StyrelseAkademien

European Commission, Directorate-General for Justice and Consumers

Att.: Commissioner Didier Reynders
Ms Maija Laurila, Head of Unit for Company Law

Re. the European Commission report Study on directors' duties and sustainable corporate governance, and the Inception Impact Assessment, based on this report

The Swedish Academy of Board Directors (Sw. *StyrelseAkademien*) is deeply concerned about the combined content of these documents and its likely implications for the legal foundation for business entrepreneurship and hence the entire market economy in the European Union. As the Swedish member institute of ecoDa we stand fully behind the response submitted by this association but would like to further expound on our concerns as outlined below.

Far-reaching policy interventions into this system must be founded on solid empirical evidence, provided through in-depth scientific research based on generally accepted research methodology, and on thorough analyses of their possible repercussions on the prevailing legal systems in the EU Member States. The documents referred to fulfil neither of these requirements.

As will be elaborated on in the attached Annex to this letter, the study in question displays such fundamental shortcomings in terms of methodological design and analytical stringency, as well as of its practical execution, that it cannot reasonably be used as a basis for EU-level legislative interventions. What is further remarkable is the almost total lack of transparency regarding the empirical database of the study, both in terms of profiles of the data providers used (companies and individuals) and of the data actually obtained. To provide a reasonably comprehensive account of the empirical database underlying the findings of a research study is a prerequisite for its credibility as a basis for policy conclusions.

As to the Inception Impact Assessment it mainly comprises an overall account of the background and intended content of the policy interventions, whereas the actual impact assessment – although certainly preliminary at this point – appears overly simplistic and in conspicuous lack of objective empirical back-up.

Against this background we urge the Commission to withdraw its present initiatives pertaining to these matters, and to return to the drawing-board for a more comprehensive, thorough and evidence-based approach for dealing with the issues at hand.

Stockholm, 25 September 2020

THE SWEDISH ACADEMY OF BOARD DIRECTORS

Svante Forsberg	Ulrika Spåls	Per Lekvall
Chair	CEO	Chair of the International Committee

Annex to letter to the European Commission, DG JUST

A CRITICAL REVIEW OF THE EU STUDY ON DIRECTORS' DUTIES AND SUSTAINABLE CORPORATE GOVERNANCE

General remarks

Overall the study appears heavily biased towards producing certain preconceived results in line with the thoughts underlying e.g. the EC Action Plan on Financing Sustainable Growth of 2018 and the 2020 EC Consultation on the Renewed Sustainable Finance Strategy. It can therefore not be seen as an objective and unprejudiced research inquiry and is thus unfit as evidential basis for EU-level policy interventions in this field.

The study starts out by painting a grossly distorted picture of the private business sector, portraying it as made up of narrow-minded and greedy, short-term profit maximisation companies with little or no regard of the effects of their activities to the surrounding society. This gross misrepresentation of the great majority of modern listed (as well as unlisted) companies in the EU member states is then used as a pretext for proposing a range of ill-conceived and potentially damaging interventions into since long well-tested and fine-tuned legal systems setting the ground-rules for business enterprises.

The underlying thinking appears to be that private companies should assume the prime responsibility for solving some of modern society's most pressing issues, such as climate change, environmental pollution, human rights violations etc., that the political system seems unable and/or unwilling to take on with sufficient determination. If fully implemented as proposed in the report, this would have devastating effects on the efficiency, innovativeness and competitiveness of European companies – and hence on the EU economy at large.

Methodological weaknesses

The study suffers from some serious methodological shortcomings which by themselves render it unfit as a basis for EU-level legal intervention:

Most of the field research, aimed to provide new empirical data for the ensuing analyses and conclusions, appears unfocused and partly failed. For example, the web survey, the design of which has been heavily criticised for being biased towards predetermined results[1], produced a mere 62 usable responses, the sources of which are self-recruited and their backgrounds unaccounted for.

The conspicuous lack of transparency about the outcome of the empirical research efforts is also remarkable. At least the following ought to be disclosed in order to enable the reader to interpret and assess the results referred to:

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[1] See letters to the Commission from the Swedish Corporate Governance Board and Italian ASSONIME of 6 September and 27 November 2019, respectively.

- Regarding the web survey a summary account of the responses to each of the questions in the questionnaire and, to the extent available, of the nationality and professional profile of the individuals behind the 62 usable responses (and should no such information be available this further decreases the relevance of the study).
- Further details about the design of the 10 case studies (member state composition, some account of the information sought, topics discussed etc.) and at least a summary (anonymised if warranted to the participants) account of the outcome of each study.
- The member state profile of the 48 interviews carried out for the assessment of the impacts of the options and - to the extent possible with regard to the integrity of individual respondents - at least a summary account of the outcome of these interviews broken down according to relevant respondent categories.
- The profile of the 4,719 companies making up the financial and business database at least in terms of nationality but to the extent available also other characteristics such as size, business sector, listed on regulated market or MTF etc.

In the absence of more comprehensive hard-data evidence, the study rests heavily on reviews of existing literature within the field, the choice of which appears severely biased towards the preconceived outcome and the views and opinions of which it uncritically reiterates.[2]

Analytical shortcomings

Also from a sheer analytical point of view the report suffers from serious weaknesses, the most conspicuous of which are in our opinion the following:

The one-sided focus on short-termism as the major – if not only – determinant of companies' indifference to the interests of a broader circle of stakeholders than its shareholders is grossly oversimplified. True enough, an overly short time perspective in the governance of a company may certainly contribute to such behaviour, but this may also have many other conceivable causes such as myopic views of the role of companies in the society, unsuitable remuneration systems for the board and management, insufficient appreciation of the advantage of mutually rewarding relations with stakeholder groups, etc. – not to mention sheer ignorance or even arrogance on the part of the board and/or owners of the company. In view of the crucial role of the concept of corporate sustainability behaviour in this study, a more in-depth and broad-minded analysis of its conceivable causes and determinants would have been appropriate.

Furthermore, given that short-termism is assigned such a crucial role in the study, its operational definition would have deserved more thorough consideration. In fact neither of the two indicators used to measure the concept - pay-outs to shareholders (dividends plus share buy-backs) and capital expenditure (on physical assets), both in relation to gross and net revenue - can be seen as universally associated with overly short-term business behaviour:

[2] See for example several references to the so-called SMART project at the University of Oslo, infamous for its consistent ideological and anti-business bias.

- From an individual company point of view there is a host of other considerations conceivably underlying dividend decisions, from ridding the company of excess capital to securing its long-term competitiveness on the capital market and hence its access to risk capital.
- And also regarding capital expenditure there are many other – and usually more decisive – considerations underlying investment decisions than alleged attempts to maximise short-term profits. It may further be noted that the emergence of modern, knowledge-intensive industries at the expense of more capital-intensive traditional firms is likely to contribute to a long-term downward trend of physical capital expenditure levels in companies, without this having any couplings whatsoever to the degree of short- or long-termism.
- For both indicators the 1993-2018 time series appears interpreted in a rather biased way: in both cases the main changes occurred during the 1990's whereas the trends from around 2000 and onwards are more or less constant. The report duly acknowledges this but nonetheless repeatedly refers to the development 1993-2018 as a coherent downward-leaning trend for both indicators.
- Finally in this context, the report seems to pursue the notion that it would be desirable from a societal point of view to keep company dividends as low as possible; at least the 60% total pay-outs noted towards the end of the observed period appears considered unduly high. This is indeed a weird idea. In a modern market economy most of the capital paid out to shareholders of listed companies is in fact re-invested as business risk capital, often in new and more dynamic companies. To try to retain the capital in existing companies would pertain to nothing less than stifling the restructuring and renewal of the business sector. Seen in this light the 60% pay-outs of the later part of the studied period appear more healthy for the societal economy than the 20% reported for the early 1990's.

Furthermore, so-called shareholder primacy is consistently described as synonymous with short-term profit maximisation. Again this is indeed a gross oversimplification, possibly unduly affected by characteristics of the UK market:

- Firstly, as to the short-termism issue, in contrast to the UK market, most of the EU market is characterised by more concentrated ownership structures with, in many cases, one or a few strong - sometimes controlling – owners dominating listed companies. And such shareholders are typically long-term owners with investment horizons sometimes extending over decades ahead. In fact also many institutional investors, especially those managing pension capital and other assets with a long-term return expectation, may have investment horizons almost in line with many dominating owners.[3]
- Secondly, even with a long-term perspective the typical shareholder interest is rarely (exceptions certainly exist) to maximise profit at any price. On the contrary, the expectation of a

[3] It should be noted that a preparedness to divest whenever needed to protect the beneficiaries' money is not synonymous with a short-term investment strategy. An institutional owner may have a very long-term view of its engagement in a company, evidently manifested in the way it exerts its ownership duties, but still being prepared to sell its shares should the long-term prospects of the company severely deteriorate.

good return on the capital invested is in general constrained by a number of side conditions such as limited risk appetite, a solid balance sheet, restrictions regarding business sectors entered etc. Also, in later years increasing considerations of a broad range of sustainability aspects in order to secure the company's long-term "license to operate" in the eyes of the surrounding society are further broadening the scope of factors qualifying a sheer profit-seeking shareholder interest.

- All in all, the interest of most modern listed-company shareholders – institutional, private, industrial or public - is neither to prioritize short-term profit generation nor to maximise it at any price but to earn the best available return on capital invested consistent with a conduct in the society in which the company operates that ensures its long-term survival and prosperity.

Ill-conceived policy implications

The report concludes by outlining certain policy implications of the study pertaining to legal interventions by the EU. Some of those are very far-reaching and would, if implemented, fundamentally change the ground-rules for entrepreneurship and the conduct of business in the EU.

Possibly the potentially most damaging of these changes is the proposed view of the concept of the interest of the company. Traditionally this has been understood as derived from the interest of its owners, however, as outlined above, with due regard of legitimate interests of a range of other parties with an interest in or being affected by the activities of the company. Examples of such interests are those of employees, customers, creditors, etc., as well as other relevant "stakeholders" with whom the company must maintain mutually rewarding relations in order to survive and prosper long-term. This view, however, is put in question by the report, which instead proposes a view of the company as having interests of its own, in principle detached from the interests of its shareholders as well as those of any other specific stakeholder group.

This is a deeply problematic approach for several reasons. *Firstly* it rests upon a view of the company as a sort of living organism with its own values, desires and preferences, irrespective of those of its original founders, present shareholders and other interested parties. However, since this is a practical impossibility, including for the company to articulate its interests, some other party must act as its "proxy" in this respect, and the only conceivable such proxy is the board. However, assigning the board with such powers would totally strip the shareholders of the control of the company and instead leave this to the board. This, in turn, would pertain to nothing less than to in one blow reverse four decades of achievements of modern corporate governance, the key purpose of which has been to take back shareholder control of companies from high-handed and self-sufficient boards.

Secondly this leads to the question how the board is to be appointed? Clearly the shareholders could single-handedly be entrusted with this prerogative since they would ensure to appoint a board obedient to their interests, thus still leaving the company with interests aligned with those of its owners. Instead the power to appoint at least a significant portion of the directors must be handed over to some other stakeholder groups, unclear which but presumably with representation of a reasonably broad range of such interests. This would leave boards comprising directors representing widely different interests in the company's activities, a situation that would be detrimental to the efficiency of the board's work. Conflicts of means to reach commonly held goals is common-place and fundamentally healthy in board work. In contrast, conflicts of interests may be devastating, especially if the interests are mutually conflicting and there are no obvious grounds for prioritizing between them.

Thirdly, a change of this kind would pertain to a widening of the fiduciary accountability of directors to apply not primarily to the shareholders but to a broader range of stakeholder groups. But accountability to several “masters” means in practice accountability to none: directors who are held to account for their performance regarding some stakeholder interests may always point at having given precedence to those of others. Therefore, all in all, a development of this kind would fundamentally upset the judicial system upon which the governance of companies rests.

Finally it should be noted that a considerable portion of the 4,719 companies making up the prime empirical database of the study is likely to be domiciled in the UK, a market that differs from most present-day EU markets both in terms of ownership structure of listed companies and the extent of share buy-backs in relation to traditional dividends. If this portion is significant (a piece of information conspicuously absent in the report) it appears dubious, to say the least of it, to base proposed policy implications for the EU member states on findings largely affected by the specific circumstances of the UK market.

Concluding remarks

Some of the ideas put forth in this study and in the Commission’s Inception Impact Assessment largely based on it, on both accounts with only scant and partly distorted empirical support, are very far-reaching and may severely damage the competitiveness and dynamism of European listed companies compared with in particular their American and Chinese counterparts. This, in turn, would risk making Europe lag further behind in the global race for economic wealth.

STYRELSEAKADEMIEN is a non-profit, independent association committed to the development and further strengthening of Swedish company boards and their directors. We comprise around 7,000 board directors and company owners from all over the country in our 16 regional units. Together we professionalize Swedish board work.

Since 2012 StyrelseAkademien is the Swedish member institute of the European Confederation of Directors’ Associations (ecoDa).