DISCLOSURE INSIGHT ACTION

CDP EUROPE'S COMMENT ON
Sustainable corporate governance

Background

CDP welcomes the opportunity to participate in the consultation on sustainable corporate governance with the aim of improving the EU regulatory framework on company law and corporate governance. CDP strives for companies to better manage sustainability-related matters in their own operations and value chains as regards climate change, water and forests.

Our responses to this consultation are based on the following information sources and recent responses to related public consultations:

- CDP Report 2019 on "Supply chain: Changing the chain"
- CDP Europe Report 2018 on "Higher ambitions, higher expectations"
- CDP Europe Report 2019 on "Europe's low-carbon investment opportunity"
- Public consultation responses from CDP Europe on the revision of the Non-Financial Reporting Directive and Renewed Sustainable Finance Strategy
- Study on directors' duties and sustainable corporate governance[1]
- Study on due diligence requirements through the supply chain[2]
- Shareholders Right Directive 2017/828/EU

Short-termism in company Director's duties and the need from capital markets to align with long-term investment decision making

Focusing on short-term returns without taking into account long-term implications may have underperformance of the corporation and investors in the long-term as consequence and by extension, of the economy as a whole.

The European Supervisory Authorities delivered three reports in December 2019 (ESMA report, EBA report and EIOPA report), which address the evidence of short-term pressure that corporates have from the financial sector. For instance, as mentioned in the ESMA report, **the improvements in ESG disclosures "can contribute counter undue short-termism in financial markets by complementing the information provided through traditional financial metrics with information on how issuers manage ESG factors that affect a company's future"**.[3]

Following this reasoning, short-termism should be replaced by long-term risk management, which lies on policymakers to promote. European investors should explicitly integrate climate risks into their legal fiduciary duties, and consider risks over the timeframes of their clients' assets – just as France's Article 173 law has done.

Encouraging through regulation long-term environmental risks into decision making to give forward looking analysis will be critical for our financial system at the time of supporting a well below 2-degree or 1.5-degree pathways. Therefore, bringing environmental risks into focus allows investors to better price and manage them and enables companies to make long-term investments without fearing share price dips.

[1] See "Study on directors' duties and sustainable corporate governance", July 2020.
[2] See "Study on due diligence requirements through the supply chain", January 2020.
[3] See ESMA report, p.22.

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Main barrier for achieving this is the current lack of quantity and quality of long-term GHG emissions target information disclosed by European companies. Disclosure of stock-listed companies in Europe shows, that while several companies are setting absolute and/or intensity emission reduction targets, only few are setting long-term targets. In particular, over 240 companies disclose absolute targets, over 250 companies have set intensity targets and over 200 companies have both absolute and intensity targets. More than 170 companies report not to have set a target. Only 65 of the reported absolute targets are long-term 2050 targets. Over 400 targets end by 2025, over 600 by 2030 and over 740 by 2035 (cumulative). This situation must be improved so that financial markets can efficiently allocate capital towards the low-carbon transition of the EU economy. For the EU Action Plan on 'Financing Sustainable Growth' to be successful and the EU to achieve its 2030 and 2050 climate targets, it will be fundamental to maintain an accurate picture of GHG emissions by European companies. Even more important will be to understand how corporate GHG emissions are likely to evolve in the medium to long-term. A key component in this regard is to have information on corporate GHG absolute emissions targets. However, as evidence suggests, this data is currently not sufficiently available.

The Shareholders Rights Directive II will also play an important role and should be in line with the proposed framework Directive on sustainable corporate governance. For example, at the time of adding transparency obligations for institutional investors and asset managers by requiring them to develop and disclose an engagement strategy including a description of how they monitor investee companies on non-financial performance, social and environmental impact and corporate governance, and to disclose on an annual basis how their engagement policy has been implemented.

Corporate governance and board level-oversight

EU action in company and corporate governance should pursue the general objective of promoting more sustainable corporate governance and contributing to more accountability for the companies' sustainable value creation. To achieve this, the EU should intervene to seek a balance between an attenuation of short-termism pressure on companies' directors and promote sustainability integration into corporate decision-making.

Policymakers should focus on strengthening the role of directors in pursuing their company's long-term interests and improve director's accountability for the sustainability of their business conduct.

Regarding the promotion of corporate governance that contribute to a company's sustainability, article 20 of the Accounting Directive should be extended / revised to include specific references to internal control and governance systems addressing sustainability factors; also, the expertise of Board members in relation to sustainability issues should be clarified.

Moreover, it is important to strengthen 'outside-in' governance disclosures by incorporating TCFD recommended disclosures on Governance (describe the board's oversight of climate- [and natural capital-] related risks and opportunities and describe management's role in assessing and managing climate- [and natural capital-] related risks and opportunities) into the 'corporate governance statement' in Article 20 and in the non-financial statement in 19a and 29a of the Accounting Directive.

We encourage the EC to consider the following legislative actions to strengthen sustainable corporate governance in Europe:

a) Specify directors' duties requiring them to consider the interests of stakeholders including society at large, and to identify and mitigate climate and other sustainability risks and impacts connected to the company's business operations and value chain;

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b) Require corporate boards to integrate sustainability risks, opportunities and impacts into the business strategy, and to identify, set and disclose measurable, specific, time-bound, and science-based emissions reduction targets;
c) Propose to amend the Shareholder Rights Directive II to integrate executive renumeration with long-term climate and sustainability objectives;
d) Require companies to consider sustainability expertise in the board member nomination process ("Sustainability Expert");
e) Require corporations to set mid- to long-term business targets that define the pathway by which the company is aiming to align their sustainability impact with what is required by the latest available science.

The above-named suggestions go well in line with measures that companies are already undertaking to ensure sustainability items are integrated into strategic business planning. As examples,

- Already in 2017, 92% of European companies responding to CDP's investor request for climate reported Board or other senior management having responsibility for climate change[4].
- Similarly, 80% of European companies reported having set monetary or non-monetary internal incentives for the management of climate issues[5].
- Additionally, almost 500 companies (as of October 2020) have already pledged to align their emissions reductions targets with the goals of the Paris Agreement (so-called Science-Based Targets), out of which around 50% have already had these targets checked and verified by the Science Based Targets Initiative[6].

Therefore, issuing such legislative action would not impose unrealistic regulation on companies but would ensure that companies that are currently not well set up in this respect follow their more forward-oriented peers in addressing sustainability with a long-term perspective. Furthermore, it would ensure a level-playing field, whereby more long-term oriented companies would not look like worse investments on paper given potentially smaller short-term returns compared to peers with a stronger short-term focus.

There are further indicators that good corporate governance, board oversight and long-term planning do also make companies more attractive investments for the capital markets. As an example, the STOXX Global Climate Change Leaders index (containing all companies that gained the best score (A) in CDP's climate change rating, which places strong emphasis on governance and long-term planning) has consistently and significantly outperformed a not sustainability-focused benchmark index (STOXX 1800) – see description below[7].

[4] See CDP Europe Report 2018 on "Higher ambitions, higher expectations".
[5] Ibid.
[6] See here to meet the companies that are already setting their emissions reduction targets in line with climate science.
[7] See "Europe's low-carbon investment opportunity", February 2020.

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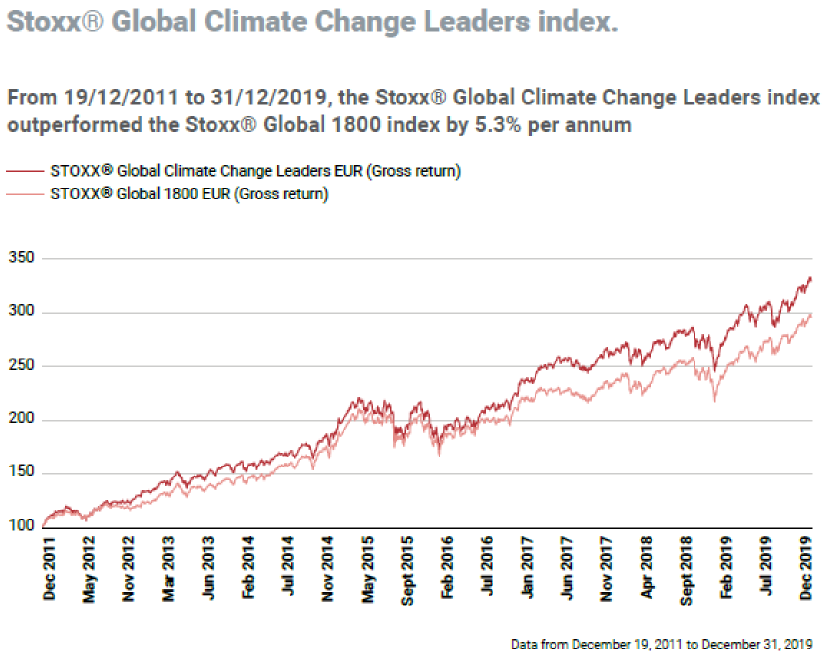
Index STOXX Global Climate Change Leaders containing all companies that gained an A score in CDP's climate change rating has significantly outperformed a not-sustainability-focused benchmark index (STOXX 1800)

5.3%

per annum outperformance of A List companies on the stock market over the past 7 years.



Most companies, over 840, in Europe reported in 2019 to have board-level oversight of climate-related issues. Only a few companies, just over 30, mainly in the Services and Manufacturing sectors, disclose oversight below board-level. The management levels reported by companies differ from assessing climate-related risks and opportunities, managing climate-related risks and opportunities or both assessing and managing climate-related risks and opportunities.

For assessing climate related-risks and opportunities most companies report the CEO, CFO, the risk committee and the sustainability committee as the responsible management level. For managing climate related-risks and opportunities many companies report the CEO and the business unit manager as the responsible management level, however the reported management level is more diverse and many companies also report the responsible management level on manager-level positions, e.g. energy manager and sustainability manager. For both assessing and managing climate-related risks and opportunities companies mostly report CEO, Chief Sustainability Officer (CSO) and the sustainability committee as the responsible management level.

Many companies, over 700, in Europe reported to have employee incentive systems in place, including the attainment of targets. Almost 170 companies do not have incentive systems in place, mainly in the Services and Manufacturing sectors.

Supply chain transparency and due diligence

The private sector is critical at the time of setting up the level of ambition and there is an expectation for business to rise to the challenge. For instance, investors are now looking at environmental data when choosing investments.

In this context, companies have been acting to reduce emissions within their operations and improving the energy efficiency of their products for years. In the efforts of pushing the boundaries of corporate sustainability even further, it is important to also look at the sphere of influence that a company can have in its supply chain.

Engaging with a company's supply chain is a crucial component of a holistic environmental strategy. We know from data reported to CDP that the emissions in a company's supply chain are usually far greater than its operational emissions (5.5 times higher on average); the same is true for the associated impacts and risks regarding deforestation and water security.

Sustainable sourcing and supply chain transparency are increasingly being recognized not only as an important part of a company's environmental strategy, but also as a fundamental part of a sound overall business strategy. For instance, during 2019 CDP surveyed supply chain members to better understand how they manage their relationships with their suppliers. The survey found that 95% of responding members believe suppliers showing environmental leadership are better value companies to partner with long-term, with only 5% stating that in their experience those suppliers are more costly. To drive more action throughout their supply chains, companies are starting to integrate environmental data into the way they manage suppliers on a day-to-day basis. Also, by putting environmental data at the heart of procurement practices, companies are ensuring that sustainable purchasing becomes business as usual.

In order to achieve this, CDP supply chain members integrate their environmental data into a combination of procurement tools and processes. Other members have set clear expectations by including specific language around environmental performance in their contracting and tendering documents.

Key points in supply chain transparency and due diligence:

- Whether a company provides staff incentives for supplier engagement is a simple indicator of the internal importance placed on company's approach to managing climate change in their supply chain.
- Businesses' spend profiles are also heavily influenced by their overall corporate strategy. Integration of climate change issues into this strategy will feed into their sourcing priorities and supplier engagement.
- Examples of incentives would include monetary rewards and other benefits for the management of climate change issues; and the inclusion of indicators for environmental criteria in purchases and/or supply chain engagement.
- Another tool is for purchasing companies to including environmental requirements in their supplier codes of conduct and procurement policies, e.g. for suppliers to disclose complete, consistent and accurate emissions data and action plans to reduce emissions.
- Science Based Targets: Science-based targets need to include 'scope 3' emissions if they account for over 40% of an organisation's total emissions, which they usually do. Companies must set emissions reduction targets that collectively cover at least 2/3 of scope 3 emissions. For many companies, the majority of their scope 3 emissions will be concentrated in their supply chain and so being able to track and reduce emissions in the supply chain is often key to enabling a company to meet their SBT.

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About CDP Europe

CDP Europe is part of the global CDP non-profit network, that drives companies and governments to reduce their greenhouse gas emissions, safeguard water resources and protect forests. Voted number one climate research provider by investors and working with institutional investors with assets of US$96 trillion, we leverage investor and buyer power to motivate companies to disclose and manage their environmental impacts. Globally, over 8.400 companies with over 50% of global market capitalization disclosed environmental data through CDP in 2019, including more than 2.100 European companies representing approximately 76% of the European market capitalization. This is in addition to the over 950 cities, states and regions globally who disclosed – including more than 215 in Europe – making CDP's platform one of the richest sources of information globally on how companies and governments are driving environmental change. CDP, formerly Carbon Disclosure Project, is a founding member of the We Mean Business Coalition.

Berlin, 08/10/2020

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Supported by the
LIFE programme of
the European Union

CDP Europe gratefully acknowledges EU funding support.