THE DIRECTOR GENERAL

Mr Didier Reynders
Commissioner for Justice and Consumers
European Commission
Rue de la Loi 200
B-1049 Brussels
BELGIUM

13 October 2020

Dear Commissioner,

RE: Due Diligence and Sustainable Corporate Governance: follow up video-call 7 October

I warmly thank you for the good exchange last Wednesday 7 October.

As promised, I would like to follow-up with a few written remarks on some of the issues we discussed, including on the recent Commission study on directors' duties.

On the July 2020 Commission's Study on Directors Duties (E&Y)

I would first like to reiterate that BusinessEurope plans to remain a constructive partner on sustainable corporate governance and due diligence dossiers. We look forward to the upcoming public consultation for which we will prepare a well-developed response.

The basis of the E&Y study[1] analysis and recommendations is the assumption that European listed companies are driven by short-termism and at the same time do not take account of society's and stakeholders' interest. This basic assumption drives the whole study, including the methodology and the choice of sources, leading to a misleading picture of European companies.

The study **defines "short-termism"** as simply the ratio between, on one hand, a company's pay-outs in terms of dividends and share buy-backs and, on the other hand, the company's net income. The higher the ratio between these two, the greater the short termism since the distributed funds, according to the study, should instead have been reinvested in the company. In **theoretic terms, this ratio cannot be used as a universal measure of short-term behaviour**.

The study also does not take into account **the role played by the capital market in allocating and re-allocating resources**. Lock-in effects are precisely against the logic of dynamism and innovation in business. The prospects of competitive yields are essential to the ability of companies to attract risk capital from what today is a global

[1] https://op.europa.eu/en/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-en

capital market. In addition, **funds must be re-allocated from companies that lack sustainable investment alternatives to forward-looking companies with profitable and more sustainable projects** (e.g. with less impact on the climate, involved in cutting-edge research). This dynamic has been the cornerstone of economic policy which is aiming to promote a continuous process of structural change

US studies[2] on S&P 500 companies did **not establish that high pay-out figures deprived companies of the capital needed to invest in sustainability** as both cash flow and investment grew in the decade between 2007-2016.

Capital of European listed companies is largely held by institutional owners such as pension funds, insurance companies, mutual funds, long-term active asset-managers and similar institutions are responsible. The funds paid out to these investors, as well as to other categories of large owners such as foundations, are essentially **re-deployed in new investments** in listed companies, other areas of the business community or passed on to cutting edge research through large foundations. States' budgets also benefit where there are large shareholding positions in national listed companies. Therefore, the **notion that the study gives that distributed funds disappear** is not reflective of the reality.

From an empirical point of view, the **study is based on a review of** 4,700 companies **from only 16 out of 27 European** countries. **One third of those companies come from the UK**. This means a considerable proportion of the evidence is built around companies that fall outside future EU future measures, applying a different legal corporate system, and having a traditionally different ownership structure (more dispersed ownership model against continental Europe).

The report seems to claim that a more diverse stakeholder representation (other than those appointed by shareholders and employees) on the board of directors would lower pay-outs, which in turn would serve the sustainability agenda. The same argument is applied to a reformulation of the profit purpose of companies. **Company law regimes of the 16 countries considered in the study differ significantly** which makes it difficult if not impossible to identify an acceptable explanation why pay ratios are higher in some places than in others. Curiously, according to the study, **Finland has nearly double the pay-out ratio of Sweden, nevertheless, company law regimes of these two countries are nearly identical** in all relevant parts so the causality that the study claims to establish is non-existent.

The study proposed far-reaching proposals/reforms based on a **web-based survey involving slightly more than 60 stakeholders**, amongst others, interest organisations, and interviews with 16 persons in 12 countries **(including UK**). The study **does not provide any background information about respondents**, e.g. nationality or professional background. In addition, the study bases its claims on 10 case studies and 48 selected interviews, without a summary or background data on these qualitative data. At the end of 2019, **we have indicated to DG JUST services that the surveys tailored for associations and companies were filled with predetermined questions** that

[2] Fried, J. M., & Wang, C. C. Y. (2019). Short-Termism and Capital Flows. Review of Corporate Finance; Studies, 8(1), 207–233. https://doi.org/10.1093/rcfs/cfy011

could lead to predetermined results. For these reasons, BusinessEurope and many of its members refrained from replying.

Short-termism is a problem that the EU can and should address in different policy areas, **but it is clearly portrayed in an inaccurate way** by this study. If the EU is moving to change the existing corporate model it should do it based on a more comprehensive research and robust assessment.

We have witnessed a **worrying decrease in listings** in the past years and since 2015 there have been **300% fewer initial public offerings (IPOs)** in European stock markets. One of the main reasons explaining these figures are the cost and weight of legal requirements. **Europe's share of the global stock market value of non-financial companies has fallen by nearly 50 %**, while the dominance of the US and China has grown. **The total stock market value of all European listed companies today equals probably only one tenth of the global market value**. The combined market value DAX30 is less of two two-thirds of the exchange value of Apple alone. There is an inefficient supply of (risk) capital in Europe which the European Capital Market Union initiative is trying to address. It is key that any future initiative stemming from DG JUST is reconcilable with these objectives.

On due diligence

The **study on due diligence requirements through the supply chain from February 2020** [3] showed that 70% of business survey respondents believed there were benefits of EU-level regulation on a general due diligence. Many of those companies believe EU action would be a way to ensure a level playing field by avoiding fragmentated national approaches harmful to the competitiveness of European companies. Although this is an advantage that we also acknowledge, we would like to stress that a clear majority of businesses from all sizes and sectors do share strong concerns regarding the possible introduction of an EU mandatory framework for supply chain due diligence.

Adopting **a new legislative framework in this area raises many questions** – scope, adequate level of accountability, how to ensure that the responsibilities of states and companies are not inverted - and could have negative and unwanted impacts (e.g. jeopardising meaningful and successful company practices, and possibly dampening investment in third countries).

In addition, at a time where value chains are heavily disrupted due to the **COVID19 crisis**, introducing a new layer of legislation in the near future could make it harder for companies to effectively secure, redesign or be able to rebuild essential supply chains in the upcoming exit and recovery phases. Potential legislation would need to take this into account and equally consider long-term structural changes to global value chains induced by COVID-19.

[3] https://op.europa.eu/en/publication-detail/-/publication/8ba0a8fd-4c83-11ea-b8b7-01aa75ed71a1/language-en

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If the EU decides to go ahead with a legislative measure, the following fundamental considerations need to be taken into account:

- Any framework should be based on an **obligation of means** rather than obligation of results;
- It must **avoid transferring to companies the responsibilities of states/governments** - their respective roles should not be mixed;
- Consideration should be made on the impact on EU companies' overall **competitiveness vis-à-vis companies from other parts of the world**;
- **Third country private or publicly held companies** could, under certain conditions (e.g. turnover-based threshold in the EU) also be covered by the future EU framework;
- If reporting requirements are devised, **overlap must be avoided with other EU requirements** (e.g. non-financial reporting);
- **Any EU measure should be aligned with international standards** (e.g. UN and OECD) and guidelines, as many European companies are part of global supply chains and must be able to maintain global competitiveness and reflect meaningful requirements on their international suppliers;
- Regulatory requirements need to be **sufficiently clear** so that business can implement with confidence of compliance. The level of detail should be **proportionate** to provide clarity for business, but without being prescriptive to a point that encourages a tick-box approach rather than the more holistic materiality-based and impact-oriented approach and which takes away necessary flexibility for companies to adapt to their specificities;
- **Small and medium-sized companies (SMEs)** face distinct challenges in meeting due diligence responsibilities, not least because of their limited resources. A possible mandatory approach will impose bigger burdens on them. And even if SMEs are out of the scope of an EU initiative, the obligations will be imposed on them downstream, as part of the supply chain of companies that are within the scope. Any EU measure needs to take this into account.

On Societas Europaea (SE) regulation temporary measures and IT tools for general shareholder meetings

The temporary amendment to the SE regulation (adopted on May) extending the deadline to hold general shareholder meetings was greatly appreciated by European companies that use this company form as it gave them the necessary legal certainty to organise their AGMs this year. As the current context points to similar limitations (gatherings) in the first half 2021 **we would urge you to consider an extension of the temporary amendment until the end of 2021**.

The current pandemic has accelerated the use of digital/remote means for conducting and participating to general shareholder meetings in listed companies but also beyond. As this is a trend that will certainly be intensified in the future it would be advisable that the Commission looks into the overall legal picture at EU and member state level and assess whether there are legal gaps that would need to be addressed at the European level.

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On the idea of a 'green pledge'

We are in contact with your cabinet on this to better understand the reach, nature and other relevant elements be able to test it with potentially interested companies. Your head of cabinet Ms Tuts is speaking at the next meeting of BusinessEurope's Advisory and Support Group (ASG) on 19 November. This group is composed by 69 major European and multinational companies, from all sectors of the economy and it could be a good opportunity to raise awareness and get some preliminary feedback on this idea.

We remain at your disposal should you which to discuss further.

Yours sincerely,

Markus J. Beyrer