and its investment obligations. In order to draft their submissions, the NDPs required evidence from the parties in the case and the tribunal granted redacted access on the basis that this improved the transparency of proceedings. Ultimately, South Africa settled the case by agreeing to reduce the ownership share required for divestment.

Since *Foresti*, the rate of submissions by NDPs has rapidly increased.[218] Most recently, the tribunal granted permission for NDP submission by the European Commission in the case of *United Utilities*[219] to intervene. This was on the basis that the judgment of the Court of Justice of the European Union

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[216] See: *United Utilities (Tallinn) B.V. and Aktsiaselts Tallinna Vesi v Republic of Estonia*, ICSID Case No ARB/14/24, 'Decision on the application for leave to intervene as a non-disputing party submitted by the European Commission' (2 October 2018), para 10.

[217] *Foresti v. Republic of South Africa*, ICSID Case No. ARB(AF)/07/1, Letter Regarding Non-Disputing Parties (Oct. 5, 2009).

[218] https://icsid.worldbank.org/en/Pages/Process/Decisions-on-Non-Disputing-Party-Participation.aspx#

[219] *United Utilities (Tallinn) B.V. and Aktsiaselts Tallinna Vesi v Republic of Estonia*, ICSID Case No ARB/14/24, 'Decision on the application for leave to intervene as a non-disputing party submitted by the European Commission' (2 October 2018).

in *Achmea*[220] has implications for the jurisdiction of the tribunal in the case. This signals a growing interest of NDPs to contribute to the adjudicative processes of investment adjudication.

We would advocate that, given the significance of environmental and labour protections envisaged in SDGs to NGOs and trade unions, that EU investment chapters in FTAs and other investment instruments grant explicit access to NDP submissions on sustainability grounds (in compliance with SDG 16.3 and 16.7), with express entitlements to access also other submissions and evidence in the proceedings insofar as it enables representation of concerns relating to SDGs 1 – 15.

### 6.1.5 Supporting a multilateral approach to promote sustainability

We propose that the EU continues to support a multilateral approach that promotes sustainable development within the World Trade Organization (WTO), alongside its regional trade strategy. This could, for example, involve creating a side-agreement on Article XX of the General Agreement on Tariffs and Trade (GATT) to support sustainable trade and/or encouraging international treaty commitments regarding labour rights, such as the International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families (1990), which many EU States have still not ratified. Multilateral agreements need to be fostered and sought by the EU on environmental, social and economic sustainability issues, which are then utilized as a reference point for trade policy.

We note the statement of the President of the Commission that Europe 'will always look for multilateral solutions' and that she intends 'to lead on updating and reforming the World Trade Organization'.[221] We see a way for this to be done through the conclusion of multilateral agreements which would be a source of reference for Article XX of the GATT and even a potential side agreement to that Article relating more generally to sustainability objectives.

The architecture of the GATT 1994 provides ten 'general exceptions' in Article XX under which a member of the WTO can seek to justify their otherwise GATT-inconsistent measure, for example a restriction placed on the import of products on environmental or labour grounds.

To rely on Article XX as an 'affirmative defence',[222] members must satisfy a two-tier 'necessity test'. First, it is necessary to demonstrate that the measure specifically addresses an issue set out in at least one of the paragraphs of the general exceptions (which relate for example to such issues as 'public policy' and 'prison labour'). Secondly, there must be 'a sufficient nexus between the measure and the interest protected'.[223] Then, the chapeau to Article XX must be satisfied and this requires a Member to demonstrate that the measures does not constitute 'arbitrary or unjustifiable discrimination' or a 'disguised restriction on international trade'. The panel will 'weigh and balance' the contribution of the measure to the objective pursued and have determined that this requires 'a genuine relationship of ends and means between the objective being pursued and the measure at issue'.[224] This assessment is carried out on a case-by-case basis.[225]

[220] Case C-284/16, *Slovak Republic v Achmea B.V.* 2018/C 161/07
[221] Von der Leyen, n.22 above, 17.
[222] *Brazil – Certain Measures Concerning Taxation and Charges* WT/DS472/AB/R, WT/DS497/AB/R of 13 December 2018, Report of the Appellate Body at para 5.83. Discussed in C.E. Foster, 'The Problem with Public Morals' (2019) 10 *Journal of International Dispute Settlement* 622 at 630-631.
[223] *Brazil – Certain Measures Concerning Taxation and Charges* WT/DS472/AB/R, WT/DS497/AB/R of 13 December 2018, Report of the Appellate Body at para 7.516
[224] *Brazil – Retreaded Tyres*
[225] *Brazil – Taxation*, AB para 7.528

In this way, WTO members have sought to justify environmental measures under Article XX(b), which allows for the adoption of unilateral measures 'necessary to protect human, animal or plant life or health'[226] and Article XX(g), which requires a measure to 'relate to' the 'conservation of natural exhaustible resources'.[227] The Dispute Settlement Body (DSB), including panels and (until 10 December 2019) an operative Appellate Body, have been willing to interpret Article XX in the light of international law, including multilateral hard and soft law instruments. Most recently, in the *Brazil – Taxation* dispute, the panel agreed with the view submitted by Brazil that the Millennium Development Goals could serve as evidence of a global commitment to bridge the digital divide and promote social inclusion and, therefore, give weight to Brazil's policy objective to achieve this specific MDG target through digital regulation.[228] Arguably the UN General Assembly Resolution on Agenda 2030 which sets out the foundational SDGs could similarly act as a point of reference. This would also be consistent with the preamble to the foundational WTO agreement.

To date, despite a number of attempts to rely on Article XX as a defence, only one has been successful,[229] indicating that unilateral State measures promoting sustainability are not readily defensible. It remains possible for the EU to argue for a side-agreement on Article XX of the General Agreement on Tariffs and Trade (GATT) to support sustainable trade. This could enable clarity in the application of Article XX. However, it may be difficult to gain the political traction to achieve that agreement, especially given fears of 'developing countries' in the Global South of protectionism based ostensibly on environmental and labour clauses.[230] A more viable plan may be to give force to sustainability standards in GATT Article XX proceedings by greater EU engagement with multilateral treaty commitments regarding labour and environmental rights. For example, encouraging greater ratification of the International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families (1990) might be helpful in this respect. As the European Parliament has also observed, another significant multilateral measure would be achievement of a binding UN Treaty for Transnational Corporations and Human Rights.[231]

## 6.2 Shifting business towards sustainability

### 6.2.1 Redefining the purpose of the undertaking and the duties of its board

As key in our Business reform proposal, is our draft proposal for an amendment of the Company Law Directive 2017,[232] Title I, to add the redefinition of the purpose of the undertaking and the duties of the board in a new Chapter IIA in Title I.

[226] *Brazil-Retreaded Tyres; EC-Asbestos; China-Raw Materials; China-Rare Earths.*
[227] *US-Shrimp; US-Tuna II; China Raw-Materials.*
[228] *Brazil – Certain Measures Concerning Taxation and Charges* WT/DS472/R, WT/DS497/ R Panel Report at para 7.592.
[229] *EC – Measures Affecting Asbestos and Products Containing Asbestos* WT/DS135/AB/R (12 March 2001).
[230] N. Delgado, 'Towards Work Liberalization: The WTO Discourse on Labour Standards and Policy' (2019) 35 *International Journal of Comparative Labour Law and Industrial Relations*, Issue 4, 455; and R.R. Babu, 'Sustainable Development Concept in the WTO Jurisprudence: Contradictions and Connivance' in R. Sarkar and A. Shaw (eds), *Essays on Sustainability and Management: Emerging Perspectives* (Singapore: Springer, 2017), 53-73.
[231] Impact of international trade and EU's trade policies on global value chains, European Parliament resolution of 12 September 2017 on the impact of international trade and the EU's trade policies on global value chains (2016/2301(INI)) at OJ C 337/40.
[232] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law (Text with EEA relevance). Latest consolidated version available here: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02017L1132-20190731

We choose the term 'undertaking' to broaden the scope from 'company' and will also suggest broadening of the scope of the Company Law Directive accordingly, to include any type of undertaking with limited liability. The undertakings applicable in every Member State should be listed in a new Annex III of the Company Law Directive. Annex III should include all the entities listed in present Annex II and all other entities with limited liability in every Member State, such as all cooperative forms.

## *PROPOSAL FOR A NEW CHAPTER II A*
## *Purpose and Governance of Undertakings*

*Article 1*
**Scope**

The coordination measures prescribed by this Chapter shall apply to the provisions laid down by law, regulation or administrative action in Member States relating to the types of undertaking listed in Annex III.

*Article 2*
**The purpose of the undertaking**

1) The purpose of the undertaking is to create sustainable value within planetary boundaries, balancing the interests of its members, other investors, and other involved and affected parties.

2) In the articles of association a more detailed purpose, specific to the business of the undertaking may be formulated, within the overarching purpose as expressed in the above paragraph.

*Article 3*

**The duties of the board**

1) The board shall commit to working to ensure that the undertaking fulfils its overarching purpose, balancing the interests of its members, other investors, and other involved and affected parties. The board shall ensure that the business model of the undertaking is in line with the purpose, and develop and publish a strategy that enables the achievement of this purpose throughout the business, integrating it in the internal control and risk management systems. The strategy shall aim to secure that the full life of the products, processes and services of the business stay within planetary boundaries, employing best available knowledge and technology; it shall serve to promote good governance, decent work and equality, support and protect human rights of its workers and affected communities and people.

2) To this end, the board shall, every three years or more frequently in case of fundamental changes to the business model, ensure that a stringent sustainability assessment is carried out of the business of the undertaking. This shall include employing sustainability due diligence across the operations of its business, which shall cover:

a) environmental issues, including greenhouse gas emissions; impacting on biodiversity; water use; land use; biogeochemical flows (nitrogen and phosphorus); atmospheric aerosol emissions; introducing novel entities (including chemical pollution, plastics and nanomaterials) into nature; and contributions to ozone depletion and to ocean acidification.
b) social issues, including human rights and labour rights, decent work and equality, and including affected communities and people, and seeking to ensure that also the needs and concerns of especially vulnerable groups and persons affected by the business are identified.
c) governance issues, including anti-corruption and anti-bribery, anti-tax evasion, and inclusion of workers and other affected people and communities in open, participatory processes

3) Based on the sustainability assessment as described above, the board shall identify ongoing negative sustainability impacts and principal risks of future negative sustainability impacts, and where justifiable, define and select relevant quantitative and qualitative Key Performance Indicators.

4) Where the negative impacts or risks thereof are caused by lack of legal compliance, the board must ensure that this is rectified as soon as possible. For other issues, a system for an ambitious continuous improvement process must be put into place.

5) The processes included in the sustainability assessment, the identification of the ongoing negative sustainability impacts and principal risks of future negative sustainability impacts as well as the selection of relevant Key Performance Indicators, shall be assured by external experts.

6) The duties of the board in Section 2(1)-(5) shall be proportional and adapted to the scale and complexity of the undertaking.[233]

7) By means of delegated act and in accordance with Article 163, the European Commission shall issue mandatory guidance for how the sustainability assessment including the due diligence requirements is to be carried out, and the scalability of the duties based on the scale and complexity of the undertaking. The guidance shall be revised every three years, through an open participatory process, integrating expertise and affected communities.

### 6.2.2 Incentivising shareholders to promote sustainable value creation

To channel the potential of shareholders' support for sustainable value creation within planetary boundaries, we propose that other amendments are considered in the Company Law Directive 2017 as a part of the inclusion of the proposed new Chapter IIA.

***Title I, Chapter IV: Capital maintenance and alteration***

In *Section 3, on Distribution*, we propose that Article 56(1) on the general rules on distribution is amended, so that distribution to shareholders is made contingent on compliance with the rules in

[233] See the SMART Products Reform Proposals Report, with a similar scaling for the products' sustainability due diligence as a part of the suggested 'duty to know' in the proposed new Framework Directive for Products, Section 3.4.1.

the proposed new Chapter IIA. This will serve as a driver for shareholders through the general meeting to follow up that the board companies with its duties.

We also propose that an Article 58a is added to the Company Law Directive 2017, giving a similar duty for action as is now in Article 58 in case of serious loss of capital. The proposed Article 58a would concern serious unsustainability issues, connected to the duties proposed in 6.2.1 above, encompassing a lack of an ambitious continuous improvement plan, or lack of a follow-up of the plan to rectify negative findings or risks thereof in the sustainability assessment and sustainability due diligence. Article 58a should contain rules on who would have the competence to call a general meeting in such a situation, and should include any board member, any shareholder owning more than 5% of the shares, top executive management, or employees representing one third of the employees in the undertaking or in the corporate group the undertaking is a parent company in, or in another undertaking which the undertaking controls or of which it affects the business decisions.

In *Section 4 Rules on companies' acquisitions of their own shares*, we propose that Article 64(3) on the financial assistance for the acquisition of shares, should be amended to include in the written report justifying the financial assistance the relevance of the assistance for the achievement of the overarching purpose of the undertaking.

In *Section 5 Rules for the increase and reduction of capital*, we propose that sustainability requirements, connected to our proposal in 6.2.1 above, are integrated into the rules regulating reduction of capital, so that reduction of capital with the aim of distribution to shareholders is made contingent along the lines suggested for Article 56(1) above, which will reinforce that proposed change.

***Title II: Mergers and Divisions of Limited Liability Companies***
We also propose that the sustainability requirements in 6.2.1 above are integrated throughout the rules concerning mergers and divisions in Title II of the Companies Act 2017, with the aim of these issues always being a part of the decision-making in cases of changes in the structure of the undertaking. These rules are especially important when applied to cross-border mergers and divisions.

Similarly, this must be applied also to cross-border conversions, once these rules are integrated based on the European Parliament's and the Council's compromise in November 2019 into the Company Law Directive 2017.[234]

### 6.2.3 Realising the potential of reporting – ensuring relevance and reliability

#### *6.2.3.1 European Regulatory framework*

The backbone of European reporting regulation is the Accounting Directive of 2013,[235] setting rules for preparing annual financial statements and consolidated financial statements, management

[234] There is a compromise accepting the Directive, see European Parliament and the Council, Directive of the European Parliament and of the Council amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions, 6 November 2019, PE-CONS 84/19, available at https://data.consilium.europa.eu/doc/document/PE-84-2019-INIT/en/pdf.

[235] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending

reports, reports on payments to governments, corporate governance statements and 'non-financial' statements. The harmonisation of European accounting law started in 1978 with the Fourth Company Law Directive on annual accounts,[236] continuing in 1983 with the Seventh Company Law Directive on consolidated accounts.[237] These directives were replaced in 2013 by the Accounting Directive. The Directives do not only apply to listed companies incorporated in the EU, but also to all other types of companies referred to in those directives, including (other) public and private companies with limited liability.

Accounting Directive includes rules on preparing financial statements (Articles 4—18), management report (Article 19), non-financial statement (Article 19a), corporate governance statement (Article 2), consolidated financial statements (Articles 21—28), consolidated management report (Article 29), consolidated non-financial statement (Article 29a), publication (Articles 30—33), auditing (Articles 34—35), provisions concerning exemptions and restrictions to exemptions (Articles 36—40), and report on payments to governments (Articles 41—48).

The rules in Article 19a are complemented by the Commission non-binding Guidelines (2017) on methodology for reporting non-financial information,[238] and Guidelines (2019) on reporting climate-related information.[239] The 2019 Guidelines integrate the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) (see the criticism in Section 2 above),[240] and take account of the Commission proposal for taxonomy on sustainable activities[241] (see Section 7 of the Finance Report). Besides national legislation based on the Directive, listed undertakings must prepare their consolidated financial statements according to International Financial Reporting Standards (IFRS), based on the 2002 IAS Regulation.[242] After the Regulation in force, the IFRS has dominated the European financial reporting scene both directly and indirectly through implementation of the Directive and national accounting standards influenced by IFRS.

A comprehensive reform of the EU framework requires detailed analysis of financial statements regulation both in the Accounting Directive and the International Financial Reporting Standards, which we encourage the Commission to launch. In this Report we concentrate on those reforms that are necessary to fulfil the potential of the proposals we set above in Section 6.2.1, concentrating on management report and non-financial statement, and rules on auditing.

The weakness of the Accounting Directive is in its nature of a framework directive, as its implementation is in the hands of the Member States. The Commission is wary 'to take the lead' but

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Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC, OJ L 182, 29.6.2013, p. 19–76.

[236] Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, OJ 1978, L 222.

[237] Seventh Council Directive 83/349/EEC of 13 June 1983 based on Article 54(3)(g) of the Treaty on consolidated accounts, OJ 1983, L 193.

[238] European Commission. Communication from the Commission — Guidelines on non-financial reporting (methodology for reporting non-financial information), C/2017/4234, OJ C 215, 5.7.2017, p. 1–20.

[239] Communication from the Commission, Guidelines on non-financial reporting: Supplement on reporting climate-related information, C/2019/4490, OJ C 209, 20.6.2019, p. 1–30.

[240] https://www.fsb-tcfd.org/about/.

[241] European Commission, Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment (Text with EEA relevance), 24.5.2018, COM(2018) 353 final.

[242] Regulation (EC) no. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, OJ 2002, L 243.

also wary with the International Financial Reporting Standards Foundation and the International Accounting Standards Board,[243] responsible of the development of the IFRS, albeit it is self-evident that financial statements prepared according to the Directive and the IFRS do not faithfully portray the risks companies are exposed to as regards sustainability risks such as those associated with climate change and other environmental harm, as well as their impacts.[244]

As in Section 6.2.1 above, our proposals cover any type of undertaking. Unlike in the present framework, our proposals do not include exemptions based on size or sector of the undertaking. However, for SMEs we suggest a scalability of reporting duties based on the scale and complexity of the undertaking, as proposed in Section 6.2.1 above.

#### *6.2.3.2 SMART proposal for a management report reform*

During the last decades, a complicated net of separate reports is created. Financial and consolidated financial states, management and consolidate management report, non-financial and consolidated non-financial statement, corporate governance statement and report and consolidated report on payments to governments are separate, with only weak connection points with each other. Most of the reports remain unassured. The scope of the provisions varies, some provisions applying to nearly all undertakings, some to the few biggest undertakings only or undertakings in specific business branches.

Amendments to the Fourth and Seventh Directive in 2003 were an important step in the development of European reporting framework, introducing first time requirements of information relating to environmental and employee matters, now in Article 19(1)(3) of the Accounting Directive.[245]

Chapter 10 of the Accounting Directive introduced in 2013 on the report on payments to governments ('country-by-country report'), requiring undertakings to prepare and make public a report on payments made to governments on an annual basis (Article 42(1)), was an important step but it applies to only large undertakings and all public-interest entities active in the extractive industry or the logging of primary forests.

Additionally the Commission proposed in April 2016, in order to implement in the Union Action 13 of the OECD Action Plan endorsed by the G20 to fight base erosion and profit shifting (BEPS) requiring a country-by-country report from multinational enterprises (MNEs) on income tax paid, a new Chapter 10a to the Accounting Directive requiring that MNEs disclose publicly in a specific report the income tax they pay together with other relevant tax-related information. MNEs, whether headquartered in the EU or outside, with turnover of more than EUR 750m would need to comply with these additional transparency requirements. For the first time, not only European businesses but also non-

[243] Speech by Executive Vice-President Valdis Dombrovskis at the IFRS Foundation conference "Financial reporting: remaining relevant in a changing environment", 19 February 2020, https://ec.europa.eu/commission/commissioners/2019-2024/dombrovskis/announcements/speech-executive-vice-president-valdis-dombrovskis-ifrs-foundation-conference-financial-reporting_en.

[244] Deloitte, IFRS Foundation Trustees' stakeholder event with focus on non-financial reporting, 19 February 2020, https://www.iasplus.com/en/news/2020/02/trustees. See also Section 2 above on the financial risks of unsustainability.

[245] Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings.

European multinational companies doing business in Europe would have the same reporting obligations.[246] The proposal is however still in the Parliament and in the Council.

The Parliament adopted the proposal in June 2019, adding to the information to be provided and to be published details of public subsidies received and any donations made to politicians, political organisations or political foundations and whether undertakings, subsidiaries or branches benefit from preferential tax treatment, from a patent box or equivalent regimes. The report on income tax information would be published in a common template laid down by a Commission delegated act. [247] The template could be a very simplified exercise, requiring an explanation if for example the undertaking has benefited from preferential tax treatments or other positive treatments.

Similarly, Article 19a of the Accounting Directive ('Non-Financial Reporting Directive') of 2014 was an important follow up to open the space for a discourse on how to report on the sustainability impacts of business. However, the lack of stringency and of verification requirements in the Directive means that it still open for unsustainable businesses to greenwash – or now, SDG-wash – and difficult for businesses attempting to be sustainable, to show this to their potential contractual parties and the society at large. It lacks also verification; Article 19a(6) of the Directive leaves it to the Member States to require a verification by an independent assurance services provider. Otherwise, Member States shall only ensure that the statutory auditor or audit firm checks whether the non-financial statement or the separate report has been provided (Article 19a(5) of the Directive).

*Instead of amending Article 19a,[248] the duties to provide information on the environmental and social impact of the undertaking's activities proposed above in Section 6.2.1 should be included in the management report by amending Article 19 and repealing Article 19a of the Accounting Directive. This information should be based on binding delegated acts issued by the Commission in accordance with Article 49 of the Accounting Directive.*

*At the same time, the information required in the separate report on payments to governments should be included in the management report, as well as the information on paid income taxes, proposed by the Commission in 2016. As proposed the report on income tax information should include information relating to all the activities of the undertaking and its ultimate parent undertaking, including activities of all affiliated undertakings consolidated in the financial statement in respect of the relevant financial year.*

Based on our proposals above, the amended Article 19 of the Accounting Directive should include rules for identification of ongoing negative sustainability impacts and principal risks of future negative sustainability impacts, and where quantifiable, select relevant Key Performance Indicators, including, in the case the negative impacts or risks thereof are caused by lack of legal compliance, report how they have been rectified.

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[246] Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches, 12.4.2016, COM(2016) 198 final, 2016/0107 (COD).

[247] European Parliament (2014-2019) P8_TA(2017)0284: Disclosure of income tax information by certain undertakings and branches, Amendments adopted by the European Parliament on 4 July 2017 on the proposal for a directive of the European Parliament and of the Council amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches (COM(2016)0198 – C8-0146/2016 – 2016/0107(COD)) (Ordinary legislative procedure: first reading), https://www.europarl.europa.eu/doceo/document/TA-8-2017-0284_EN.pdf.

[248] See Public consultation on the revision of the non-financial reporting directive, 20 February 2020, https://ec.europa.eu/eusurvey/runner/non-financial-reporting-directive-2020?surveylanguage=EN.

The European Commission delegated acts should give guidance for how the sustainability assessment proposed in Section 6.2.1, including the due diligence requirements are to be carried out, to integrate improved scientific basis and development of best practice than having regularly to instigate further revisions of company law. Guidance should also be given for the provisions on the identification requirements. The Commission guidance should be revised every three years, through an open participatory process, integrating expertise and affected communities. Connecting the redefined purpose and the duties of the board proposed in Section 6.2.1 with reporting and accounting, gives the possibility of realising the potential of sustainability reporting while ensuring enforcement of the proposed rules.

We propose that Article 19 of Accounting Directive shall be amended by adding in it the following provisions:

*(1) The management report shall include information on how the board of the undertaking has dealt with* the *negative impacts and risks of negative impacts referred to in Article 3 of Chapter IIA of Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law, including, where quantifiable, the selected Key Performance Indicators.*

*(2)* The *information shall also, where appropriate, include references to, and additional explanations of, amounts reported in the annual financial statements.*

*(3) The Commission shall be empowered to adopt delegated acts in accordance with Article 49 to give binding guidance on the provisions in this Article, including the Key Performance Indicators.*

*(4) The Commission guidance shall be revised every three years, through an open participatory process, integrating expertise and affected communities.*

The guidance referred to in paragraph 3 should be given in the same delegated act the guidance given based on Article 3, paragraph 7 of Chapter IIA in our proposal to amend the Company Law Directive in Section 6.2.1 above.

In addition, the country-by-country reports for payments to governments and of income tax information in Chapter 10 and proposed Chapter 10a of the Accounting Directive should be added to Article 19.

Similar amendments should be made in Article 29 on the consolidated management report, with repeal of Article 29a on consolidated non-financial statement.

#### *6.2.3.3 SMART proposals for Transparency Directive*

The Transparency Directive[249] establishes requirements in relation to the disclosure of periodic and ongoing information about issuers whose securities are already admitted to trading on a regulated market situated or operating within a Member State (Article 1(1)). According to Article 4(1) of the Directive the issuer shall make public its annual financial report at the latest four months after the end of each financial year and shall ensure that it remains publicly available for at least 10 years. The annual financial report shall comprise audited financial statements and consolidated financial

[249] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.

statements and a management report and consolidate management report (Article 4(2)).[250] The audit report, signed by the person or persons responsible for auditing the financial statements, shall be disclosed in full to the public together with the annual financial report (Article 4(4)(2)).

Amendment of Article 19 and repeal of Article 19a of the Accounting Directive requires also amendments in the Transparency Directive. Article 4 of the Transparency Directive should be amended accordingly. As all information, including country-by-country information reported according to Chapter 10 and the proposed 10a of the Accounting Directive, is given in management report, there is however no need to amend the wording of Article 4(2). Article 4(5) and 4(6) should be amended however in the following way:

*5. The management report shall be drawn up in accordance with Article 19 of Directive 2013/34/EY and, if the issuer is required to prepare consolidated accounts, in accordance with Article 29 of Directive 2013/34/EU*.

### 6.2.4 Assurance of processes and auditing of reporting

#### *6.2.4.1 The EU auditing framework*

According to Article 34 of the Accounting Directive Member States shall ensure that the financial statements are audited by one or more statutory auditors or audit firms approved by Member States to carry out statutory audits on the basis of 2006 Auditing Directive.[251] The statutory auditor(s) or audit firm(s) shall also express an opinion on whether the management report is consistent with the financial statements for the same financial year, and (whether the management report has been prepared in accordance with the applicable legal requirements, state whether, in the light of the knowledge and understanding of the undertaking and its environment obtained in the course of the audit, he, she or it has identified material misstatements in the management report, and shall give an indication of the nature of any such misstatements. Same rules apply mutatis mutandis with respect to consolidated financial statements and consolidated management reports.

Article 34 does not apply at all to the non-financial statement referred to in Article 19a and the consolidated non-financial statement referred to in Article 29a or to the possible separate non-financial reports. According to Article 19a(5) Member States shall ensure only that the statutory auditor or audit firm checks whether the non-financial statement or the separate report has been provided. However, according to Article 19a(6) Member States *may* require that the information in the non-financial statement or the consolidated non-financial statement or in the separate report be verified by an independent assurance services provider.

According to Article 26(1) of the Auditing Directive, Member States shall require statutory auditors and audit firms to carry out statutory audits in compliance with international auditing standards

[250] Additionally, the annual financial report shall comprise statements made by the persons responsible within the issuer, whose names and functions shall be clearly indicated, to the effect that, to the best of their knowledge, the financial statements prepared in accordance with the applicable set of accounting standards (either national or IFRS) give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer and the undertakings included in the consolidation taken as a whole and that the management report includes a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

[251] Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (Text with EEA relevance). Latest consolidated version is available here: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02006L0043-20140616.

(defined in Article 26(2) as International Standards on Auditing (ISAs), International Standard on Quality Control (ISQC 1) and other related Standards issued by the International Federation of Accountants (IFAC) through the International Auditing and Assurance Standards Board (IAASB), in so far as they are relevant to the statutory audit) adopted by the Commission. No international auditing standards have been adopted so far, so Member States may apply national auditing standards, procedures or requirements as long as the Commission has not adopted an international auditing standard covering the same subject-matter.

According to Article 26(3), the Commission is empowered also to adopt the international auditing standards in the area of audit practice, independence and internal quality controls of statutory auditors and audit firms for the purposes of the application of those standards within the EU. According to Article 26(5) where a Member State requires the statutory audit of small undertakings, it may provide that application of the auditing standards is to be proportionate to the scale and complexity of the activities of such undertakings. Member States may take measures in order to ensure the proportionate application of the auditing standards to the statutory audits of small undertakings, based to the scale and complexity of their activities ('scalability').

#### *6.2.4.2 SMART proposal for full audit of management report*

Unlike in present provisions, all reporting needs to be taken as seriously and be subject to equivalent requirements as traditional financial reporting, not according to the superficial 'conformity check' of Article 34(1) second paragraph of the Accounting Directive. A 'full audit' of the management report is realistic.[252] 'Full audit' according to Article 34(1)(1) Accounting Directive would require revision of the provision so that Member States shall ensure that the financial statements of undertakings are audited and management reports are assured by one or more statutory auditors or audit firms approved by Member States to carry out statutory audits on the basis of the Auditing Directive.

We propose that the information provided in the management report under Article 19 of the Accounting Directive should be under full audit according to Article 34(1) first paragraph of the Accounting Directive. All reporting needs to be taken as seriously and be subject to equivalent requirements as those that apply to financial statements and consolidated financial statements, not according to the superficial 'consistency check' of Article 34(1) second paragraph.

Also these proposals apply to all undertakings, with scalability rule based on the undertaking's scale and complexity as proposed in Section 6.2.1 above should be applied to the rules proposed on reporting and auditing according to the applicable accounting and audit standards.

Based on this, we propose that a following provision to be added to Article 19 of the Accounting Directive:

*(5) In accordance with Article 34, Member States shall ensure that the management report is audited by one or more statutory auditors or audit firms approved by Member States to carry out statutory audits on the basis of Directive 2006/43/EC.*

Additionally, we propose that Article 34(1) of the Accounting Directive is amended as follows:

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[252] See European Commission. Review of country-by-country reporting requirements for extractive and logging industries; Final report; November 2018, p. 14, https://ec.europa.eu/info/sites/info/files/business_economy_euro/company_reporting_and_auditing/documents/181126-country-by-country-reporting-extractive-logging-industries-study_en.pdf.

*(1) Member States shall ensure that the financial statements and management reports of undertakings are audited by one or more statutory auditors or audit firms approved by Member States to carry out statutory audits on the basis of Directive 2006/43/EC.*

Article 34(3), providing that Article 34 shall not apply to the non-financial statement referred to in Article 19a(1) and the consolidated non-financial statement referred to in Article 29a(1) or to the separate reports referred to in Articles 19a(4) and 29a(4), shall be repealed accordingly.

To ensure full audit of management report Audit Directive of 2006 (as amended by Directive of 2014)[253] should be amended by adding international assurance standards to the European auditing framework to include management report under full audit. The international auditing standards referred to in Article 26 of the Audit Directive should include International Standard on Assurance Engagements ISAE 3000 (Revised), *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, that can be applied to assurance of different kind of emerging forms of external reporting (EER), to create greater trust in the resulting assurance reports by users of EER, to assure that relevant, reliable, confidence-creating, comparable and accurate information has been provided.[254] The ISAE 3000 framework is still very general and would need to be tailored to the specific reporting regime to define the scope.[255]

Based on this, we propose that Article 26 of Audit Directive shall be amended as follows:

*(1) Member States shall require statutory auditors and audit firms to carry out statutory audits and statutory assurances in compliance with international auditing standards adopted by the Commission in accordance with paragraph 3.*

*Member States may apply national auditing and assurance standards, procedures or requirements as long as the Commission has not adopted an international auditing standard covering the same subject-matter.*

*(2) For the purposes of paragraph 1, 'international auditing standards' means International Standards on Auditing (ISAs), International Standard on Quality Control (ISQC 1), International Standard on Assurance Engagements (ISAE 3000) and other related Standards issued by the International Federation of Accountants (IFAC) through the International Auditing and Assurance Standards Board (IAASB), in so far as they are relevant to the statutory audit.*

It is important that both the review in the management report and its assurance are scalable, taking into consideration both the size and the industry of the undertaking. Based on this, we propose that Article 26(5) of the Auditing Directive is amended to read as follows:

[253] Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (Text with EEA relevance). The latest consolidated version is available here: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02006L0043-20140616.
[254] International Auditing and Assurance Standards Board, Extended External Reporting (EER) Assurance. Available at https://www.iaasb.org/projects/extended-external-reporting-eer-assurance.
[255] European Commission, *Review of country-by-country reporting requirements for extractive and logging industries: Final report*, November 2018, https://ec.europa.eu/info/sites/info/files/business_economy_euro/company_reporting_and_auditing/documents/181126-country-by-country-reporting-extractive-logging-industries-study_en.pdf, p. 68.

*In application of the auditing standards referred to in paragraph 1 is to be proportionate to the scale and complexity of the activities of such undertakings.*

*The Commission shall be empowered to adopt, by means of delegated acts in accordance with Article 48a, measures in order to ensure the proportionate application of the auditing standards to the statutory audits of small undertakings.*

In line with these proposals, Article 4(4) of the Transparency Directive[256] should be amended in the following way:

*4. The financial statements and the management report, and, if the issuer is required to prepare consolidated accounts and consolidated management report, the consolidated financial statements and the consolidated management report shall be audited in accordance with Article 34 of Directive 2013/34/EU.*

### 6.2.5 Public and private enforcement

#### *6.2.5.1 Enforcement through the company registrar*

We suggest that the submission of the following documents be a prerequisite for the continued validity of the registration of an undertaking:

a) the strategy (valid until resubmitted)

b) the externally assured documentation of the sustainability assessment and the sustainability due diligence (at a minimum every three years)

c) financial statements (annually)

d) the audited management report (annually)

This entails that lack of submission of any of these documents will lead to sanctions and eventually, in case of continued non-compliance, the winding-up of the undertaking, or dissolution. This is comparable to the consequence for nullity of a company in present Article 12(2) of the Company Law Directive 2017.

#### *6.2.5.2 Public enforcement through a European public body*

Inspired by the system of the Australian Securities and Investment Commission,[257] we propose a European regulatory body that could bring public interest proceedings against undertakings that are not following up their EU company law duties. This could for example be limited to enforcing the duty to undertake a sustainability due diligence and draw up a continuous improvement plan.

[256] Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC (Text with EEA relevance). Latest consolidated version available here: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02013L0050-20131126.

[257] https://asic.gov.au/

We also suggest that the European Ombudsman be given mandate to investigate complaints against European businesses alleging violations of the EU company law duties. The European Ombudsman should be given the competence to require information and documentation from European undertakings, make public statements and issues fines to non-compliant undertakings. This would provide a channel for dealing with complaints from, for example, workers in global value chains of European undertakings, without them having to resort to a lawsuit against the European undertaking. It would complement and strengthen the possibilities that is now available through the National Contact Points for the OECD Guidelines for Multinational Enterprises.

##### *6.2.5.3 Enforcement through claims from affected parties*

This issue concerns a harmonisation of procedural rules and possibly also substantive rules for claims from affected parties, which may range from company law and contractual legal bases to tort-based claims. With the international trend of lawsuits against parent and lead companies and decision-makers in them, a harmonisation and codification of the procedural and substantive rules for such claims could provide more legal certainty to both affected parties as well as undertakings.

In a study undertaken for the European Parliament's Sub-Committee on Human Rights in February 2019,[258] recommendations are made to revise European procedural rules to make it easier and clear in which cases alleged victims of human rights violations may be brought against European parent companies. We suggest a broader revision, clarifying that cases may be brought also against European lead undertakings of global value chains. We propose that this is linked to the duty to undertake a sustainability due diligence, which should be a duty for the undertaking – and to make it effective and ensure follow-up – a duty for the board, as we have outlined in Section 6.2.1 above. If the sustainability due diligence has not been carried out in accordance with EU law and harm has occurred, there should be a presumption of liability for the undertaking and its board members. Conversely, if due diligence has been carried out and assured by external experts as proposed as a duty, this may serve as a defence for the undertaking and its board. This will increase the legal certainty for European business, while providing better access to justice for affected workers and communities.

### 6.2.6 Enabling sustainable SMEs

To enable SMEs' sustainable business models the rules proposed should be proportionate to the scale and complexity of the activities of the undertaking ('scalability'). Scalability does not mean exemptions of certain rules proposed but a general rule of simplified procedures in both due diligence and reporting. As an inspiration can be used According to Article 26(5) of the Auditing Directive discussed above in Section 6.2.3. As The SMEs in national and global value chains have right to require the information necessary to fulfil the duties set to them from the controlling or lead undertaking of the value chain, would it be a company law based parent company or contract based lead undertaking. The Commission can be mandated to give delegated acts on scalability.

To support SMEs, a SME Resource, consisting of an Advisory Hub and an Advisory Portal should be established to provide resources and advice to SMEs fulfilling their due diligence and reporting duties. The Hub and the Portal could be established in an existing organisation as InvestEU.[259] The Commission proposes in the European Green Deal Investment Plan an InvestEU Advisory Hub support the identification, preparation, development, structuring, procuring and implementation of

[258] https://www.europarl.europa.eu/RegData/etudes/STUD/2019/603475/EXPO_STU(2019)603475_EN.pdf
[259] https://europa.eu/investeu/home_en.

sustainable investment projects,[260] and a free, online user-friendly InvestEU Portal for EU businesses, financial intermediaries and project promoters.[261] Similarly, the SME Resource would provide a single point of entry for a comprehensive service to SMES when they seek help in fulfilling their duties. The SME Resource could be connected to the InvestEU Advisory Hub for SMEs seeking finance for their sustainable initiatives.

## 6.3 Facilitating sustainable financial markets

To fulfil the full potential a comprehensive reform of business regulation also other fields of the EU business regulation should be analysed. We give here examples of major other EU legal instruments that fall under scrutiny and some tentative proposals for reform. The European framework also includes so-called self-regulation. For this reason we discuss first the two major types of business self-regulation, corporate governance codes and stewardship codes.

Many of the instruments that could be discussed here are overlapping with those instruments we have already discussed above, as the Transparency Directive, or what discuss in the Finance Report. The most important one belonging to the latter group is the Disclosure Regulation, which we discuss in detail in Section 8.2 of the Finance Report. Under Action 9 of the Action Plan *Financing Sustainable Growth* the Commission emphasised that in terms of disclosure by the financial sector, there is merit in enhancing transparency of asset managers and institutional investors, including the way in which they consider sustainability risks and their exposures to climate-related risks.[262] The Commission proposal for this Disclosure Regulation was given in May 2018,[263] and accepted in the Parliament in April 2019.[264] A common text was agreed in October 2019.[265] The Regulation was published December 2019.[266]

According to the Commission *European Green Deal* from December 2019[267] the EU must be at the forefront of coordinating international efforts towards building a coherent financial system that supports sustainable solutions, as the private sector will be key to financing the 'green transition'. The Commission will present *a renewed sustainable finance strategy* in the third quarter of 2020.[268] It

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[260] European Green Deal Investment Plan, p. 17.
[261] European Green Deal Investment Plan, p. 16.
[262] European Commission, Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions: Action Plan: Financing Sustainable Growth (8.3.2018, COM/2018/097 final), p. 10.
[263] European Commission, Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341, 24.5.2018, COM(2018) 354 final.
[264] European Parliament legislative resolution of 18 April 2019 on the proposal for a regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 (COM(2018)0354 – C8-0208/2018 – 2018/0179(COD)). Available online: http://www.europarl.europa.eu/doceo/document/TA-8-2019-0435_EN.html (accessed on 1 November 2019).
[265] Regulation of the European Parliament and of the Council on sustainability-related disclosures in the financial services sector (Text with EEA relevance), PE-CONS 87/19, https://data.consilium.europa.eu/doc/document/PE-87-2019-INIT/en/pdf.
[266] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Text with EEA relevance), PE/87/2019/REV/1, OJ L 317, 9.12.2019, p. 1–16.
[267] European Commission, Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions: The European Green Deal, 11.12.2019, COM(2019) 640 final.
[268] The European Green Deal, 16—17.

shall focus to strengthen the foundations for sustainable investment by relying on a taxonomy for classifying environmentally sustainable activities, based on the Taxonomy Regulation (see in detail Section **Error! Reference source not found.** of the Finance Report ), by embedding sustainability into t he corporate governance framework and by increasing companies' and financial institutions' disclosure on climate and environmental data (see Section 6.2.3 above). All these goals require an evaluation of all financial markets regulation.

### 6.3.1 Corporate governance codes and stewardship codes

The corporate governance code movement has been a mighty force in enforcing shareholder primacy paradigm. From and due the failure of the paradigm in the financial crisis of 2007, a shift in the corporate governance movement took place, emphasising the role of corporate shareholders, popularly denoted as 'stewardship'. Normatively spearheaded by the UK Stewardship Code of 2010,[269] the stewardship movement emerged as principles concerning 'a desirable corporate governance attribute able not only to improve corporate governance and performance, but also to ensure long-term stability and social responsibility'.[270] However, the stewardship movement did not mitigate but tended to enforce the shareholder primacy paradigm, demanding shareholder 'empowerment', a policy shift making corporate managers accountable not to the company as it is based on law, but to the shareholders, wrongfully perceived as 'owners' of the company.[271]

According to this policy thinking the corporate boards should be 'independent' (however that is interpreted) and focus on monitoring on behalf of the shareholders rather than managing the company independently. Instead, shareholders should 'engage' with companies on issues ranging from strategy to corporate responsibility, issues that company law assigns to the board.[272] These shareholder engagement and empowerment policies have become increasingly embedded in corporate governance codes, listing rules, company legislation, European Union directives and transnational regulatory standards.[273] We see this especially in the EU reform of the 2007 Shareholders' Rights Directive,[274] and a number of European jurisdictions have seen the emergence of specific stewardship codes. The amended 2017 Shareholders' Rights Directive[275] includes elements found in existing corporate governance and stewardship codes, as a requirement for institutional

[269] Financial Reporting Council, The UK Stewardship Code, July 2010, https://www.frc.org.uk/getattachment/e223e152-5515-4cdc-a951-da33e093eb28/UK-Stewardship-Code-July-2010.pdf.
[270] REF Katelouzou, forthcoming 2019
[271] 'Shareholders own shares, entitling their holders to rights and duties in a company, but they do not own companies or the assets within companies. From property right perspective, a company owns its own assets and owes its own responsibilities. See already P. Ireland 'Company Law and the Myth of Shareholder Ownership' (1999) 62 *Modern Law Review*.
[272] Simon Deakin, 'Against shareholder empowerment' in Janet Williamson, Ciaran Driver and Peter Kenway (eds) *Beyond shareholder value: The reasons and choices for corporate governance reform* (London: TUC, July 2014), 36—40, 36.
[273] Deakin, 'Against', 36.
[274] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14.7.2007, p. 17–24.
[275] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017, p. 1–25.

investors to publicly disclose their policy for how they integrate shareholder engagement in their investment strategies or explain why they have chosen not to do so ('comply or explain').[276]

According to the arguments behind the codes (and also in stewardship regulation such as the EU Shareholder Rights Directive), encouraging shareholders to act as 'stewards' is a way forward not only towards better corporate governance in the mainstream, economics-focused sense, but also towards more sustainable and responsible companies in light of the environmental and social challenges we as a global community face. Stewardship concept is widely connected to institutional investors, referring to the actions that asset managers can take in order to enhance the value of the companies that they invest in on behalf of their own beneficiaries. The main components of stewardship are monitoring of the investee companies, voting at their general meetings, engagement with the companies and their boards and management, and finally exclusion, screening out companies from portfolio.[277] However, 'stewardship' can be understood also in a wider meaning, covering not only institutional investors but also other major shareholders as states, sovereign wealth funds, public pension funds and private investment companies, individuals and families as it is case especially in Asia where both states and families are major control holders.[278]

There are however several examples of negative impacts of stewardship, as has been noted in the case of Japan, where the Japanese government adopted a stewardship code with the aim of reforming its traditional lifetime employee, risk-averse, and stakeholder-oriented governance system towards a more shareholder-oriented, profit maximizing, and less risk-averse governance system.[279]

Linked to this, 'stewardship' thinking may tend to blur the responsibility that flows from company law. If too much emphasis is placed on idea of the controlling shareholder as a 'good steward', the power of defining the purpose of the stewardship – and thereby indirectly of the company – may lie with the shareholder. We see this as connected with the problem with shareholder primacy, and a danger that stewardship just becomes a form of 'enlightened' shareholder primacy. We propose to mitigate shareholder primacy through redefining the corporate purpose, and thereby correcting the bias as concerns the role of shareholders too.

What is also very important from our perspective, is that voluntary stewardship does not appear be a strong enough management tool for handling an issue as important as sustainable development in a world with increasingly rapid changes in their surroundings and greater uncertainty and volatility in the global markets. To handle this the there is a need of responsible body to demonstrate fast decisions and ensure corporate flexibility, vested with the power to run the undertaking – which is

[276] EY, Q&A on stewardship codes, August 2017, 2 < https://www.ey.com/Publication/vwLUAssets/ey-stewardship-codes-august-2017/$FILE/ey-stewardship-codes-august-2017.pdf>.

[277] Lucian Bebchuk and Scott Hirst, 'Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy' (2019) 119 *Columbia Law Review* ___-___, ___.

[278] See Gen Goto, Alan K Koh and Dan W Puchniak, 'Diversity of Shareholder Stewardship in Asia: Faux Convergence' (November 4, 2019), forthcoming, Vanderbilt Journal of Transnational Law; NUS Law Working Paper No. 2019/027; The University of Tokyo Business Law Working Paper Series No.2019-E-01; NUS Centre for Asian Legal Studies Working Paper 19/08; NUS EW Barker Centre for Law & Business Working Paper 19/05; European Corporate Governance Institute - Law Working Paper No. 485/2019 <https://ssrn.com/abstract=3481543> or <http://dx.doi.org/10.2139/ssrn.3481543>.

[279] See Gen Goto, Alan K Koh and Dan W Puchniak, 'Diversity of Shareholder Stewardship in Asia: Faux Convergence' (November 4, 2019), forthcoming, Vanderbilt Journal of Transnational Law; NUS Law Working Paper No. 2019/027; The University of Tokyo Business Law Working Paper Series No.2019-E-01; NUS Centre for Asian Legal Studies Working Paper 19/08; NUS EW Barker Centre for Law & Business Working Paper 19/05; European Corporate Governance Institute - Law Working Paper No. 485/2019 <https://ssrn.com/abstract=3481543> or http://dx.doi.org/10.2139/ssrn.3481543.

the board. We suggest therefore that the responsibility of the sustainability strategy and follow-up should be a duty of the boards instead relying on voluntary actions and guidelines. As we have proposed, the implementation of sustainability would be independent from the shareholders (whatever nationality, type, shape or size) or the individual board members. The collective boards of the investee companies distinguish themselves as the right place in the financial governance structure to place such responsibility, not with the shareholders. There is a danger that too much focus on stewardship deflects attention towards shareholders instead of on core company law issues including duties of the board.

The progress that we note below in the 2017 amendments of the Shareholders' Rights Directive, may be perceived, however, as a codification of best practice in existing corporate governance and stewardship codes. The codes are heterogenous. The first generation codes may generally be said to be informed by and reinforce shareholder primacy; the second generation is informed by 'stakeholder thinking' and in the third generation we increasingly see the inclusion of 'sustainable value creation', corporate culture and comprehensive risk management. As examples can be mentioned the new Dutch, French and Belgian corporate governance codes.[280] However, due to the heterogeneity between the European codes, while recognising the progress made in the third generation codes, we do not see the codes as sufficient regulatory instruments to promote the shift of business to sustainability. Legislative reform of business law is needed, as outlined starting in Section 6.2.1 above. Yet, the codes that support sustainable value creation and integration of sustainability into risk management, can play a role in strengthening the legislative reform and developing best practices.

As for the remaining codes that continue to promote shareholder primacy and undermine company law, revisions should be undertaken at the local level, through open and transparent processes. This should be followed up by the Commission, so that if this does not happen, steps may be considered.

### 6.3.2 Shareholder Rights Directive

The Shareholders' Rights Directive[281] (SHRD) enacted in 2007 and amended in 2017 establishes requirements in relation to the exercise of certain shareholder rights attached to voting shares in relation to general meetings of companies which have their registered office in a Member State and the shares of which are admitted to trading on a regulated market situated or operating within a Member State. As mentioned in Section 6.3.1 above, it also establishes specific requirements in order to encourage shareholder engagement, in particular in the long term. Those specific requirements apply in relation to identification of shareholders, transmission of information, facilitation of exercise of shareholders rights, transparency of institutional investors, asset managers and proxy advisors, remuneration of directors and related party transactions.[282]

As stated above, SHRD, as corporate governance codes and stewardship codes, can be criticized bringing the shareholders in the forefront of corporate governance instead the interested of the company itself, and so promoting shareholder primacy paradigm. However, the Directive contains

[280] Corporate Governance Code Monitoring Committee, The Dutch Corporate Governance Code, 8 December 2016; Afep – MEDEF, Corporate Governance Code of Listed Corporations, amended in June 2018; Corporate Governance Committee, The 2020 Belgian Code on Corporate Governance.
[281] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14.7.2007, p. 17–24, as amended by Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder, OJ L 132, 20.5.2017, p. 1–25. Directive 2007/36/EC is often identified as the SHRD and Directive (EU) 2017/828 as the SHRD II.
[282] Article 1 of the Shareholders' Rights Directive.

also several provisions promoting long-term value creation, shared by the best corporate governance codes, and transparency of corporate activities, including directors' remuneration (Articles 9a and 9b) and related party transactions (Article 9c), promoted firstly by the corporate governance codes. Transparency on remuneration and related party transactions are tools to prevent corruption and waste of corporate resources, ultimately leading to undermining of the economic basis of companies and so the whole global economy.

The SHRD includes several provisions increasing transparency of listed companies, including Article 3a on identification of shareholders. The provision is linked with Articles 9—16 of the Transparency Directive on notification of major holdings. As the SHRD ensures the company's right to identify their shareholders to communicate with them without intermediaries as well as to facilitate the exercise of their rights and shareholder engagement,[283] Article 12(6) of the Transparency Directive obligates the company to make public all the information contained in the notifications of changes in major shareholdings that shareholders are obliged to notify the company of according to Articles 9-12.

Among the most important provisions in the SHRD is Chapter 1b on transparency of institutional investors, asset managers and proxy advisors and especially Article 3g on development of an engagement policy that describes how they integrate shareholder engagement in their investment strategy, and publication of it and its implementation. However, the requirements are voluntary on a comply or explain basis; according to Article 3g(1), Member States shall ensure that institutional investors and asset managers either comply with the requirements set out in Article 3g(1) or publicly disclose a clear and reasoned explanation why they have chosen not to comply with one or more of those requirements. According to Articles 3h and 3i Article 3h institutional investors and asset managers should prepare and disclose their investment strategies and how they are consistent with the profile and duration of their liabilities, in particular long-term liabilities, and how they contribute to the medium to long-term financial and non-financial performance of their assets. The asset managers' disclosures shall include reporting on the key material medium to long-term risks associated with the investments, on portfolio composition, turnover and turnover costs, on the use of proxy advisors for the purpose of engagement activities and their policy on securities lending and how it is applied to fulfil its engagement activities if applicable, particularly at the time of the general meeting of the investee companies. Such disclosure shall also include information on whether and, if so, how, they make investment decisions based on evaluation of medium to long-term performance of the investee company, including non-financial performance, and on whether and, if so, which conflicts of interests have arisen in connection with engagements activities and how the asset managers have dealt with them.

These provisions can be compared with the disclosure requirements set to financial market participants and financial advisers set in the new Disclosure Regulation[284] (see above and Section 8.2 of the Finance Report). According to Article 3 of the Disclosure Regulation financial market participants shall publish their policies on the integration of sustainability risks in their investment decision-making process. In the same manner, financial advisers shall publish information about their policies on the integration of sustainability risks in their investment advice or insurance advice. These

[283] Preamble 4 of the SHRD II.

[284] European Parliament legislative resolution of 18 April 2019 on the proposal for a regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 (COM(2018)0354 – C8-0208/2018 – 2018/0179(COD)). Available online: http://www.europarl.europa.eu/doceo/document/TA-8-2019-0435_EN.html (accessed on 1 November 2019).

provisions are mandatory. In the same manner, the provisions in Article 3g—3i should be mandatory without exceptions.

*We propose that Articles 3g—3i of the SHRD should be amended so that the requirements in it are mandatory. The detailed contents should be amended so that they are in line with the SMART proposals in Section 6.2.1 above.* The SHRD is not covering the relationships between companies and their shareholders only. Article 3j contains rules on proxy advisors. The provisions obliged proxy advisors to publish information on their research methodologies, advice and voting recommendations and conflicts of interest. There are no material rules, however, on proxy advisors' behavior.

*In Finance part Section 8.1 SMART proposes that the scope of the Disclosure Regulation should be expanded to include proxy advisors.*

One of the most criticized provisions of the SHRD are those of right to vote on the remuneration policy in Article 9a. The language of the provisions is unclear, for instance what the company's long-term interests and sustainability and criteria to corporate social responsibility mean. *We propose that the language shall be linked with the proposals set in Section 6.2.1 above*. Specifically, remuneration should be connected with the continuous improvement process, documented through the audited management reports. According to Article 9b(1)(1) Member States shall ensure that the company draws up a clear and understandable remuneration report. *We propose that the remuneration report should be included in the management report that the company prepares according to Article 19 of the Accounting Directive, and it should be audited according to Article 34 of the Directive, both as amended according to SMART proposals presented above in Sections 7.2.2 and 7.2.3.*

According to Article 9b(1)(2)(b) the remuneration report shall contain the annual change of remuneration, of the performance of the company, and of average remuneration on a full-time equivalent basis of employees of the company other than directors over at least the five most recent financial years, presented together in a manner which permits comparison, regarding each individual director's remuneration.

*The provision should be expanded to cover the whole value chain the company is controlling, with a requirement to disclose the ratio of the lowest pay in the value chain and the highest executive pay.*

### 6.3.3 Takeover Directive

The Takeover Directive,[285] adopted after much strife in 2004,[286] is informed by a legal-economic theory with assumptions that are as questionable as those informing shareholder primacy, and strongly related to them. The 'market for corporate control', which the Takeover Directive intended to facilitate and reinforce, is based on two main assumptions: that uninvited takeovers of corporate control on the stock market are normally rationally motivated and that a vibrant market for

[285] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids (Text with EEA relevance)

[286] Leading to the following comment in the Financial Times: *'Lex: Takeover directive'* Financial Times, 23 November 2003, (ft.com): 'A fruit ripened as slowly as the European Union's planned takeover directive ought to taste unusually sweet. Alas, 14 years of deliberations have produced a sour, shrivelled thing, replete with the rancid overtones of political horse-trading' and concludes: 'The result is a sorry mess which will set European capital markets back for years. Better to abandon it altogether than allow it through in this form.'

corporate control leads to an increase in value.[287] The intended increase in value is linked to the assumed disciplining effect[288] of the threat of uninvited takeovers of control of listed companies: knowing that an uninvited takeover may happen is meant to ensure that boards and by extension top management work as efficiently as possible to avoid takeovers and thereby being replaced. If the disciplining effect does not play out, an acquirer takes over control and increases the value of the company by making the necessary changes.

The concept of the rational bidder is based on the flawed premise that takeovers are initiated when the bidder sees a possibility for increasing the value of the target, typically by replacing its board and top management, or of the bidder and the target together, through synergy effects. While some takeovers undoubtedly are initiated with such motivations, takeovers are also motivated by hubris, by the aim of growing bigger, whether for fear of being taken over, or for the status of controlling a larger business.[289]

Already in a traditional socio-economic understanding of value creation, facilitating a market for corporate control destroys value, with the only positive outcomes typically being for shareholders of the target company that sell, with 'inconclusive or negative' results beyond this.[290] Although two of the main rules intended to facilitate this 'market for corporate control' (the board neutrality rule and the breakthrough rule) had to be made optional through a complicated opt-in-opt-out structure, because they were seen as so controversial at the time, they still have a negative signalling effect.[291] The disciplining effect on 'managers' (i.e. boards and senior management) of the threat of takeovers, undermines the role of boards and senior management, rendering them too short-termistic and narrowly focused on keeping the share price up. This is the same short-termistic approach that is

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[287] See also, for an early reaction from a US perspective, J.C. Coffee, Jr. 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 *Columbia Law Review*, stating on p. 1153 that the theory of the market for corporate control has been 'overstated' and 'not received the critical scrutiny it deserves', and on p. 1199 that the theory has 'approached the status of a truism' and that its proponents tend to 'minimize the importance of other techniques of ensuring accountability – such as independent boards, shareholder voting, derivative litigation, or mandatory disclosure statutes'.

[288] Questions were raised at an early point about the disciplining effect itself, see *inter alia* P. Câmara, 'Defensive measures adopted by the board: Current European Trends' (OECD: Company Law Reform in OECD Countries (2000)) www.oecd.org/dataoecd/61/16/1931854.pdf, p. 3 with further references, indicating that takeover threats may, instead, make managers decrease their efforts, and stating that there is a significant risk of short-termism

[289] E.g. See also M. Martynova and L. Renneboog, 'Takeover Waves: Triggers, Performance and Motives' (ECGI Finance Working Paper No. 97/2005) <ssrn.com/abstract:_id=820984>, p. 36, based on a review of the empirical evidence.

[290] M. Martynova and L. Renneboog, 'Takeover Waves: Triggers, Performance and Motives' (ECGI Finance Working Paper No. 97/2005) <ssrn.com/abstract:_id=820984> last visited 29 September 2007, pp. 22–25 with further references, who state on pp. 22–23 that the long-term wealth effects (i.e. the effect on the share price) demonstrate that 'takeovers lead to a decline in share prices several years following the transaction', while, on p. 24, they state that 14 out of 25 studies regarding operating performance 'report a post-merger decline in the profitability of merging firms', while six show insignificant changes and five show a 'significantly positive increase in operating returns'. The authors add, on p. 25, that both types of studies 'suffer from measurement errors and statistical problems' and that the results should be interpreted with caution. See for a more extensive analysis, Chapter 15 of B. Sjåfjell, *Towards a Sustainable European Company Law: A Normative Analysis of the Objectives of EU Law* (Kluwer Law International, 2009).

[291] B. Sjåfjell, 'The Core of Corporate Governance: Implications of the Takeover Directive for Corporate Governance in Europe' (2011) 22 *European Business Law Review* 641–708.

seen as having contributed to the global financial crisis of 2008-2009, and now increasingly associated with the unsustainable path on which we are on.

The overall effect of the directive is assumed to have detrimental effects for employees and companies, and thus for society, as it may tend to undermine the trust on which long-term relationships, such as typically that of the employees with the company in which they are employed, are based. This coincides with a stronger drive at the time towards shareholder primacy in European company and securities law policy and in the corporate governance debate, resulting in a more 'direct exposure of employees to "market forces" and risk'. [292] The Takeover Directive serves to encourage short-term focus on the share price, with an overall negative effect on the board's capability to balance the different interests involved.

The directive contains a principle of company interest (Article 3(1)(c))[293] and a rule that requires the board to take this into consideration when giving its opinion on the bid – the board is also to include the employees in this process (Article 9(5)). However, the board is not intended to act on the basis of its insight as to the company interest in the face of a takeover attempt. Instead, the board's negotiating position is compromised (through the board neutrality rule in Article 9(2)-(4)), a narrow and short-term focus on shareholder profits is promoted, and potential acquirers are encouraged to circumvent the board and break through established control structures (the breakthrough rule in Article 11), in spite of the potential detrimental effect on the company's long-term strategies. The employees' incentives for long-term commitment to the company may also be compromised. The possibility that a change of control may be positive is outweighed by the negative effects of the directive's substantive rules.

In light of the grand challenge of our time, it is vital to secure sustainable value creation. To secure sustainable value, we must mitigate the destruction of value in the form of that which is less easy to measure (especially in the short-term): long-term sustainable value creation as in the creation of value for the business, its employees, the communities in which it is located and its contractual parties, within planetary boundaries; the trust in a future for a business and in a business that is needed for loyal employees and patient capital, for a mutually respectful collaboration with communities across it global value chains.

Although questions were posed at the time concerning the assumptions of the market for corporate control,[294] these were clearly not considered. Nor was the actual diversity of control structures, in their varying societal, political and economic contexts, taken into account. We suggest that a comprehensive assessment should be undertaken of the regulatory framework for listed companies in light of the overarching aims of the EU Green Deal and Agenda 2030 interpreted in light of the EU's overarching aim of sustainability.

[292] As noted already in 2007, S. Deakin and D.H. Whittaker 'Re-embedding the Corporation? Comparative perspectives on corporate governance, employment relations and corporate social responsibility' (2007) 15 *Corporate Governance: An International Review* p. 1.

[293] 'The board of an offeree company must act in the interests of the company as a whole (…)'. See for an analysis of this concept of the interests of the company, Sjåfjell, 'The Core of Corporate Governance'.

[294] A study on the then takeover proposal, presented to the European Parliament in 2002, stated that the 'very foundations' of the Takeover Directive could be disputed, B. Dauner Lieb and M. Lamandini, 'The new proposal of a directive on company law concerning takeover bids and the achievement of a level playing field' (Study No IV/2002/06/01 – commissioned by the European Parliament. No reference to this part of the report could been found in the subsequent preparatory work for the Takeover Directive; see further the analysis of the Takeover Directive in Section Part V of Sjåfjell, *Towards a Sustainable European Company Law*.

As preliminary proposals to mitigate some of the most negative impacts of the Takeover Directive, we propose the following amendments:

- The listing of aspects to be included in the offer document, Article 6(2)-(3), should be amended to include environmental, social, economic and governance sustainability aspects, to resonate with and reinforce the sustainability due diligence requirements that we propose included in the Company Law Directive 2017 (see 6.2.1 above).
- The target board neutrality rule in Article 9(2)-(4) should be replaced with a rule clarifying the board's competence to protect the interests of the company, see also Article 3(1)(c), and its overarching purpose of sustainable value creation within planetary boundaries (see 6.2.1 above).
- The target board's duty in Article 9(5) to prepare a statement with advice to the target shareholders concerning the bid, should be revised to include sustainability aspects (see 6.2.1).
- Consultation of employees should happen at an earlier point in time than indicated in Article 6(1) as the late involvement of employees undermines the employee protection through the legislative framework in Article 14.
- Article 6(3) on the offer document shall be revised to include sustainability aspects (see 6.2.1).
- Article 11, the breakthrough provision, should be repealed, as there is not an empirical evidence supporting that such a rule has a positive effect, and indications that it may have a negative effect.

### 6.3.4 Prospectus Directive

Most companies that want to raise capital through public offers or have securities admitted to be traded on regulated markets need to provide investors with a *prospectus*. A prospectus is a legal document that describes a company's main line of business, its finances and shareholding structure the securities that are being issued and/or admitted to trading. It contains the information an investor needs before making a decision whether to invest in the company's securities (such as shares, bonds, derivatives). The EU introduced rules on prospectus in 2003, with Directive 2003/71/EC.[295] These rules underwent a major revision in 2010, with the adoption of the amending Directive 2010/73/EU.[296]

The purpose of the EU prospectus rules is to ensure that adequate and equivalent disclosure standards are in place in all EU countries so that investors can benefit from the same level of information. Under these rules, once a prospectus has been approved in one EU country, it is valid throughout the EU ('single passport for the issuers'). The rules also ensure that minimum protection for investors is of the same standard across the EU.

[295] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (Text with EEA relevance), OJ L 345, 31.12.2003, p. 64–89.

[296] Directive 2010/73/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (Text with EEA relevance), OJ L 327, 11.12.2010, p. 1–12.

In 2015 the European Commission conducted a consultation[297] which identified shortcomings in the regime introduced by the prospectus directive. For companies, these rules constitute a lot of legal paperwork often running into hundreds of pages. This can be costly and burdensome for businesses, especially for smaller ones. The feedback also showed that it can be difficult for investors to wade through very detailed information. As part of the Capital Markets Union Action Plan,[298] the EU adopted in June 2017 a Regulation (EU) 2017/1129 to improve the prospectus regime.[299] The Regulation aims to make it easier and cheaper for smaller companies to access capital, introduce simplification and flexibility for all types of issuers, in particular for secondary issuances and frequent issuers which are already known to capital markets, and improve prospectuses for investors by introducing a retail investor-friendly summary of key information, catering for the specific information and protection needs of investors.

The heart of the Prospectus Regulation are the risk factors presented in the summary of the prospectus. According to Preamble 29 and Article 16 of the Regulation the presentation of risk factors in the prospectus should consist of a limited selection of specific risks which the issuer considers to be of most relevance to the investor when the investor is making an investment decision. The description of the risk factors in the summary should be of relevance to the specific offer and should be prepared solely for the benefit of investors and not give general statements on investment risk, or limit the liability of the issuer, offeror or any persons acting on their behalf. Those risk factors should, where applicable, highlight the risks, in particular for retail investors, in the case of securities issued by credit institutions. The materiality of the risk factors should be based on the probability of their occurrence and the expected magnitude of their negative impact.

According to Preamble 54 the primary purpose of including risk factors in a prospectus is to ensure that investors make an informed assessment of such risks and thus take investment decisions in full knowledge of the facts. Risk factors should therefore be limited to those risks which are material and specific to the issuer and its securities and which are corroborated by the content of the prospectus. A prospectus should not contain risk factors which are generic and only serve as disclaimers, as those could obscure more specific risk factors that investors should be aware of, thereby preventing the prospectus from presenting information in an easily analysable, concise and comprehensible form. Among others, *environmental, social and governance circumstances* 'can also constitute specific and material risks for the issuer and its securities and, in that case, should be disclosed'. To help investors identify the most material risks, the issuer should adequately describe and present each risk factor in the prospectus. A limited number of risk factors selected by the issuer should be included in the summary of the prospectus.

However, there is no indication of environmental, social and governance risks in the Regulation itself. According to Article 16(4), in order to encourage appropriate and focused disclosure of risk factors, ESMA shall develop guidelines to assist competent authorities in their review of the specificity and materiality of risk factors and of the presentation of risk factors across categories depending on their nature. According to Article 16(5) the Commission is empowered to adopt delegated acts in

[297] European Commission, Consultation on the Review of the Prospectus Directive, https://ec.europa.eu/finance/consultations/2015/prospectus-directive/index_en.htm.
[298] European Commission, Capital markets union: A plan to unlock funding for Europe's growth, https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union_en.
[299] Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC (Text with EEA relevance), OJ L 168, 30.6.2017, p. 12–82.

accordance with Article 44 to supplement this Regulation by specifying criteria for the assessment of the specificity and materiality of risk factors and for the presentation of risk factors across categories depending on their nature. There is no Commission delegated act so far. ESMA has however issued Guidelines on risk factors under the Prospectus Regulation in October 2019.[300]

In spite of Preamble 54, the present Guidelines do not include requirements for reporting on climate and wider sustainability risks in the guidelines on risk factors in prospectuses. ESMA just mentions that environmental, social and governance risks can be specific and material risk factors to the issuer (para 35).

*ESMA should revise the Guidelines and include in them strict requirements for issuers to report on specific sustainability risks as identified through sustainability due diligence proposed in Section 6.2.1 above.*

According to Preamble 17 of the Prospectus Regulation, incentivising board members[301] and employees to hold securities of their own company can have a positive impact on companies' governance and help create long-term value by fostering employees' dedication and sense of ownership, aligning the respective interests of shareholders and employees, and providing the latter with investment opportunities. The Preamble is not reflected in the Regulation itself, and the question may be raised if employee shareholdership automatically enhances sustainable value creation, or if it facilitates first and foremost the employees' private interests, with the danger of even shifting the focus of the employees towards shareholder interests (shareholder primacy) to the detriment of the undertaking's sustainable value creation.

However, as it is continued in Preamble 17, participation of employees in the ownership of their company is particularly important for small and medium-sized enterprises (SMEs), in which individual employees are likely to play a significant role in the success of the company. Therefore, there is no obligation to publish a prospectus for offers made in the context of an employee-share scheme within the Union, provided a document is made available containing information on the number and nature of the securities and the reasons for and details of the offer or allotment, to safeguard investor protection (see Article 1(4)(i) of the Regulation). To ensure equal access to employee-share schemes for all directors and employees, independently of whether their employer is established in or outside the Union, no equivalence decision of third country markets should be required either, as long as such information document is made available. Thus, all participants in employee-share schemes will benefit from equal treatment and information.

*Albeit the purpose for the exemptions is feasible, their consequences for undertakings' sustainable value creation should be scrutinized.*

[300] ESMA, Guidelines on risk factors under the Prospectus Regulation, 01/10/2019 | ESMA31-62-1293, https://www.esma.europa.eu/sites/default/files/library/esma31-62-1293_guidelines_on_risk_factors_under_the_prospectus_regulation.pdf.

[301] The English version of Preamble uses a term 'director' that is not used in Continental and Nordic European company law systems.

### 6.3.5 MiFID II

The core of the rules on investment services is the Directive 2014/65/EU on markets in financial instruments (MiFID II)[302] and Regulation (EU) No 600/2014 on markets in financial (MiFIR).[303] MiFID II is the cornerstone of the European Commission's Financial Services Action Plan and the most significant piece of legislation with regards to financial instruments. With the introduction of MiFID II, the scope of the MiFIR has been enlarged and covers more companies and financial products and includes fewer exemptions.[304]

MiFID II requires investment firms to offer 'suitable' products to meet their clients' needs, when offering advice (Article 25). According to the EU Action Plan *Financing Sustainable Growth*, for this reason, those firms should ask about their clients' preferences (such as environmental, social and governance factors) and take them into account when assessing the range of financial instruments and insurance products to be recommended, i.e. in the product selection process and suitability assessment. According to Action 4 of the Action Plan, subject to the outcome of its impact assessment, the Commission will amend the MiFID II to ensure that sustainability preferences are taken into account in the suitability assessment. Based on these delegated acts, the Commission will invite ESMA to include provisions on sustainability preferences in its guidelines on the suitability assessment to be updated by Q4 2018. ESMA published in December 2018 a consultation paper setting out proposals requiring the integration of sustainability risks into investment decisions or advisory processes under MiFID II,[305] which was followed by a draft Delegated Regulation from the Commission in January 2019.[306]

The Commission has not yet issued its final Delegated Regulation, nor ESMA its revised Guidelines. However, on 17 February 2020 the Commission issued a consultation on review of MiFID II and MiFIR.[307] However, these proposals do not include an obligation to integrate sustainability factors in the regulated entities' investment policies.[308] The MiFID II/MiFIR review is related to the ongoing Capital Markets Union (CMU) initiative and will take into account the relevant actions set out in the forthcoming CMU Action Plan which will build on the recommendations from the CMU High Level Forum (foreseen for publication in May 2020).[309]

The actors covered by MiFID II are covered also by the new Disclosure Regulation[310] (discussed in detail Section 8.2 of the Finance Report), obliging financial market participants shall publish their policies on the integration of sustainability risks in their investment decision-making process. These

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[302] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast) (Text with EEA relevance).
[303] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (Text with EEA relevance).
[304] H. Ahlström, 'Policy Hotspots for Sustainability: Changes in the EU Regulation of Sustainable Business and Finance' (2019) 11:499 *Sustainability*, doi:10.3390/su11020499.
[305] https://www.esma.europa.eu/press-news/consultations/consultation-integrating-sustainability-risks-and-factors-in-mifid-ii.
[306] https://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-act-2018_en.pdf.
[307] https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12168-Review-of-the-regulatory-framework-for-investment-firms-and-market-operators-MiFIR-2-1-.
[308] Ahlström, 'Policy Hotspots'.
[309] https://ec.europa.eu/info/publications/cmu-high-level-forum_en.
[310] European Parliament legislative resolution of 18 April 2019 on the proposal for a regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 (COM(2018)0354 – C8-0208/2018 – 2018/0179(COD)). Available online: http://www.europarl.europa.eu/doceo/document/TA-8-2019-0435_EN.html (accessed on 1 November 2019).

provisions are mandatory. We propose in the Finance Report broadening and enlargening the scope of Disclosure Directive. This revision should be done in coordination with the revision of MiFID II.

*In the review the Commission should implement sustainable finance in MiFID II and the delegated acts issued by the Commission. This review should be done in coordination with review of the Disclosure Regulation to ensure a comprehensive regulation of financial market actors' duty to integrate sustainability fully in their decisionmaking.*

## 6.4 Protecting European business in the transition to sustainability

In the Green Deal communication, the Commission writes 'As the world's largest single market, the EU can set standards that apply across global value chains'.[311] This applies not only through international standards but indirectly through its regulation of European business. Our reform proposals are in line with this.

To facilitate the transition of European business to sustainability, border protection measures should be put into place to protect European businesses in the transition period. This would have the added advantage of preventing unsustainable products from coming into the European market, further supported by and reinforcing the proposals made in the SMART Products report for conditions for access to the EU market.[312] It would also indirectly influence businesses in third countries, both those who work together with European undertakings in corporate groups, global value chains or networks, and those who wish to have access to European markets.

Amongst measures that should be considered is the Carbon Border Tax, announced in the political guidelines for the current Commission.[313] However, this should not be limited to carbon. For example, a broadening of this proposed initiative to encompass also other forms of environmental degradation should also be looked into. Products based on unsustainable production, whether in the form of environmental degradation, exploitation of people or undermining of the economic basis of societies such as through tax evasion, should not be allowed into the European market, including through online sales.

While the proposals we make in this report for integrating sustainability into European businesses will make them attractive for the increasing number of sustainability-oriented investors, we should also consider initiatives that can protect the European market against foreign investments that are not sustainability-oriented. A possible avenue here may be to consider an expansion of the screening of foreign direct investments into the EU. The Regulation on screening framework of foreign direct investments into the EU[314] establishes – if not compulsory rules on control of foreign direct investments (FDIs) based on national security or public order – a cooperation mechanism between the European Commission and Member States requiring the Member States to inform the Commission and other Member States of any FDI review that has been initiated. Other Member States may then provide comments where they consider such FDI is likely to affect their national

[311] European Commission, Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions: The European Green Deal, 11.12.2019, COM(2019) 640 final.
[312] E. Maitre-Ekern, M. van der Velden and M.B. Taylor 'Towards a Sustainable Circular Economy: SMART Reform Proposals', SMART report, draft on file with current authors. See also the separate report on SMART proposals for sustainable public procurement, proposing exclusion of companies who do not abide by labour rights and environmental obligations in their entire supply chain (draft on file with current authors).
[313] https://ec.europa.eu/commission/sites/beta-political/files/political-guidelines-next-commission_en.pdf
[314] Regulation (EU) 2019/452 of the European Parliament and of the Council of 19 March 2019 establishing a framework for the screening of foreign direct investments into the Union, PE/72/2018/REV/1, OJ L 79I , 21.3.2019, p. 1–14.

security or public order, or where they have information relevant for the review. The Commission may issue opinions following comments from other Member States or on any FDI where justified. The ultimate decision whether or not a Member State will permit the FDI in its territory remains exclusively with each Member State. Albeit it is difficult to introduce a compulsory screening mechanism to prevent foreign direct investments that might endanger sustainability in the European Economic Area, the scope of the Regulation could be broadened from FDIs that are likely to affect to security or public order, to FDIs that are likely to undermine environmental protection and the achievement of the social foundation in the European Economic Area.

# 7 Concluding reflections

We believe that sustainability is possible, and that there never has been a better time for putting into place the reforms necessary to remove the barriers to achieving sustainability. Facilitating the transition of European business to sustainability is crucial to achieving sustainability – and vital to ensure that Europe has the market leaders of tomorrow. The financial risks of unsustainability bring home the significance of integrating sustainability throughout the business of any undertaking. If this is not done, the financial risks will increasingly materialise, as the international trend of lawsuits against European businesses is already showing. Ultimately, the risk of continuing with 'business as usual' is existential. The global catastrophic risks of continued environmental degradation cannot be ignored. There are a number of scenarios that can lead to societal collapse, and in none of these are steady returns for investors or profitable business likely. Sustainability is not only possible – it is necessary, for all of us.

Our proposals in this draft report range from the EU's role as a global actor in international trade and investment law to proposals for changes in EU company law, accounting and auditing law and across a range of financial market legislation. This report should be seen in context with the SMART Finance Report and the SMART Products report. Even seen together, these reports do not cover all areas. As a part of the comprehensive reform that we propose the Commission undertake to ensure that European market actors transition to sustainability, a range of issues need to be included that we have not covered in our project. These include IPR law, competition law, state aid,[315] and taxation.[316]

We welcome feedback to this draft report.[317]

[315] State aid is also highlighted in the EU Green deal, Section 2.2.2.

[316] *Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions. The European Green Deal. COM/2019/640 final*.Section 2.2.2: 'At national level, the European Green Deal will create the context for broad-based tax reforms, removing subsidies for fossil fuels, shifting the tax burden from labour to pollution, and taking into account social considerations. There is a need to ensure rapid adoption of the Commission's proposal on value added tax (VAT) rates currently on the table of the Council, so that Member States can make a more targeted use of VAT rates to reflect increased environmental ambitions, for example to support organic fruit and vegetables'

[317] Comments may be submitted by this online form or by e-mail to smart-admin@jus.uio.no.

# References

[To be added for the final version]

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