THE "S" IN ESG

European Union sets new legal framework for Social Governance

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The EU has developed a classification framework for sustainable activities in the business world that can be broken down into three categories:

- Environmental
- Social
- Governance – together also known as ESG.

ESG criteria are becoming more and more significant in regard to businesses' sustainable development in the long term. Different from the traditional evaluation of corporate financial performance, ESG has been seen as an investment concept and corporate evaluation standard which focuses on corporate environmental, social responsibility and corporate governance performance. The S, Social, criteria are not only focused on the company's relationship with its employees, e.g., labor standards, diversity, and inclusion. It also takes internal stakeholders into account, and even considers compliance with social criteria along the whole supply chain. In addition, social criteria are a critical aspect when it comes to a company's reputation.

SOCIAL MASTERCLASS? EU'S CORPORATE SUSTAINABILITY DUE DILIGENCE DIRECTIVE

On February 23, 2022, the European Commission published the proposal for a Directive on Corporate Sustainability Due Diligence (CSDD (EU)2022/0051(COD)). The directive aims to foster sustainable and responsible corporate behavior throughout global value chains. It will enhance the protection of the environment and human rights in the EU and beyond to succeed in the EU's transition to a climate-neutral and green economy in line with the European Green Deal and in delivering on the UN Sustainable Development Goals. Companies will be required to

- identify
- prevent
- end
- or (at least) mitigate

adverse impacts of their activities on human rights, such as child labor and exploitation of workers, and on the environment, for example, pollution and biodiversity loss. Therefore, the management of a company needs to appropriately incorporate environmental and social risks into the company's long-term strategies, business decisions, and financial and investment planning and consider the related opportunities and impacts. The due diligence obligations must be integrated into corporate policy, which includes risk management, risk analysis, preventive measures, and establishment of a complaints procedure, etc.

According to CSDD, the new due diligence rules will first apply to EU companies of substantial size and economic power that have more than 500 employees and a more than EUR 150 million worldwide net turnover. In two years, the rules will also apply to other companies operating in the EU in defined high-impact sectors (e.g., textile and leather industry, agriculture, raw materials extraction, or metal processing) that have more than 250 employees and a net turnover of EUR 40 million worldwide and more. The directive also applies to non-EU companies active in the EU, however, Small and Medium Enterprises (SMEs) are not directly in the scope of the directive. CSDD applies to the company's own operations, their subsidiaries, and their value chains, which means

both direct and indirect established business relationships of the company.

Germany, as the most important economy in the EU, has already introduced regulation even though the EU itself is still discussing even stricter rules; The German Supply Chain Act (LkSG) came into force on January 1, 2023. The law regulates corporate responsibility for human rights compliance in supply chains for the first time. From 2023, the law initially applies to companies with at least 3,000 employees, and from 2024 also to companies with at least 1,000 employees in Germany.

ESG INCENTIVES FOR THE C-SUITE

Linking ESG criteria to compensation systems for executives and even regular employees is nowadays a growing trend in the EU. Apart from the expectations of investors, the employees and the public, taking ESG criteria into account in compensation schemes is considered to have a leverage effect on integrating sustainability aspects in companies' HR policies. The basic goals of this compensation option are rewarding the c-suite for their contribution to ESG and helping the company achieve its ESG goals. 42 of the 100 largest European companies use ESG criteria as a variable component of executive compensation. In France, there are about 70 percent of the 50 largest companies use ESG criteria for executive compensation as of 2021. Since January 1, 2020, in Germany, according to section 87 Stock Corporation Act (AktG), the compensation structure of board members of listed companies must be geared to the "sustainable and long-term" development of the company. A survey conducted by the investment company Union Investment together with the Sustainable Governance Lab at the University of Giessen shows that almost all big stock-listed companies have included sustainability targets in the remuneration of their management boards, and another HR survey in Germany finds that 47% of the companies take ESG criteria into consideration when assessing the remuneration of members of the management team.

But ESG in the context of incentive plans doesn't just mean to change the traditional company car to an e-vehicle. ESG criteria are expected to be set in the compensation systems, ideally throughout the entire company and for employees at every level of the organization. ESG incentives can be based on specific requirements regarding DEI, health protection and occupational safety, and this can be taken into many different forms. For example, bonuses for participation in ESG training courses or involvement in social projects are conceivable. Members of a company's management and also rank-and-file employees can be rewarded for their contribution to the company's ESG transformation. Or the annual bonus of the management can be evaluated by the company's ESG performance. However, it needs to be taken into consideration that the ESG goals often cannot be achieved in a short time. Therefore, a company can create a long-term ESG incentive plan in accordance with incorporating ESG into its business.

GUIDELINES OF THE CORPORATE GOVERNANCE CODE

Since June 2022, the new German Corporate Governance Code (DCGK) entered into force. The DCGK is a set of rules that primarily contains recommendations and suggestions for listed companies on good corporate governance. The DGCK is issued by the German Federal Ministry of Justice and the rules are the most important guidelines for companies' best practices in Germany. The Code is reviewed annually by the Government Commission on the German Corporate Governance Code and amended, if necessary. The latest amendment of the DCGK essentially places an increased focus on environmental, social and governance (ESG) criteria. As a result, listed companies must also consider and monitor social and environmental sustainability as part of their corporate strategy and planning.

The DCGK describes the role of company in society and its social responsibility (corporate citizen). In that sense, company's social responsibility is not limited to the influence of environmental and social factors on corporate success. Additionally, the impact of the business on humanity and the environment also must be considered from the inside-out perspective. The management board and supervisory board can integrate these perspectives into their day-by-day operations and monitor activities in the interests of the company. Furthermore, recommendation A.3 of DCGK states that internal control and risk management systems will also need to monitor sustainability targets as well as the collection and processing of sustainability data in the future, which is suitable for the company's specific risk profile. According to Recommendation C.1 of DCGK, the competence profile of the supervisory board has been expanded to include expertise regarding sustainability issues relevant to the company. Recommendation D.3 states that accounting and auditing of the company shall also include sustainability reporting.

SUNSET FOR ESG?

In the EU, ESG has been increasingly critical to the overall development of businesses in the long term and legislators tend to strengthen laws and rules and establish even stricter regulations in this field from a worldwide prospective. The EU is currently discussing the final form of the CSDD and intends to impose even harsher legislation. Also in Asia, for example in China, ESG is becoming a more and more significant criteria when it comes to a company's business development and governance, especially for listed companies in this regard. According to the *Guidelines of the Shanghai Stock Exchange in 2022*, to promote the harmonious and coordinated development of the company itself and society as a whole, listed companies should actively protect the rights and interests of stakeholders, employees, suppliers and consumers with integrity, practice the concept of sustainable development. And they are expected to actively engage in environmental protection as well as public social welfare projects, while pursuing economic benefits and protecting the interests of shareholders.

But on the other hand, a recent *ESG investing report by the business paper The Economist* criticized the ESG scoring system as being operated by an unreliable third-party rating agency. The report also states that "sustainable investment" is not more than a third of all assets under management in the big economies, which makes ESG look more important than it actually is. Also noticeable according to the paper is that "ESG has become a gravy train for the investment industry." Investors may prefer to invest in companies with better ESG performance, however, some asset managers have turned this to their own advantage.

So, sooner than later, the time might come to rethink and repair the existing ESG system.

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