AFME response to European Commission's Consultation on Sustainable Corporate Governance

8 February 2021

AFME welcomes the opportunity to comment on the European Commission's Consultation on Sustainable Corporate Governance, which is an additional milestone in the implementation of a harmonised and consistent European framework for sustainable finance, in line with the objectives established by the EU Action Plan on Financing Sustainable Growth and by the European Green Deal.

We have provided our detailed responses to the questions raised by the consultation in **Appendix A** herein but would like to draw the attention of the Commission to our key messages.

Overall, we support the embedding of sustainability into companies' business models broadly, both in terms of risk management, business opportunities and governance practices, thus taking a holistic approach to sustainability. Environmental, social and governance (ESG) considerations are recognised as an imperative to the long-term success of a business enterprise and therefore should be considered in all aspects of its business activity. With the financial sector being already highly regulated, we stress the importance for the forthcoming sustainable corporate governance and due diligence framework to be coherent with the existing sectoral laws including on corporate governance and sustainability.

Human rights, social and environmental due diligence

- We support the development of a flexible, proportionate, principle-and-risk-based EU-wide legal framework establishing a minimum set of requirements for company due diligence to help identify potential or actual adverse impacts on sustainability factors by company operations. Such a framework can be supplemented by sector-specific non-legislative measures and/or guidelines that would help promote consistency of application among entities operating in different industries.
- We believe that the scope and parameters of the mandatory due diligence framework should be carefully calibrated, taking into account the specifics of the financial sector.
    - Definitions, of "supply chain", "business relationships" and "value chain" must be clearly defined, considering their applicability by undertakings in the financial sector. Financial companies, as compared with non-financial, deal with thousands of counterparties, directly and indirectly, through a wide range of activities they perform, thus having extremely extensive value chains.
    - The scope of the mandatory due diligence should be restricted to the first tier of counterparties, the relationship with whom banks can realistically control. This approach would be consistent with current legislation on prevention of financial crime and money laundering.
- We strongly recommend that, in order to support a development and implementation of consistent due diligence practices globally, the Commission should work at the international level (for example though the International Platform on Sustainable Finance) to help establish a minimum set of internationally accepted standards or principles that can then be applied across multiple jurisdictions.
- Should the Commission propose a regulation on due diligence requirements, we understand that such due diligence rules would apply to all EU legal entities in scope, which would be critical to ensuring a level playing field among EU and non-EU domiciled companies providing financial services in the EU.

However, we stress that calibrating the scope of the due diligence requirements and any associated liabilities should take into account that any extraterritorial application to multinational companies and global groups, if such is being contemplated, could create conflict between home and host governance regimes, when such kind of regulatory rules already exist. The application of the due diligence rules to branches of non-EU banks and to intragroup service arrangements should also be carefully considered.

Directors' duties and other corporate governance arrangements

- We agree that corporate directors should balance the interests of relevant stakeholders, with a view to take account of relevant ESG considerations. However, companies should retain the discretion to identify relevant stakeholders and contextualise their ESG risk management practices in terms of concrete ESG issues and stakeholders identified, as well as to decide on the most appropriate governance arrangements, procedures and targets based on the sector, industry, business models and other specific facts and circumstances.
- We strongly believe that a legal framework in this area should focus on the requirement for companies to set up and follow adequate due diligence processes and procedures as well as disclose on such processes and procedures ("obligation of means"); it should not impose a legal obligation on a company to meet interests and expectations of all stakeholders ("obligation of results"). Furthermore, the obligation for directors to manage stakeholder interests in the long-term interests of the company should not result in their personal liability, if they acted in good faith and observing proper practices.
- Regarding the linking of ESG risk management and remuneration policies, companies in the financial sector in the EU are already subject to a number of requirements around their remuneration policies[1]. CRD IV, the EBA Guidelines on sound remuneration policies and the ECB Guide on climate-related and environmental risks take a very holistic approach regarding remuneration and, in our view, stimulate sustainability-oriented behaviours in banks. Furthermore, the EBA is now working on the guidelines on management and supervision of ESG risks for credit institutions and investment firms[2] which will provide recommendations on how remuneration policies can be reflective of ESG risks. We therefore think that the current framework covering the banking and capital markets industry is sufficient to ensure that sustainability targets will be reflected in the banks' objectives and business strategy, which would be translated into remuneration arrangements.
- We support a requirement for boards of directors to regularly assess their level of expertise on ESG matters and take appropriate actions to increase such expertise, including via regular trainings, interaction with in-house sustainability experts, designating sustainability champions amongst Board members, etc. Whilst appointing members of the Board skilled in ESG issues would be positive, there should not be a legal requirement to have a certain number of board members with specific sustainability expertise. It is the collective expertise and voice of the Board that matters for decision on a company business orientation, which should not be measured by an absolute number of Board members with a specific skill set.

Conclusion

The EU sustainable corporate governance and due diligence framework, being complementary to the review of the Non-Financial Reporting Directive (NFRD), will play an important role in ensuring a steady and resilient low-carbon transition – if adopted on a principle-based and proportionate basis and in consideration of existing laws and regulations. We would like to thank the Commission for the vital work accomplished so far

[1] Examples are provided in the detailed consultation response
[2] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20and%20ISDA%20joint%20response%20to%20EBA%20ESG%20and%20SREP%20DP%20%20FINAL%2003022021.pdf

and we look forward to continued engagement and dialogue on this important matter. We stand ready to discuss the content of our response or to provide any further clarity regarding the statements made.

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About AFME

AFME (Association for Financial Markets in Europe) advocates for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. AFME is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. AFME aims to act as a bridge between market participants and policy makers across Europe, drawing on its strong and long-standing relationships, its technical knowledge and fact-based work. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu.

Consultation Document Proposal for an Initiative on Sustainable Corporate Governance

Appendix A

8 February 2021

Fields marked with * are mandatory.

Section I: Need and objectives for EU intervention on sustainable corporate governance

*Questions 1 and 2 below which seek views on the need and objectives for EU action have already largely been included in the public consultation on the Renewed Sustainable Finance Strategy earlier in 2020. The Commission is currently analysing those replies. In order to reach the broadest range of stakeholders possible, those questions are now again included in the present consultation also taking into account the two studies on due diligence requirements through the supply chain as well as directors' duties and sustainable corporate governance.

*Question 1: Due regard for stakeholder interests', such as the interests of employees, customers, etc., is expected of companies. In recent years, interests have expanded to include issues such as human rights violations, environmental pollution and climate change. Do you think companies and their directors should take account of these interests in corporate decisions alongside financial interests of shareholders, beyond what is currently required by EU law?

- Yes, a more holistic approach should favour the maximisation of social, environmental, as well as economic/financial performance.
- Yes, as these issues are relevant to the financial performance of the company in the long term.
- No, companies and their directors should not take account of these sorts of interests.
- Do not know.

*Please provide reasons for your answer:

We support the embedding of sustainability into companies' business models broadly, both in terms of risk, business opportunities and governance practices, thus taking a holistic approach to sustainability. We also expect that integrating sustainability considerations into a company business and strategy would be inherently linked to its economic performance and resilience in the longer term. The maximisation of social and environmental performance should be balanced with the economic viability of companies who by the definition remain commercial enterprises. To this end:

- Whereas we do not encourage the creation of new key performance indicators1, we believe that an EU corporate governance and due diligence framework based on principles of transparency and disclosure and relevant, existing sustainability KPIs would be an effective means for influencing business behaviour and ensuring a broad-based approach to company management. We strongly

[1]According to the progress report by EFRAG Project Task Force on Preparatory Work for the Elaboration of Possible EU Non-Financial Reporting Standards (PTF-NFRS) as of 31 October 2020, more than 5000 KPIs or data points of a nonfinancial nature have been inventoried so far, of which more than 3000 are generic, whereas 700 relate to climate and environment.

believe that a principle-based framework would be most appropriate to fit various industries, recognising their individual specificities and complexities, including already existing and forthcoming laws and regulations (for example, the financial sector). Such a general, principle-based framework can be supplemented by non-legislative industry specific guidelines to promote consistency of application of the general framework by entities in scope.

- Sustainability KPIs and related disclosures can, for example, relate to specific sustainability objectives and the effects on management remuneration, or how the tasks of ensuring sustainability and the company's long-term orientation are anchored at the board level. It will therefore be largely up to the owners, customers, investors and other relevant stakeholders of the company to assess whether the company is sufficiently accountable for sustainability issues rather than for this to be achieved via supervisory models or models based on actual law enforcement. Models based on supervision and/or violation and law enforcement in relation to the resulting damage effects are likely to be reflected in other legislative areas, including legislation on the environment, the labour market, human rights, etc. The interaction between different EU legislative measures should therefore also be carefully covered.
- In this context it should also be considered that:
    - Financial institutions and listed companies are already subject to more stringent requirements in terms of governance supervision and accountability. For example, listed companies must comply with corporate governance codes developed by stock exchanges. Similarly, financial institutions must comply with the provisions set out in the EU Capital Requirements Directive and Regulation and the ECB guide on fit and proper assessments of board members and senior positions in significant credit institutions. Additionally, for financial institutions there are laws in place to govern counterparty due diligence, including transactional due diligence (please refer to Appendix I for an example related to securitisation transactions).
    - The recently adopted EU sustainable finance regulations[2] will indirectly prompt (mostly larger) companies to account for the sustainability of their economic processes so that banks and asset managers can market financial products as sustainable. With further development and implementation of sustainability reporting frameworks in the EU (i.e. NFRD revision) and globally, companies will face a direct obligation to provide information on how they consider sustainability in their business models.
    - Investors and clients have an increasing demand for sustainable investing, and there is therefore market pressure on companies in relation to a more strategic long-term approach to sustainability, both in relation to risks and business opportunities. This will create the need for new competencies and responsibilities in the management and boards of directors.
    - With the development of international, regional and national action plans in the sustainability field, companies will be subject to a number of regulatory requirements and other measures that will help shape up how businesses will operate (for example, measures directed at addressing the risks related to climate change and environmental degradation that, at the EU level, will be adopted via the Climate Law and other measures under the EU Green Deal).
    - Balancing stakeholders' interests is a difficult process. There is a high degree of complexity on how to approach conflicting interests (e.g., deciding between a positive environmental impact against a negative social impact). Furthermore, the assessment of conflicting stakeholder interests needs to be carefully considered in the context of imposing liability to directors for their decision making and enforcing director's duty of care.

[2] EU Taxonomy Regulation, EU Sustainable Finance Disclosure Regulation and EU Low Carbon Benchmarks Regulation

- Finally, the mapping of existing requirements and definitions across EU member countries is also important in determining possible gaps/overlaps and informing the need for a harmonization.

*Question 2: Human rights, social and environmental due diligence requires companies to put in place continuous processes to identify risks and adverse impacts on human rights, health and safety and environment and prevent, mitigate and account for such risks and impacts in their operations and through their value chain.

In the survey conducted in the context of the study on due diligence requirements through the supply chain, a broad range of respondents expressed their preference for a policy change, with an overall preference for establishing a mandatory duty at EU level.

Do you think that an EU legal framework for supply chain due diligence to address adverse impacts on human rights and environmental issues should be developed?

- Yes, an EU legal framework is needed.
- No, it should be enough to focus on asking companies to follow existing guidelines and standards.
- No action is necessary.
- Do not know.

*Please explain:

We acknowledge different levels of maturity of national due diligence initiatives in Europe and the need for a harmonised approach, and thus we support an EU-wide legal framework that would establish a minimum set of requirements for company due diligence to address potential or actual adverse impacts on sustainability factors by company operations. However, there are a number of factors that need to be considered before such a framework is put in place:

- Firstly, we support the premise in the Commission's Inception Impact Assessment paper on Sustainable Corporate Governance explicitly stating that *"Depending on the scope and detail of the initiative, it would also need to be assessed to what extent legislative and to what extent non-legislative measures would be best suited to meet the objectives. In particular, it will need to be established which issues would need to be laid down in legislation and which issues would rather have their place in complementary guidance."* As mentioned in our response to Q1, we support a general principle-based legislative framework accompanied by non-legislative industry specific guidelines.
- Secondly, it is not clear if the question refers to a framework that would cover a broad spectrum of social issues or focuses on human rights specifically. We think that the framework should be broad enough to cover a wider range of social issues consistent with the existing legislation, such as the EU Taxonomy and the EU Sustainable Finance Disclosure Regulation.
- It is not clear whether the question seeks feedback on whether, in addition to own operations, the due diligence should also cover companies in the "supply chain" or in the entire "value chain" (the two concepts seem to be used interchangeably whilst potentially having different meaning). Therefore, the two definitions should be clearly defined in the new proposal.
- Following the above point on the definitions, the scope and parameters of the mandatory due diligence framework should be carefully defined bearing in mind that value and supply chains can differ substantially across sectors and industries. Conducting a due diligence through the entire value

chains for some industries will simply be unfeasible. For example, we have considered the definition of a value chain that was included in a draft **Own Initiative Legislative (INL) Report**[3] by the European Parliament on corporate due diligence and corporate accountability, stating that a value chain means "***all activities, operations, business relationships and investment chains of an undertaking inside or outside the EU.*** Value chain includes entities with which the undertaking has a direct or indirect business relationship, upstream and downstream, and which either (a) supply products or services that contribute to the undertaking's own products or services, or (b) receive products or services from the undertaking". In the context of applying the definition to the financial sector, and specifically the capital markets industry that AFME represents, it appears that it would effectively capture all counterparties, as well as counterparties of the counterparties (and further) that banks have direct or indirect relationships with. By indirect relationships we mean any business activity that involves financial instruments and products where the bank would not be a party to a contractual relationship with the companies underlying financial instruments or products (for example, trading in securities in secondary markets, investing in certain types of investment funds, using investment benchmarks supplied by benchmark administrators as part of passive investment strategies, trading in and hedging with securities derivatives that can track the value of a specific security or a benchmark, etc.).

- We stress that the financial sector's value chain is distinct from the value chain of a company producing physical goods. Financial institutions (FIs) have a lower ability to influence the business practices of their clients than it does to influence the business practices of a supplier, where product/service specifications can be made. This does not remove the need for FIs to conduct risk-based due diligence, but it does mean that options for risk mitigation are more limited. One of the main ways in which FIs can mitigate risk is to limit their appetite for business in higher-risk markets, which may have unintended consequences for underserved markets in particular. Considering the nature of the financial sector, we believe that the definition of the value chain, and the scope of due diligence, should be restricted to the first tier of counterparties, the relationship with whom banks can realistically control. Banks should be able to rely on the equivalent due diligence procedures performed by counterparties in the first tier in respect of their value chains (i.e., a bank would generally be able to rely on information from a counterparty demonstrating that the counterparty performed appropriate value chain due diligence on its end). This approach would be consistent with the KYC ("know your client") procedures performed by banks in compliance with financial crime and money laundering prevention laws.
- We also think that the new framework should ensure flexibility and take a proportionate principle- and risk-based approach to due diligence in order to cater for specific facts and circumstances relevant to the undertaking under assessment, including its jurisdiction and geographical location.
- Finally, it is critical to ensure that the new framework will not duplicate or make more complicated the implementation of existing sectoral legislation. For example,
    - **EU Sustainable Finance Disclosure Regulation (SFDR)** requires disclosing due diligence policies with respect to the principal adverse impacts of investment decisions on sustainability factors at the entity level as well as to provide disclosures at a product level of how a financial product considers principal adverse impacts on sustainability factors, and endorsing the due diligence guidance for responsible business conduct developed by the OECD and the United Nations-supported Principles for Responsible Investment
    - **EU Taxonomy Regulation requires** the application of the "do no significant harm principle" in respect of other environmental objectives as well ensuring compliance with a range of minimum social safeguards in the assessment of whether an economic activity can be classified

[3] https://www.europarl.europa.eu/doceo/document/JURI-PR-657191_EN.pdf

as environmentally sustainable. The social safeguards are based on several international conventions and frameworks - the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Right.

- **EU Low Carbon Benchmarks Regulation** requires benchmark administrators to explain in the benchmark statement how environmental, social and governance factors are reflected in each benchmark provided and published.
- **EU Non-Financial Reporting Directive (NFRD)** – already requires large companies to publish a non-financial statement that would include information on the due diligence processes implemented by the reporting company, also regarding, where relevant and proportionate, its supply and subcontracting chains, in order to identify, prevent and mitigate existing and potential adverse impacts. We appreciate that the quality and comparability of reporting on this aspect might require improvement, however with the review of the NFRD being underway, we expect due diligence processes and procedures underpinning the due diligence reporting to naturally evolve and strengthen with the new framework in place.

* Question 3: If you think that an EU legal framework should be developed, please indicate which among the following possible benefits of an EU due diligence duty is important for you (tick the box/multiple choice)?

- Ensuring that the company is aware of its adverse human rights, social and environmental impacts and risks related to human rights violations other social issues and the environment and that it is in a better position to mitigate these risks and impacts
- Contribute effectively to a more sustainable development, including in non- EU countries
- Levelling the playing field, avoiding that some companies freeride on the efforts of others
- Increasing legal certainty about how companies should tackle their impacts, including in their value chain
- A non-negotiable standard would help companies increase their leverage in the value chain
- Harmonisation to avoid fragmentation in the EU, as emerging national laws are different
- SMEs would have better chances to be part of EU supply chains
- Other

Other, please specify:

* Question 3a. Drawbacks

Please indicate which among the following possible risks/drawbacks linked to the introduction of an EU due diligence duty are more important for you (tick the box/multiple choice)?

- Increased administrative costs and procedural burden
- Penalisation of smaller companies with fewer resources

- Competitive disadvantage vis-à-vis third country companies not subject to a similar duty
- Responsibility for damages that the EU company cannot control
- Decreased attention to core corporate activities which might lead to increased turnover of employees and negative stock performance
- Difficulty for buyers to find suitable suppliers which may cause lock-in effects (e.g. exclusivity period/no shop clause) and have also negative impact on business performance of suppliers
- Disengagement from risky markets, which might be detrimental for local economies
- Other

Other, please specify:

The parameters and scope of the new due diligence obligations will need to be clearly defined in the proposed legislation. We agree that companies need to have and follow adequate processes and procedures to identify risks associated with causing adverse impacts on ESG factors by their business operations, however it is imperative to ensure that companies will not be held liable for damages that they cannot control (for example, a bank offering services in the EU should not be held liable for the infringement of environmental or social rights of a counterparty to the bank's client simply because of having a relationship with the client – if the bank has conducted reasonable due diligence procedures in relation to its client).

Section II: Directors' duty of care – stakeholders' interests

In all Member States the current legal framework provides that a company director is required to act in the interest of the company (duty of care). However, in most Member States the law does not clearly define what this means. Lack of clarity arguably contributes to short-termism and to a narrow interpretation of the duty of care as requiring a focus predominantly on shareholders' financial interests. It may also lead to a disregard of stakeholders' interests, despite the fact that those stakeholders may also contribute to the long- term success, resilience and viability of the company.

Question 5. Which of the following interests do you see as relevant for the long- term success and resilience of the company?

	Relevant	Not relevant	I do not know/I do not take position
* the interests of shareholders	X	○	○
* the interests of employees	X	○	○
* the interests of employees in the company's supply chain	○	○	X
* the interests of customers	X	○	○
* the interests of persons and communities affected by the operations of the company	X	○	○
* the interests of persons and communities affected by the company's supply chain	○	○	X
*the interests of local and global natural environment, including climate	X	○	○
* the likely consequences of any decision in the long term (beyond 3-5 years)	X	○	○
* the interests of society, please specify	X	○	○
* other interests, please specify	X	○	○

the interests of society, please specify:

The list is not exhaustive, as further explained below, but provides some examples: healthcare, education, overall prosperity, high standard of living, access to high-quality goods and services.

other interests, please specify:

We think that the majority of the aforementioned interests, would be relevant for the long-term success

and resilience of companies. We also think that the above list is not exhaustive and can vary depending on each undertaking. However, consistent with our position noted in the response to Q2, we think that the scope of mandatory counterparty due diligence and legal liability attached to it, should be restricted to the first tier of counterparties, the relationship with whom banks can realistically control.

As we are conscious of the negative consequences of imposing liability to companies for issues outside their control, we do not take position on the relevance of the interests of employees in the company's supply chain, as well as the interests of the persons and communities affected by the operations of the company.

Question 6. Do you consider that corporate directors should be required by law to:

(1) identify the company´s stakeholders and their interests, (2) to manage the risks for the company in relation to stakeholders and their interests, including on the long run (3) and to identify the opportunities arising from promoting stakeholders' interests?

	I strongly agree	I agree to some extent	I disagree to some extent	I strongly disagree	I do not know	I do not take position
* Identification of the company´s stakeholders and their interests	○	X	○	○	○	○
* Management of the risks for the company in relation to stakeholders and their interests, including on the long run	○	X	○	○	○	○
* Identification of the opportunities arising from promoting stakeholders' interests	○	X	○	○	○	○

* Please explain:

We agree that a director's duty of care should include a broad consideration of stakeholders' interests that go beyond shareholders' financial interests. We also agree that companies should manage the risks for the company in relation to stakeholders and their interests as well as identify the opportunities arising from promoting stakeholders' interests.

In their roles as investors, AFME members note that it is important for companies to know who their stakeholders are and, therefore, to "identify" them (without prioritising one above the other), while also identifying related risks and opportunities, as well as conflicting issues among the different stakeholder categories.

However, whilst it is appropriate that directors provide oversight over these duties, it should not be prescribed by law how to perform them. We believe that the Commission should elaborate a set of principles that companies can use in identifying the most relevant stakeholders. However, the list of stakeholders should not be prescriptive, and their identification should be limited to the relevant stakeholders, taking into consideration commercial sensitivities and privacy concerns around their identification. There seems to be a risk of an overflowing number of individuals or groups who might identify themselves as relevant stakeholders, thereby making this provision unworkable (please refer to our responses to Q8 and Q9 that raise a point that stakeholder management will always presume some reasonable trade-offs).

Given that relevant stakeholders are industry-, and in many cases entity-specific, and depend on a company's most material ESG risks and opportunities, it will be necessary for companies themselves to identify the relevant stakeholders and their interests, and to proactively manage these risks and opportunities. However, we would expect that any legal framework in this area should focus on the requirement for companies to set up and follow respective processes and procedures to identify relevant stakeholders and balance their interests as well as disclose on such processes and procedures, it should not impose a legal obligation on the company to meet interests and expectations of all stakeholders. We note that such processes and procedures should not be prescribed in law as they will depend on specific facts and circumstances pertinent to an undertaking (refer to our response to Q7),

Finally, we note that listed companies in the European Union are generally performing the duties in question already, which are part of corporate governance codes embedded in the listing rules of major stock exchanges. We encourage the Commission to consider how to bring the similar requirements (in a balanced and proportionated manners) also to non-listed companies and to other sectors that are less supervised and regulated than the financial sector.

*Question 7. Do you believe that corporate directors should be required by law to set up adequate procedures and where relevant, measurable (science–based) targets to ensure that possible risks and adverse impacts on stakeholders, i.e. human rights, social, health and environmental impacts are identified, prevented and addressed?

- I strongly agree
- I agree to some extent
- I disagree to some extent
- I strongly disagree
- I do not know
- I do not take position

* Please explain:

Considering the importance of certain sustainability related impacts to business, especially in the longer term, the implementation of strong governance processes with regard to the management of material sustainability impacts (risks & opportunities) is pivotal.

We note that national corporate governance codes and regulations, where they exist, already require companies to take into account issues material to the business. The Board is responsible for the oversight of these risks (as for non-ESG risks) while risk management is a responsibility of the executive management. Moreover, now that sustainability risks and factors have been widely recognized as a component of long-term business viability and growth, we are seeing market forces leading companies

into adopting sustainability as part of the broader corporate strategy and business models. Delivering on such a sustainability-oriented strategy would naturally fall under the responsibility of management under already existing laws governing duties and responsibilities of corporate directors. We therefore think that addressing this issue is not about introducing new legal requirements on duties of corporate management but rather interpreting the existing requirements through the lens of sustainability. Perhaps the Commission should consider issuing additional guidance to help companies with this effort.

To this end, AFME and Latham&Watkins published a white paper[4] *Governance, conduct and compliance in the transition to sustainable finance* aiming to assist banks (and financial services sector more broadly) in integrating sustainability considerations across the organization.

If an EU legal obligation were introduced for corporate directors to ensure that possible risks and adverse impacts on stakeholders - i.e. human rights, social, health and environmental impacts - are identified, it should not be accompanied by a prescriptive requirement of certain processes, procedures and targets. As noted in our response to Q6, it should be left to companies to identify relevant stakeholders and contextualise their ESG risk management practices in terms of concrete ESG issues and stakeholders identified, as well as to decide on the most appropriate governance arrangements, procedures and targets based on the sector, industry, business models and other specific facts and circumstances.

Furthermore, companies should not be liable for preventing and addressing material adverse impacts on ESG factors, as this would simply be unfeasible. Their responsibility should be to have the right processes in place to allow for the identification of material adverse impacts, without however dictating risk appetite for counterparties, potentially forcing termination of relationships.

Regarding setting up relevant targets, AFME believes that, rather than prescribing a duty of establishing targets, directors should be provided with guidance on how to achieve the relevant targets for the respective industry/company type, on the basis of the laws that already exist or are being developed to regulate business activity (e. g., EU Climate Law that sets a legally binding target of net zero greenhouse gas emissions by 2050 as well as other measures adopted under the European Green Deal; or transition pathways that should be usefully developed as guidance for all economic sectors/industries (see AFME response to the consultation on a Renewed Sustainable Finance Strategy[5] regarding the importance and usefulness of establishing clear transition pathways for the real economy sectors).

* Question 8. Do you believe that corporate directors should balance the interests of all stakeholders, instead of focusing on the short-term financial interests of shareholders, and that this should be clarified in legislation as part of directors' duty of care?

- I strongly agree
- I agree to some extent
- I disagree to some extent
- I strongly disagree
- I do not know
- I do not take position

[4] https://www.afme.eu/Portals/0/DispatchFeaturedImages/Transition%20to%20Sustainable%20Finance-FINAL-v3_1-
[5]https://www.afme.eu/Portals/0/DispatchFeaturedImages/200715_Consultation%20Response%20renewed%20sustainable%20finance%20strategy_Final%20response%20and%20Key%20messages.pdf

* Please provide an explanation or comment:

We agree that corporate directors should balance the interests of relevant stakeholders (not all stakeholders), with a view to ESG matters relevant to particular issues. To this end, it is worth noting that directors of banks and financial intermediaries, which are supervised by the relevant competent authorities, must also comply with laws, regulations, and supervisory provisions already embedding the interests of various stakeholders (e.g, creditors).

AFME members have already taken and continue to take steps to enhance their engagement with key stakeholders, looking beyond the shareholders' interests and the short-term profit-maximisation. We observe that more and more investors, including shareholders, are interested in longer term returns. To this end, directors should act in the interest of the corporation by accounting for ESG risks and factors, which are recognised as an imperative to a long-term success of a business enterprise. However, the obligation for directors to manage stakeholder interests in the long-term interests of the company should not result in personal liability, if the director has acted in good faith and observed proper practices.

Finally, the experience of individual member states, for example France and Italy, shows that a combination of hard law and soft law is possible and effective. As such, French law sets high level principles and allow companies identify stakeholder interests without extending directors' and officers' liability.

* Question 9. Which risks do you see, if any, should the directors' duty of care be spelled out in law as described in question 8?

The main risk is associated with legal uncertainty concerning the directors' and officers' legal liability.

Balancing interests of multiple stakeholders would always imply certain trade-offs – in simple terms, there would always be a party whose interests might not be fully satisfied. There is a risk that a legal obligation to "balance the interests of all stakeholders, instead of focusing on the short-term financial interests of shareholders" would open a pandora box of unintended consequences where any party that would consider themselves a relevant stakeholder might be able to initiate a legal claim against the company and its management. Consequently, high litigation risks may result in diminishing the intrinsic value of companies and thus discouraging investment.

Furthermore, over-regulation often leads to a loss of innovation, loss of efficiency, over-expenditure and bankruptcy in newly established businesses. A recent review of academic research that uses cross-country comparisons to evaluate the impact of economic regulation on growth finds that higher levels of economic regulation are consistently associated with lower rates of economic growth per capita.[6]

* How could these possible risks be mitigated? Please explain.

As noted in our response to Q6, we strongly believe that a legal framework in this area should focus on the requirement for companies to set up and follow respective processes and procedures to identify relevant stakeholders and balance their interests as well as disclose on such processes and procedures ("obligation of means"), it should not impose a legal obligation on the company to meet interests and expectations of all stakeholders ("obligation of results"). We note that such processes and procedures should not be prescribed in law as they will depend on specific facts and circumstances pertinent to an undertaking.

[6] https://www.mercatus.org/system/files/broughel-regulation-growth-mercatus-working-paper-v1.pdf

An example from experience in France, where the PACTE law does not impose any "obligation of results" but "an obligation of means", demonstrates that an efficient framework is possible without imposing criminal sanctions or vicarious liability.

Were such a legislation to be introduced at the European level, amending the definition of directors' duty of care, companies should be provided with a transition period and tools to review and adjust as required their existing policies and processes/procedures.

* Where directors widely integrate stakeholder interest into their decisions already today, did this gather support from shareholders as well? Please explain.

Yes, experience suggests that integrating relevant stakeholders' interests in corporate decision-making is strategically important and is conducive to long-term value creation, which is positively evaluated by shareholders. Stakeholders, including shareholders, increasingly request financial institutions to integrate ESG matters into their strategies, governance and risk management framework.

Question 10. As companies often do not have a strategic orientation on sustainability risks, impacts and opportunities, as referred to in question 6 and 7, do you believe that such considerations should be integrated into the company's strategy, decisions and oversight within the company?

- I strongly agree
- I agree to some extent
- I disagree to some extent I strongly disagree
- I do not know
- I do not take position

* Please explain:

We agree that a proper integration of material sustainability aspects into strategy, decision-making processes and oversight is a prerequisite to enabling directors to approach sustainability risks and opportunities more holistically, understand the level of materiality to the company and stakeholders - beyond shareholders' interests. Furthermore, as already mentioned in our response to Q8, such integration is fundamental to ultimately ensuring the long-term success of a businesses.

However, as noted in our response to Q7, sustainability risks and factors are now widely recognized as a component of a long-term business viability and growth, which is motivating companies to take action in integrating sustainability consideration into their corporate strategy and business models – there is therefore no need to specifically enshrine this requirement in corporate law. Duplication with existing rules and initiatives should also be avoided.

While we understand that there are companies that may not have **yet** strategic orientation on ESG risks (partly because environmental and social risks are mostly longer-term, and sometimes outside the usual business planning horizon), we see this processing is changing rapidly – especially in the financial sector. For example, the financial sector has already in place (or forthcoming) sectoral rules and supervision that would govern the integration of sustainability considerations into the business of financial institutions (refer to Appendix I to this document).

Enforcement of directors' duty of care

Today, enforcement of directors' duty of care is largely limited to possible intervention by the board of directors, the supervisory board (where such a separate board exists) and the general meeting of shareholders. This has arguably contributed to a narrow understanding of the duty of care according to which directors are required to act predominantly in the short-term financial interests of shareholders. In addition, currently, action to enforce directors' duties is rare in all Member States.

* Question 11. Are you aware of cases where certain stakeholders or groups (such as shareholders representing a certain percentage of voting rights, employees, civil society organisations or others) acted to enforce the directors' duty of care on behalf of the company? How many cases? In which Member States? Which stakeholders? What was the outcome?

Please describe examples:

N/A – AFME chose not to respond to this question

* Question 12. What was the effect of such enforcement rights/actions? Did it give rise to case law/ was it followed by other cases? If not, why?

Please describe:

N/A

* Question 13. Do you consider that stakeholders, such as for example employees, the environment or people affected by the operations of the company as represented by civil society organisations should be given a role in the enforcement of directors' duty of care?

- I strongly agree
- I agree to some extent
- I disagree to some extent
- I strongly disagree
- I do not know
- I do not take position

* Please explain your answer:

We note that there are already existing and effective channels that allow stakeholders to raise issues associated with a company's business practices (for example EU regulation on whistle blowers' protection and collective redress). Granting a formal role to stakeholders in the enforcement of directors' duty of care would be unmanageable in practice and potentially damaging to the economic viability of the business and potentially to stakeholders themselves – in particular, if conflicts between multiple stakeholders would need to be managed on an ongoing basis.

If the director's duty of care were to be amended and enshrined in law as suggested by this consultation, supervision by assigned competent authorities should be sufficient to promote consistent and objective evaluation of compliance by companies.

* Question 13a: In case you consider that stakeholders should be involved in the enforcement of the duty of care, please explain which stakeholders should play a role in your view and how.

N/A

Section III: Due diligence duty

For the purposes of this consultation, "due diligence duty" refers to a legal requirement for companies to establish and implement adequate processes with a view to prevent, mitigate and account for human rights (including labour rights and working conditions), health and environmental impacts, including relating to climate change, both in the company's own operations and in the company's the supply chain. "Supply chain" is understood within the broad definition of a company's "business relationships" and includes subsidiaries as well as suppliers and subcontractors. The company is expected to make reasonable efforts for example with respect to identifying suppliers and subcontractors. Furthermore, due diligence is inherently risk-based, proportionate and context specific. This implies that the extent of implementing actions should depend on the risks of adverse impacts the company is possibly causing, contributing to or should foresee.

*Question 14: Please explain whether you agree with this definition and provide reasons for your answer.

Please see our response to Q1. We think that definitions of business relationships, supply chain, value chain should all be clearly defined first on a standalone basis and vis-à-vis each other. We agree that companies should be expected to make reasonable efforts with respect to identifying suppliers and subcontractors, and other relevant business relationships. However, we disagree with the proposed definition of "supply/value chain" which is too broad. In practice, it is impossible to manage all the risks related to a company's "business relationships" along the whole supply/value chain. Companies' efforts should be limited to first-tier suppliers/subcontractors.

We fully agree that due diligence should be risk-based, proportionate and context specific which implies that the extent of implementing actions should depend on identifying risks of adverse impacts a company is possibly causing, contributing to or should foresee. The outcome of the due diligence process may constitute useful information for companies to factor where relevant in their risk strategies and/or business decisions as well as influence behaviours. We would also welcome guidance on what can be considered as "adequate procedure" for financial companies.

Question 15: Please indicate your preference as regards the content of such possible corporate due diligence duty (tick the box, only one answer possible). Please note that all approaches are meant to rely on existing due diligence standards, such as the OECD guidance on due diligence or the UNGPs. Please note that Option 1, 2 and 3 are horizontal i. e. cross-sectorial and cross thematic, covering human rights, social and environmental matters. They are mutually exclusive. Option 4 and 5 are not horizontal, but theme or sector-specific approaches. Such theme specific or sectorial approaches can be combined with a horizontal approach (see question 15a). If you are in favour of a combination of a horizontal approach with a theme or

sector specific approach, you are requested to choose one horizontal approach (Option 1, 2 or 3) in this question.

- Option 1. "Principles-based approach": A general due diligence duty based on key process requirements (such as for example identification and assessment of risks, evaluation of the operations and of the supply chain, risk and impact mitigation actions, alert mechanism, evaluation of the effectiveness of measures, grievance mechanism, etc.) should be defined at EU level regarding identification, prevention and mitigation of relevant human rights, social and environmental risks and negative impact. These should be applicable across all sectors. This could be complemented by EU- level general or sector specific guidance or rules, where necessary
- Option 2. "Minimum process and definitions approach": The EU should define a minimum set of requirements with regard to the necessary processes (see in option 1) which should be applicable across all sectors. Furthermore, this approach would provide harmonised definitions for example as regards the coverage of adverse impacts that should be the subject of the due diligence obligation and could rely on EU and international human rights conventions, including ILO labour conventions, or other conventions, where relevant. Minimum requirements could be complemented by sector specific guidance or further rules, where necessary.
- Option 3. "Minimum process and definitions approach as presented in Option 2 complemented with further requirements in particular for environmental issues". This approach would largely encompass what is included in option 2 but would complement it as regards, in particular, environmental issues. It could require alignment with the goals of international treaties and conventions based on the agreement of scientific communities, where relevant and where they exist, on certain key environmental sustainability matters, such as for example the 2050 climate neutrality objective, or the net zero biodiversity loss objective and could reflect also EU goals. Further guidance and sector specific rules could complement the due diligence duty, where necessary.
- Option 4 "Sector-specific approach": The EU should continue focusing on adopting due diligence requirements for key sectors only.
- Option 5 "Thematic approach": The EU should focus on certain key themes only, such as for example slavery or child labour.
- None of the above, please specify

* Please specify:

Question 15a: If you have chosen option 1, 2 or 3 in Question 15 and you are in favour of combining a horizontal approach with a theme or sector specific approach, please explain which horizontal approach should be combined with regulation of which theme or sector?

Please refer to our detailed response to Q2 in relation to the application of a corporate due diligence duty in the financial services sector. We support harmonization of corporate governance practices across the EU with a view to help facilitate the achievement of the European sustainability objectives. However, the initiative should take into consideration, in the case of financial companies, the initiatives already undertaken under the EU's Sustainable Finance Action Plan to promote sustainability in the management, operation and organization of the financial sector. It is therefore essential that a new broad cross-sectoral

legislation on sustainable corporate governance and due diligence respects the specific requirements of financial companies – and does not make them subject to "double-regulation".

Question 15b: Please provide explanations as regards your preferred option, including whether it would bring the necessary legal certainty and whether complementary guidance would also be necessary.

As noted in our response to Q2, we support a minimum set of flexible, risk- and principle-based requirements that would promote a harmonisation of due diligence practices at the EU level accompanied by sectoral and industry specific non-binding guidelines.

For this purpose, we suggest that it would be appropriate to leverage the existing international frameworks, such as the OECD Responsible Business Conduct Guidelines with its sector specific guidance documents.

* Question 15c: If you ticked options 2) or 3) in Question 15 please indicate which areas should be covered in a possible due diligence requirement (tick the box, multiple choice)

- Human rights, including fundamental labour rights and working conditions (such as occupational health and safety, decent wages and working hours) Interests of local communities, indigenous peoples' rights, and rights of vulnerable groups
- Climate change mitigation
- Natural capital, including biodiversity loss; land degradation; ecosystems degradation, air, soil and water pollution (including through disposal of chemicals); efficient use of resources and raw materials; hazardous substances and waste
- Other, please specify

* Other, please specify:

N/A

* Question 15d: If you ticked option 2) in Question 15 and with a view to creating legal certainty, clarity and ensuring a level playing field, what definitions regarding adverse impacts should be set at EU level?

N/A

* Question 15e: If you ticked option 3) in Question 15, and with a view to creating legal certainty, clarity and ensuring a level playing field, what substantial requirements regarding human rights, social and environmental performance (e.g., prohibited conducts, requirement of achieving a certain performance/target by a certain date for specific environmental issues, where relevant, etc.) should be set at EU level with respect to the issues mentioned in 15c?

N/A

* Question 15f: If you ticked option 4) in question 15, which sectors do you think the EU should focus on?

N/A

* Question 15g: If you ticked option 5) in question 15, which themes do you think the EU should focus on?

N/A

* Question 16: How could companies'- in particular smaller ones'- burden be reduced with respect to due diligence? Please indicate the most effective options (tick the box, multiple choice possible)

This question is being asked in addition to question 48 of the Consultation on the Renewed Sustainable Finance Strategy, the answers to which the Commission is currently analysing.

- All SMEs[16] should be excluded
- SMEs should be excluded with some exceptions (e.g. most risky sectors or other)
- Micro and small sized enterprises (less than 50 people employed) should be excluded
- Micro-enterprises (less than 10 people employed) should be excluded
- SMEs should be subject to lighter requirements ("principles-based" or "minimum process and definitions" approaches as indicated in Question 15)
- SMEs should have lighter reporting requirements
- Capacity building support, including funding
- Detailed non-binding guidelines catering for the needs of SMEs in particular
- Toolbox/dedicated national helpdesk for companies to translate due diligence criteria into business practices
- Other option, please specify
- None of these options should be pursued

Please explain your choice, if necessary

We think that a risk based, and proportionate approach should be applied to SMEs. For example, a comply or explain basis can be applied and accompanied by lighter due diligence and reporting requirements. It should also be highlighted that existing legal requirements already incorporate the notion of proportionality vis a vis SMEs.

* Question 17: In your view, should the due diligence rules apply also to certain third- country companies which are not established in the EU but carry out (certain) activities in the EU?

- Yes

- No
- I do not know

* Question 17a: What link should be required to make these companies subject to those obligations and how (e.g. what activities should be in the EU, could it be linked to certain turnover generated in the EU, other)? Please specify.

We think that protecting environment and societies is a global issue, and therefore, respective due diligence requirements should be established at the international level. In this respect, while acknowledging that climate change is a common concern of humankind, the Paris Agreement in its preamble explicitly recognized that Parties should, "when taking action to address climate change, respect, promote and consider their respective obligations on human rights (…)". Therefore, we strongly recommend that, in order to support a development and implementation of consistent due diligence practices globally, the Commission should work at the international level (for example though the IPSF) to help establish a minimum set of internationally accepted standards or principles that can then be applied across multiple jurisdictions.

Should the Commission propose a regulation on due diligence requirements, we understand that due diligence rules will apply to all EU legal entities in scope, which would be critical to ensuring a level playing field among entities companies, EU and non-EU domiciled, providing financial services in the EU. We understand that, in line with the inherently risk-based, proportionate and context specific nature of due diligence (as highlighted by the Commission in the introduction to Question 14 of this consultation), the Commission considers this in their approach to corporate governance and the implications for cross-border economic activities.

To this end, many financial services firms that are non-EU headquartered have established subsidiaries in the EU, to provide services to EU and non-EU clients. These subsidiaries established in the EU, will be subject to EU due diligence rules for corporate governance to help prevent companies with the EU presence from potentially causing adverse impacts on ESG factors elsewhere in the world via their EU operations, which we of course support. However, we stress that the scope of the due diligence practices and any liabilities should take into account that any extraterritorial application to multinational companies and global groups could create conflict between home and host governance regimes, when such kind of regulatory rules already exist. We would also highlight the application of such rules to branches from non-EU banks and the complications that extraterritorial application of due diligence requirements might create, would the headquarter not apply similar standards. We would also note that extraterritorial provision of EU due diligence rules might be complicated to implement and cause operational disruptions, where an EU legal entity is part of a global group (EU or non-EU headquartered) which may provide services or receive services to other parts of the global group. Any proposals should reflect that the intention of the due diligence rules is not to inhibit intra-group arrangements of global groups. We note that multinational companies have to comply with laws and regulations of countries where they have presence, which needs to be taken into account. Nevertheless, it would be unworkable if every country required multi-national companies to comply with their local rules at the group level, and when rules are conflicting, not only at the entity level registered in a specific country.

* Question 17b: Please also explain what kind of obligations could be imposed on these companies and how they would be enforced.

Regarding the obligations imposed, third-country companies can be reasonably expected to disclose on the existence of processes and procedures, and compliance with those processes and procedures, aiming to identify potential and/or actual adverse impacts on ESG factors from their business operations – based on

existing international conventions. Companies cannot be expected to comply with the specific EU laws throughout the entire group as noted in our response to Q17a.

* Question 18: Should the EU due diligence duty be accompanied by other measures to foster more level playing field between EU and third country companies?

- Yes
- No
- I do not know

Please explain:

N/A

* Question 19: Enforcement of the due diligence duty

Question 19a: If a mandatory due diligence duty is to be introduced, it should be accompanied by an enforcement mechanism to make it effective. In your view, which of the following mechanisms would be the most appropriate one(s) to enforce the possible obligation (tick the box, multiple choice)?

- Judicial enforcement with liability and compensation in case of harm caused by not fulfilling the due diligence obligations
- Supervision by competent national authorities based on complaints (and/or reporting, where relevant) about non-compliance with setting up and implementing due diligence measures, etc. with effective sanctions (such as for example fines)
- Supervision by competent national authorities (option 2) with a mechanism of EU cooperation/coordination to ensure consistency throughout the EU
- Other, please specify

Please provide explanation:

We think that supervision by competent national authorities with a mechanism of EU cooperation/coordination to ensure consistency throughout the EU would better cater for any specificities of other relevant national laws and regulatory environment (in which the NCAs should have more in-depth expertise) but would provide a common backbone to ensure a level playing field across the Union.

Question 19b: In case you have experience with cases or Court proceedings in which the liability of a European company was at stake with respect to human rights or environmental harm caused by its subsidiary or supply chain partner located in a third country, did you encounter or do you have information about difficulties to get access to remedy that have arisen?

- Yes
- No

In case you answered yes, please indicate what type of difficulties you have encountered or have information about:

N/A – AFME chose not to respond to this question

If you encountered difficulties, how and in which context do you consider they could (should) be addressed?

N/A

Section IV: Other elements of sustainable corporate governance

Question 20: Stakeholder engagement

Better involvement of stakeholders (such as for example employees, civil society organisations representing the interests of the environment, affected people or communities) in defining how stakeholder interests and sustainability are included into the corporate strategy and in the implementation of the company's due diligence processes could contribute to boards and companies fulfilling these duties more effectively.

* Question 20a: Do you believe that the EU should require directors to establish and apply mechanisms or, where they already exist for employees for example, use existing information and consultation channels for engaging with stakeholders in this area?

- I strongly agree
- I agree to some extent
- I disagree to some extent
- I strongly disagree
- I do not know
- I do not take position

* Please explain.

We support proposals to broaden the engagement of directors beyond shareholders to other stakeholder, in the form of a set of principles or best practices.

As referred to in our responses to Qs 6-8, each company should decide how to define the scope of its stakeholders and decide the best way to engage according to the specificities of their activities and organisation. This process will ensure a dialogue with the most relevant stakeholders in the sectors in which companies operate.

Employees occupy a specific and fundamental position in the company which justifies important rights of information and consultation. No other category of stakeholders should be granted the same rights.

AFME considers that it is unfeasible for companies to carry out an exhaustive overview of all their stakeholders' interests. Given that there is no universally accepted definition of "stakeholders" and no reasonable definition can be found due to the specificity of each company's environment, we believe that any legal consequences attached to this notion would be highly problematic for companies.

Finally, we reiterate it would be unfeasible to balance the interests of all the stakeholders, especially in sectors where companies have thousands of stakeholders.

* Question 20b: If you agree, which stakeholders should be represented? Please explain.

Please refer to our response to Q20a, as well as Q6-8.

Question 20c: What are best practices for such mechanisms today? Which mechanisms should in your view be promoted at EU level? (tick the box, multiple choice)

	Is best practice	Should be promoted at EU level
Advisory body	X	
Stakeholder general meeting	X	
Complaint mechanism as part of due diligence	X	X
Other, please specify		X

Other, please specify:

Involving other stakeholders, e.g. through advisory committees/dedicated partner annual meetings and the like, might be a good practice which would be suitable to certain companies (at their discretion). However, introducing such a practice as a statutory requirement seem unnecessarily burdensome to impose on companies in general. It is also unclear what the consequences of a business choosing to ignore or not to follow recommendations and advice from a broader stakeholder group consulted by a regulatory advisory body would be. It is therefore important to maintain that the company's owners and general meeting are directional and determine the company's development and goals. It should therefore be up to the individual business to choose how and to what extent it will interact with stakeholders outside the owners.

Question 21: Remuneration of directors

Current executive remuneration schemes, in particular share-based remuneration and variable performance criteria, promote focus on short-term financial value maximisation [17] (Study on directors' duties and sustainable corporate governance).

Please rank the following options in terms of their effectiveness to contribute to countering remuneration incentivising short-term focus in your view.

This question is being asked in addition to questions 40 and 41 of the Consultation on the Renewed Sustainable Finance Strategy the answers to which the Commission is currently. Ranking 1-7 (1: least efficient, 7: most efficient)

Restricting executive directors' ability to sell the shares they receive as pay for a certain period (e.g. requiring shares to be held for a certain period after they were granted, after a share buy-back by the company)	
Regulating the maximum percentage of share-based remuneration in the total remuneration of directors	
Regulating or limiting possible types of variable remuneration of directors (e. g. only shares but not share options)	
Making compulsory the inclusion of sustainability metrics linked, for example, to the company's sustainability targets or performance in the variable remuneration	
Mandatory proportion of variable remuneration linked to non-financial performance criteria	
Requirement to include carbon emission reductions, where applicable, in the lists of sustainability factors affecting directors' variable remuneration	
Taking into account workforce remuneration and related policies when setting director remuneration	

Other option, please specify	
None of these options should be pursued, please explain	

Please explain:

We understand that the Commission is looking at ways to ensure that companies across all economic sectors have remuneration policies that are consistent with the integration of sustainability considerations. In this respect we would note that companies in the financial sector in the EU are already subject to a number of requirements around the remuneration policy – please refer to Appendix I to this document for the respective references.

We consider that the introduction at EU level of harmonised general requirements and guidelines for companies' remuneration policies may be justified to ensure consistency and a level playing field, but we stress that a differentiated approach should be applied to financial companies based on the above argument. It is also important that the Board of Directors/owners continue to have flexible and attractive options for remuneration of management compared with target achievement, etc. (and which can also be closely linked to sustainability and the transformation of the company as a result of legal requirements in other areas).

More specifically, from the perspective of AFME members, many of the proposed measures in Q21 have already to be taken into account by banks due to their obligations according to CRD IV.

We are of the view that it must remain the responsibility of the financial institution to decide what share of variable remuneration relates to non-financial performance. Furthermore, we think that this solid link between the non-financial performance and the remuneration does already exist in the current supervisory framework (CRD IV, EBA Guidelines on sound remuneration policies). Hence, a mandatory proportion of variable remuneration linked to non-financial performance criteria may turn against this holistic approach.

CRD IV, the EBA Guidelines on sound remuneration policies and the ECB Guide on climate-related and environmental risks take a very holistic approach regarding remuneration and, in our view, stimulates sustainability-oriented behaviours in banks. We are of the view that the current framework ensures that sustainability targets will be reflected in the banks' objectives and business strategy and those aspects would have to be considered as company values in variable remuneration.
The current EBA Guidelines on remuneration demand that banks' remuneration systems are risk-aligned and variable remuneration is based on risk-sensitive performance criteria. As the ESG risks become integrated into banking risk-management, the remuneration systems automatically become also ESG-risk sensitive. To this, as noted in our response to the EBA Discussion Paper on management and supervision of

ESG risks for credit institutions and investment firms[7], we think that institutions that have set ESG related objectives or limits to ESG risks should reflect this fact in their incentive schemes, as part of wider business performance objectives. This should be done in a proportionate way and should also take account of the premise that there should be no double counting where ESG risks are considered part of existing risk and limits set on those.

* Question 22: Enhancing sustainability expertise in the board

Current level of expertise of boards of directors does not fully support a shift towards sustainability, so action to enhance directors' competence in this area could be envisaged [18] (Study on directors' duties and sustainable corporate governance).

Please indicate which of these options are in your view effective to achieve this objective (tick the box, multiple choice).

- Requirement for companies to consider environmental, social and/or human rights expertise in the directors' nomination and selection process Requirement for companies to have a certain number/percentage of directors with relevant environmental, social and/or human rights expertise Requirement for companies to have at least one director with relevant environmental, social and/or human rights expertise
- Requirement for the board to regularly assess its level of expertise on environmental, social and/or human rights matters and take appropriate follow-up, including regular trainings
- Other option, please specify
- None of these are effective options

Please explain:

We support a requirement for the board to regularly assess its level of expertise on environmental, social and/or human rights matters and take appropriate follow-up, including regular trainings. We consider this is a sensible approach and could be done, for example, in the context of the board's annual self-assessment session, which is considered best practice and it could be disclosed that this assessment has taken place and what follow-up has been conducted (e.g. if specific trainings were conducted during the year for the board, these should also be disclosed).

As noted in our response to the EBA Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms, we consider the board of directors to be a unique and inseparable body with collective responsibility, through which both management and supervisory functions are performed. All the members of the Board imperatively perform all the functions assigned to it as they are all, collectively, part of the decision-making process, and they all have the same rights and responsibilities; they are all under the same liability regime and should act as one single collegial body.

For this reason, we do not support a requirement for companies to have a certain number of directors with relevant environmental, social and human rights expertise. The number of Board members with specific sustainability expertise should not be an absolute number, as what matters is the collective expertise of Board members

Also, it is important to bear in mind that some time will need to be provided for such expertise to develop. In order to increase board level expertise, the designation of a Sustainability Leader on the Board of

[7]https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20and%20ISDA%20joint%20response%20to%20EBA%20ESG%20and%20SREP%20DP%20%20FINAL%2003022021.pdf

Directors could be considered but should not be a mandatory requirement. Alternatively, inhouse or external experts could be granted access to the board. Regardless of the option chosen, it will be necessary to ensure that the expertise is influential enough to have a tangible impact on board decisions.

Additionally, in order to ensure the right competencies in the Board, it may be considered to specify the Board's tasks so that, in addition to managing the overall and strategic management and ensuring a sound organization of the Company's business, it must also ensure that: relevant aspects of sustainability are incorporated satisfactorily and that the Board receives adequate reporting on this matter. This would be in line with the development of a more standardized framework for non-financial reporting (in connection with the review of NFRD) and in line with existing requirements that the Board of Directors receives adequate reporting on the company's financial situation.

* Question 23: Share buybacks

Corporate pay-outs to shareholders (in the form of both dividends and share buybacks) compared to the company's net income have increased from 20 to 60 % in the last 30 years in listed companies as an indicator of corporate short-termism. This arguably reduces the company's resources to make longer-term investments including into new technologies, resilience, sustainable business models and supply chains[19]. (A share buyback means that the company buys back its own shares, either directly from the open market or by offering shareholders the option to sell their shares to the company at a fixed price, as a result of which the number of outstanding shares is reduced, making each share worth a greater percentage of the company, thereby increasing both the price of the shares and the earnings per share.) EU law regulates the use of share-buybacks [Regulation 596/2014 on market abuse and Directive 77/91, second company law Directive].

In your view, should the EU take further action in this area?

- I strongly agree
- I agree to some extent
- I disagree to some extent
- I strongly disagree
- I do not know
- I do not take position

Question 23a: If you agree, what measure could be taken?

N/A

Question 24: Do you consider that any other measure should be taken at EU level to foster more sustainable corporate governance?

If so, please specify:

To comment on our response to Question 23, in relation to companies' dividend payments and share buy-back, the discussions do not seem to take sufficient account of the fact that increased return requirements

are essentially due to investor expectations, which are also being affected by the return obligations of pension companies/institutional investors. At the same time, it is important to maintain that the company's capital requirements can be adjusted on an ongoing basis, including through share buy-backs. A number of legislative measures have already been adopted at EU level to change investor behaviour, including that banks and asset managers must account for the sustainability of investments. Any legislative changes should therefore await the effect of these measures.

Appendix I	
Regulation governing credit institutions and investment firms	**Relevant requirements**
EBA Guidelines on Loan Origination and Monitoring **(EBA/GL/2020/06)**	The Guidelines integrate ESG factors into credit risk management. ESG integration involves the management body[8], who bears the overall responsibility for the credit risk culture. The guidelines require that the credit risk culture include an adequate "tone from the top". Hence, credit must be granted considering its impact on the institution's capital position, profitability, sustainability, **and ESG factors**. Consequently, the consideration of the institutions' ESG factors must be part of the management body's responsibilities related to credit granting activities. The guidelines require that the involved staff has sufficient knowledge and appropriate remuneration schemes.
ECB Guide on Climate-related and Environmental Risks	In the Guide the ECB looks at the governance and risk management by institutions of climate-related and environmental risks across a number of areas of an institutions' business. The Guide emphasises the need of a holistic approach by firms across their entire governance structure, business strategy, risk management framework, risk appetite, internal audit, accountability and robust reporting to management/the board of directors. On **remuneration**, the Guide stresses that "institutions are expected to ensure that their remuneration policy and practices stimulate behaviour consistent with their climate-related and environmental (risk) approach, as well as with voluntarily commitments made by the Institution", recommending that institutions could consider implementing a variable remuneration component linked to the successful achievement of climate-related and environmental objectives – however ultimately this approach should be consistent with the existing **EBA Guidelines on sound remuneration policies** (see further below).
EBA Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms (EBA/DP/2020/03)	Consultation period ended on February 3, 2021 Amongst other matters, the Discussion Paper explored key areas that support the institutions' sound and effective management of ESG risks. These areas include (i) business strategies and business processes, (ii) internal governance and controls and (iii) risk management. With regard to **internal governance** specifically, the Discussion Paper explores ESG-related strategies and policies in organisational structure, responsibilities of organizational units, including the allocation of

[8] According to Article 3, point 7, of CRD IV, Management body is "an institution's body or bodies, which are appointed in accordance with national law, which are empowered to set the institution's strategy, objectives and overall direction, and which oversee and monitor management decision-making, and include the persons who effectively direct the business of the institution".

	responsibilities to the management body and organization of the responsible committees. The Discussion paper further explores the role of **Management body, corporate and risk culture**, specifically highlighting the following aspects as being important to evaluating the organisation and functioning of the management body: • Whether the management body in its management function appropriately directs the business considering the credit institution's ESG risk-related strategy; • Whether the supervisory function adequately oversees and monitors the management decision-making and actions considering the credit institution's ESG risk-related objectives and/or limits; and • Whether the management body has sufficient knowledge, skills and experience with regard to ESG factors and ESG risks. Regarding **remuneration policies and practices**, the DP highlights the importance of the alignment of the institution's remuneration policy with its long-term risk management framework and objectives, including the variable remuneration of categories of staff whose professional activities have a material impact on the credit institution's risk profile.
EBA Guidelines on internal governance (EBA/GL/2017/11)	EBA has consulted on the updated guidelines (consultation period closed on 31.10.2020)[9] The Guidelines aim to harmonise institutions' internal governance arrangements, processes and mechanisms across the EU, in line with the requirements in the Capital Requirements Directive (CRD IV). The Guidelines set requirements on, amongst other matters: • Role and composition of the management body and committees • Overall governance framework, including organisational framework and structure • Risk culture and business conduct The proposed updates to the Guidelines explicitly note that *"the management body should aim at ensuring a sustainable business model that takes into account all risks,* ***including environmental, social and governance risks***".
Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU	EBA and ESMA have consulted on the updated guidelines (consultation period closed on 31.10.2020)[10]. These Guidelines aim to harmonise and improve suitability assessments within EU financial sectors, and to ensure sound governance arrangements in financial institutions in line with the Capital Requirements Directive (CRD IV) and the Markets in Financial Instruments Directive (MiFID II). The Guidelines highlight the importance for institutions to consider whether candidates have the knowledge, qualification and skills necessary to safeguard proper and

[9] https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Consultations/2020/EBA%20launches%20consultation%20to%20revise%20its%20Guidelines%20on%20internal%20governance%20%28EBA/CP/2020/20%29/898013/CP%20on%20Guidelines%20on%20internal%20governance%20under%20CRD_track%20changes.pdf

[10] https://www.esma.europa.eu/press-news/esma-news/eba-and-esma-launch-consultation-revise-joint-guidelines-assessing-suitability

and Directive 2014/65/EU (EBA/GL/2017/12)	prudent management of the institution. The Guidelines also foster more diverse management bodies and, therefore, contribute to improved risk oversight and resilience of institutions.
EBA Guidelines on sound remuneration policies under Articles 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013 (EBA/GL/2015/22)	The EBA has consulted on the updated guidelines (consultation period closed on 29.01.2021)[11]. The publication of a final guideline is expected in the first half of 2021. The proposal highlights that remuneration policies of credit institutions and investment firms should account for ESG risk factors, as embedded in the corporate strategy, culture and values, and also requires institutions to take account for long-terms interests of the shareholders/owners, stipulating that: "*The institution's remuneration policy for all staff should be consistent with the objectives of the institution's business and risk strategy, corporate culture and values, risk culture,* ***including with regard to environmental, social and governance (ESG) risk factors****, long-term interests of the institution, and the measures used to avoid conflicts of interest, and should not encourage excessive risk taking. Changes of such objectives and measures should be taken into account when updating the remuneration policy. Institutions should ensure that remuneration practices are aligned with their overall risk appetite, taking into account all risks, including reputational risks and risks resulting from the mis-selling of products. Institutions should also* ***take into account the long-term interests of shareholders or owners, depending on the legal form of the institution***"
EU Securitisation Regulation	All securitisations in Europe are regulated by the EU Securitisation Regulation, which already sets out the highest due diligence and disclosure standards for securitisation anywhere in the world, including (for "STS" labelled securitisations) the disclosure of information related to environmental performance of "residential loans or auto loans or leases" [Article 22(4) of the EU Securitisation Regulation]. The detailed asset specific disclosure required under the EU Securitisation Regulations means that most, if not all, information required to assess the sustainability factors in securitisation transaction is already provided to investors, who perform detailed due diligence not just to comply with EU Securitisation Regulation but also in light of their broader ESG related obligations, for instance under the EU Sustainable Finance Disclosure Regulation. While adequate disclosure of information will be key to the development of a market in sustainable investing, a lot of work has already been undertaken to subject securitisation transactions to a high level of disclosure and due diligence requirements under the EU Securitisation Regulation.

[11] https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Consultations/2021/Guidelines%20on%20sound%20remuneration%20policies%20under%20Directive%202013-36-EU/934979/CP%20on%20draft%20GL%20on%20remuneration%20policies.pdf