POSITION PAPER

Position Paper on Corporate Governance and Due Diligence

Key messages

- The objectives of achieving economic prosperity, social justice and environmental protection in a sustainable and future oriented way should and could be achieved without additional burdens for SMEs or adverse consequences for them.
- Corporate governance and due diligence are and should be clearly distinguished in approach and scope.
- SMEs are by necessity concerned about the long-term.
- There is no reason to assume that stakeholder-centric models would be substantially better than shareholder-centric models.
- SME owner-managers are more looking for pragmatic and understandable solutions to professionalise the functioning of their enterprise. Any Corporate governance initiative should take into account these obvious differences.
- We do not see the need for EU-level regulation on the subject of corporate governance for non-listed companies. The focus should be on national corporate governance codes, such as those that have long existed and proven themselves in several countries.
- If any due diligence requirements are imposed at all, they should be limited to selected and clearly defined high-risk industries and direct contractual partners ("first tier only").
- Before any new obligation enters into force, the necessary SME tools and support measures need to be in place and functioning.
- It absolutely necessary to rigorously assess the impacts of any possible new measure and take the results into account when making decisions or proposals. Moreover, the "Think Small First" principle must be applied to the whole process.

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Introduction

The European Commission has announced initiatives in the field of corporate governance and on due diligence. While these two issues are sometimes interlinked (as it is normal in an ecosystem such as an enterprise), they are and should be clearly distinguished in approach and scope. While due diligence covers a company's responsibility to outside stakeholders, corporate governance is about a board's internal responsibility towards the company. The approach and presentation by the Commission fails to clearly distinguish between the arguments and perceived problems in both fields. In order to have a fit for purpose approach, it will be necessary that any further initiative takes into account their different nature.

SMEunited supports the objectives of achieving economic prosperity, social justice and environmental protection in a sustainable and future oriented way. Since the OECD guidelines were adopted a decade ago, there has already been a lot of progress. In our opinion these objectives should and could be achieved without additional burdens for SMEs or adverse consequences for them. However, we disagree with the European Commission's analysis that underpins its justification for a legislative proposal on sustainable corporate governance and due diligence.

In addition, in light of the COVID-19 crisis the economy and the enterprises have to focus on recovery. The introduction of additional administrative burdens and costs would send more than a wrong signal to our entrepreneurs. While the Commission has publicly committed to fight against administrative burdens for SMEs, unless carefully designed this proposal could have the opposite effect. Indeed the Inception Impact assessment states that "*the obligation to set up due diligence procedures is estimated to be less than 0.14% of the revenues for SMEs and 0.009% for large companies*". Nevertheless this means concretely potential new measures that will entail costs that are 15 times higher for SMEs than for big enterprises.

In SMEunited's opinion the Commission's approach does not take into account the reality of SMEs. According to the Commission, "*companies are driven by short-termism when they redistribute the income to shareholders. They also do not take into account the interests of stakeholders and society.*" This position of the Commission is based on a questionable study which "*revealed a tendency for listed companies in the EU to focus on short-time profits to reward shareholders, to the detriment of the long-term interests of the company*". However, this refers exclusively to listed companies, which represent only a couple of thousand companies of the 23 million in the EU. It is even more worrying that according to the Commission "*the study provides a good basis for the impact assessment*", which fails to take into account both the better regulation approach and the "Think small first" principle.

Corporate Governance

The ownership structure in SME companies is completely different from the one in listed and big corporations, as it is in the hand of only one or more shareholders, most often members of

the family. The redistribution to them is made to provide for their living. SMEs are **by necessity concerned about the long-term**. They have invested their own assets and entire inheritance. Especially family businesses have to ensure that a transfer towards the next generation is guaranteed. It is also a part of directors' duties in all the Member States to ensure the interests of the company, and this implies a long-term view.

Businesses play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services. They make and sell consumer products, manufacture equipment and vehicles, grow and produce food, provide health care, generate and deliver energy and offer financial, communications and other services that underpin economic growth. For our enterprises it is clear that they need to generate long-term value for their shareholders, who provide the capital that allows companies to invest, grow and innovate. Responsibility is already deeply embedded in increasing shareholder value - as repatriation generally reduces the company's growth and value. The fight of our enterprises to stay alive during this pandemic is proof of this. It must be kept in mind that the first duty of an entrepreneur and business management is always to ensure the business continuity and liquidity of the company.

The good governance of corporations today is mainly based on shareholder-centricity which refers to a system of company law in which shareholders exercise ultimate control and in which shareholders may, within the framework of special legislation, make decisions in their own interests. A key form of exercising power in such a system is the election of the company's board of directors, and the tasks of the board ultimately aim at - in the long run - creating value for shareholders. The ultimate control over the corporation should rest with the shareholder class; the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders.

Most SMEs are established to serve the founders' own interests, and the company operates primarily at the risk of these founders. In case any changes to this basic principle are introduced, there are multiple aspects to consider.

It should also be borne in mind that especially for micro enterprises the private limited company statute was introduced to allow the entrepreneurs to separate their personal assets from those intended for professional activity. It would be unacceptable to introduce further barriers.

Regarding corporate governance, alternative models to the shareholder-centered model would need to set out when (and why) the company's goal changes in the company's development towards the interests of non-shareholders.

A key economic rationale for the shareholder-centric model, also in terms of good corporate governance, relates to the clarity of the goal set for the management, which in turn makes it possible to control the activities of management, both financially and ultimately in a legal sense. The more stakeholders are defined for the company, the more difficult it becomes to balance out the different interest of each stakeholder. An employee of the company will have a

different interest than a customer or a neighbor. This makes it impossible for a board to fulfil each stakeholder's needs, opening the door wide to unbridled litigation.

No one is forced to invest in the shares of a limited company or other securities. Models where the real goal - or obligation – is other than generating a profit for shareholders, would most likely affect investors' willingness to invest in. Also, any non-shareholder-centered models would most likely involve the risk of seeking capital outside the EU, a reduction in foreign investment and thus a loss of competitiveness. A reduction in the shareholder surplus or increased uncertainty would likely affect funding for example for the development of environmentally friendly technologies.

Another key element of the shareholder-centered model is that the involvement of other stakeholders such as customers, creditors, employees as well as the status of the environment are regulated by specific legislation and / or agreements. In general, shareholder-centricity does not mean that shareholders are a better or more important stakeholder than others, but that shareholder protection is the most socially useful way to organise shareholder protection. Other stakeholders are the most socially useful to organise in other ways, such as through specific legislation.

It should also be noted that from an environmental point of view, there should be no reason to assume that stakeholder-centric models would be substantially better than shareholder-centric models. For example, promoting the interests of an employee, customer, financier or municipality does not, at least obviously, have a more positive effect on the environment than promoting the interests of a shareholder. It has also been suggested that other stakeholders may be shorter-term oriented than shareholders.

Business practice often calls for quick strategic decisions. Not infrequently, these are based on confidential information. In addition, a few clear priorities must be set and then consistently pursued. To the extent that the Commission initiative seeks a broader stakeholder approach to strategy development, it must therefore be met with reservations. Instead, **the focus should be on national corporate governance codes, such as those that have long existed and proven themselves in several countries.**

Even if there are problems in some multinational sectors, this cannot and should not simply be assumed to be the case for the whole business community. It is certainly not a reason to regulate corporate governance for non-listed companies at European level. Before legislating there should be a broad discussion about the importance of corporate governance for all companies, especially unlisted ones and how to promote it, which has not happened in this instance. Some voluntary codes have already been drafted and initiatives taken by professional bodies at European or national level. Consequently, **we do not see the need for EU-level regulation on the subject of corporate governance** for non-listed companies. The principle of subsidiarity should be taken into account. Harmonisation at EU level would entail the risk that regional and local dimensions are not taken into account and would thus disregard

the self-regulatory character of national codes on corporate governance embedded in the legal tradition and framework of the different Member States. To our knowledge, **the national regulatory framework is sufficient and self-regulation is also functioning well.** In this way, the national characteristics of companies, company forms and business life in general can be taken into account. We find it absolutely necessary to rigorously assess the impacts of any possible new measure and take results into account when making decisions or proposals. Moreover, the "Think Small First" principle must be applied to the whole process.

SMEunited does not at all agree with the statement of the Commission that the initiative can contribute to curbing the agency problem, ie. the problem that directors act more in other interests than the long-term interest of the company. SMEunited can only recommend raising awareness about existing "best practices" and voluntary codes in order to inspire European SMEs.

SME specificities

Many of the statements in the consultation paper are directed towards listed companies, where the Board of Directors and the effective implementation of the codes on corporate governance are more important. SME owner-managers, however, are looking for pragmatic and understandable solutions to professionalise the functioning of their enterprise. In most of the small and medium sized companies one cannot speak about an "active Board of Directors", in which external directors are taking part in the governance. **Any initiative on Corporate governance should take into account these obvious differences.**

Corporate governance for non-listed companies should include concrete and specific recommendations for family businesses. Indeed, many family companies are confronted with specific family governance problems (e.g. transfer of business, transfer of shares...). The creation of a family forum or a draft of a family charter can be part of the solution. The aim of corporate governance and more specifically of codes on corporate governance is to provide help and support for running a company in an efficient way. It should offer owner-managers of small and medium sized companies a very practical manual, which they can use to bring about profitable, sustainable growth. Guidelines and suggestions need to be provided for entrepreneurs, which they can develop further in their businesses to help them prevent major checks and even conflicts.

Corporate governance is important for all companies. Indeed, corporate governance gives a company not only a professional image in the eyes of all its stakeholders and especially banks and financiers, but it can also bring an advantage in the recruitment market, where SMEs have quite a number of difficulties. It can also help to guarantee the continuity of a company, especially family enterprises, and more generally contribute to increasing the profitability of the company. Non-listed SME companies are extremely diverse; therefore, it is necessary to take the characteristics of each individual enterprise into account when developing its corporate

governance. **Particular attention should be paid to the nature, size and growth phase of the enterprise.** Indeed, corporate governance evolves as an enterprise grows.

Due Diligence

As stated in the introduction, due diligence obligations are a completely different topic than corporate governance. Whereas there should not be additional legislation on the later, a balanced European due diligence obligation could have a positive impact given certain issues are being taken into consideration.

SMEunited welcomes that the inception impact assessment stated that "*due consideration will need to be given to limiting and alleviating the burden for SMEs, for instance by the inclusion of exemptions from certain substantive and possible reporting obligations and/or by simplified standard(s), according to the proportionality principle based on the size and impact of the company*." However, SMEunited highlights that possible impacts on SMEs need to be considered more broadly.

More specifically regarding due diligence duties that would require companies to address and mitigate the adverse impacts of their operations in the supply chain one must take into account that SMEs have less capacity, knowledge, information and resources to build on diversified supply chains and to effectively implement the proposed obligations in their operations. In addition, they often have weaker bargaining power in aspects of supply-contracts than large companies. Thus, their ability to influence global value chains and market behaviour and developments is very limited. Equally, SMEs are dependent on the information provided by their suppliers as they often do not have the means or capacity to conduct extensive research on suppliers' backgrounds. All these limitations for SMEs should be properly taken into account.

Furthermore, we caution that the initiative will cause many **unintended secondary effects:**

- The initiative will overwhelm SME owners in particular with bureaucratic burdens. On the one hand, they themselves will become subject to disproportionate legislation. Above all, however, there is the concern that larger contractual partners will pass on their own due diligence obligations along the supply chain. This is often already the case now. A system must be created which genuinely shelters SMEs against unreasonable demands, not only in theory but also in practice, and not only from stakeholders and authorities, but also from business relationships. The OECD Guidelines do this with voluntary norms and extensive flexibility provisions.

- Sustainability is a challenge that needs to be addressed **jointly by multiple stakeholders** (e.g. public authorities, consumers, citizens, ...). The Commission proposal would send the wrong signal if the enterprises and the owner managers have to pay for the failures of others or of society. This is particularly true in cases where legislation and / or effective government supervision of compliance with legal standards fails. The legislation should

be focused on the process, and not on the result. Companies can be expected to draft a due diligence plan, carry it out, report on it, evaluate and if possible improve on it and allow for access to remedy. If a company fulfils these obligations, they cannot be held liable for the actions of others.

- Europe has long been a leader in responsible entrepreneurship and has made concrete improvements to living standards abroad.. The current initiative must not lead to European enterprises withdrawing from vulnerable business sectors abroad. Otherwise, competitors from countries where lower standards apply could fill this vacuum. It would send an entirely wrong signal if less responsible business conduct were 'rewarded'. A solution to this problem can again be found by looking at the OECD guidelines where companies are encouraged to find the best solution in each scenario.

- The proposed "responsibility regime" bears the inadvertent risk of handing competitors (from third countries), non-European governments and non-governmental organisations a powerful tool to put European companies under pressure.

SMEunited emphasis that it is the responsibility of businesses as well as of the other stakeholders for achieving the sustainability goals. But enterprises should be encouraged to make **voluntary contributions**, whereas legislative measures would have to place a balanced burden on all stakeholders involved.

For example, SMEs in the same sector can also be encouraged to cooperate together to increase their leverage in the value chain. This type of initiative has already been proven effective.

Moreover, **SMEs need support to identify and mitigate the risk of their supply chains and reduce the adverse human rights and environmental impact**. SMEunited already highlighted this years ago[1], but the Commission failed to deliver.

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[1] See our 2011 Position Paper: "In the last years more and more SME have become active at the international market or in markets in third countries, in order to remain competitive with the big international chains and companies. Our small enterprises are fully committed to respect the human rights. But they do not have the means, the knowledge or the power to guarantee that their providers or sub-contractors in third countries are respecting the human rights. Often they work with intermediary persons and is control (through independent advisors, company visits collaborators) extremely difficult to realise. Since many years UEAPME, also in the framework of the Multistakeholder Forum on CSR, has tried to solve this dilemma together with NGOs who do have the necessary know –how in this field. Unfortunately these NGOs neither do have the means to help our SMEs nor are not even allowed to operate in the most problematic third countries. That's why UEAPME is asking to pool together resources: the U.N, the ILO, the European Commission or the EU Embassies should provide databases to our small enterprises with reliable counterparts in third countries. Public authorities could in addition support SMEs and raise awareness amongst them concerning international trade and human rights."

According to SMEunited any proposal on Due Diligence should meet the following criteria:

The impact on SMEs needs to be considered more broadly

SMEunited insists on a thorough impact assessment and an SME test. In addition, it looks forward to seeing the concrete proposals to fulfil the application of the "one in - one out" principle according to the new working methods of the von der Leyen Commission.

The Commission needs to apply the "think small first" principle. All SMEs will be greatly impacted by the "trickle-down" effect as many of them are in the supply chain of large companies.

Limited and measurable scope

If any due diligence requirements are imposed at all, they should be limited to selected and clearly defined high-risk industries and direct contractual partners ("first tier only"). This allows evaluations to be conducted on a small scale first. Comprehensive measures could be discussed as soon as it is ensured that no unwanted secondary effects occur ("**step-by-step-approach**"). Definitions such as 'proportionality' should be very clearly defined and provide legal certainty to companies. In addition before any new obligation enters into force, the necessary SME tools and support measures need to be in place and functioning.

Avoidance of (unpredictable) liability regimes

Due diligence duties can and should be discussed **independently of damage compensation**. In general, there is the risk of a **serious break with national principles** of the law on damages in numerous member states. In addition, new compensation rules could establish highly **problematic incentive systems** (e.g., 'risk-free' cross-border litigation with legal aid). Moreover, to avoid floods of lawsuits any liability for (independent) third parties along the supply chain is firmly rejected.

Clear guidelines for dealing with third-party misconduct

Violations of human rights and environmental standards occur primarily **in countries that lack functioning regulatory oversight** structures. For the same reason, it is difficult for European companies to gain insight into the affairs of their contract partners located there. Furthermore, no government authorities can be called upon if misconduct is identified. Termination of the business relationship is usually the **only means of exerting pressure** on contract partners who violate human rights, leaving the field to competitors from overseas (with less stringent standards). Thus, clear instructions are needed on how companies should react when they

identify misconduct. Companies cannot be expected to take over the tasks governments are unable or unwilling to do.

Streamlining of parallel initiatives

Currently the EU is dealing with **several parallel projects** related to sustainable corporate governance (e.g. Sustainable Finance, Non-Financial Reporting Directive, EU Timber Regulation, EU Conflict Mineral Regulation). In addition, there are also initiatives of other organisations that have proven successful and whose structures could or should built upon (e.g. OECD Guidelines for Multinational Enterprises). All these projects require coordination to avoid duplication and additional burdens ("**Streamlining**").

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