Deutsches Aktieninstitut

HENGELER MUELLER

ESG Study: Companies in the Transformation Process

Challenges and Opportunities of Sustainability

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The transformation of our society towards sustainability is picking up steam more and more. German companies have also recognised the challenges presented by this impending and profound transformation, and are taking them head on. This is the result of a study conducted by Deutsches Aktieninstitut and the law firm of Hengeler Mueller that polled the CFOs and supervisory board chairmen of the biggest players in the German corporate landscape, which we have summarised on the following pages. A detailed German-language version of the study is available at www.hengeler.com/esg2022.

A. Introduction

The subject of sustainability, with its environmental, social and governance (ESG) facets, has gained in importance significantly over the last few years. A multitude of areas of our lives have since been affected as a result of societal expectations and legal regulations. Even companies have recognised the necessity of planning their strategy and actions around this defining issue. The reason for this is not just the regulatory pressure from national and European legislatures regarding sustainability. The public is also increasingly expecting corporate strategy and governance to additionally account for ecological and social aspects.

But what adjustment processes have corporates undertaken specifically so far, and what adjustments are they planning? How are they assessing the status quo and the progress of their efforts? What is driving the decision-makers, and how do they feel about the regulatory framework? On these and other aspects, the study 'Companies in the Transformation Process – Challenges and Opportunities of Sustainability' published jointly by Deutsches Aktieninstitut and the law firm of Hengeler Mueller will provide you with an overview. A total of 61 supervisory board chairmen, CFOs and/or their staff responded to the survey on which our study is based.

The study's findings provide answers to questions such as 'how much of the transformation towards sustainable business has already been implemented?', 'what mechanisms are companies using to monitor and steer this process?' and 'what governance trends are taking shape?' The published study therefore offers both management and supervisory boards the opportunity to have a look at the status quo of corporate governance in respect of sustainability issues, shows them what instruments can be used to review their own efforts at sustainability, and sensitises them for the upcoming regulatory changes.

B. The study's most important findings

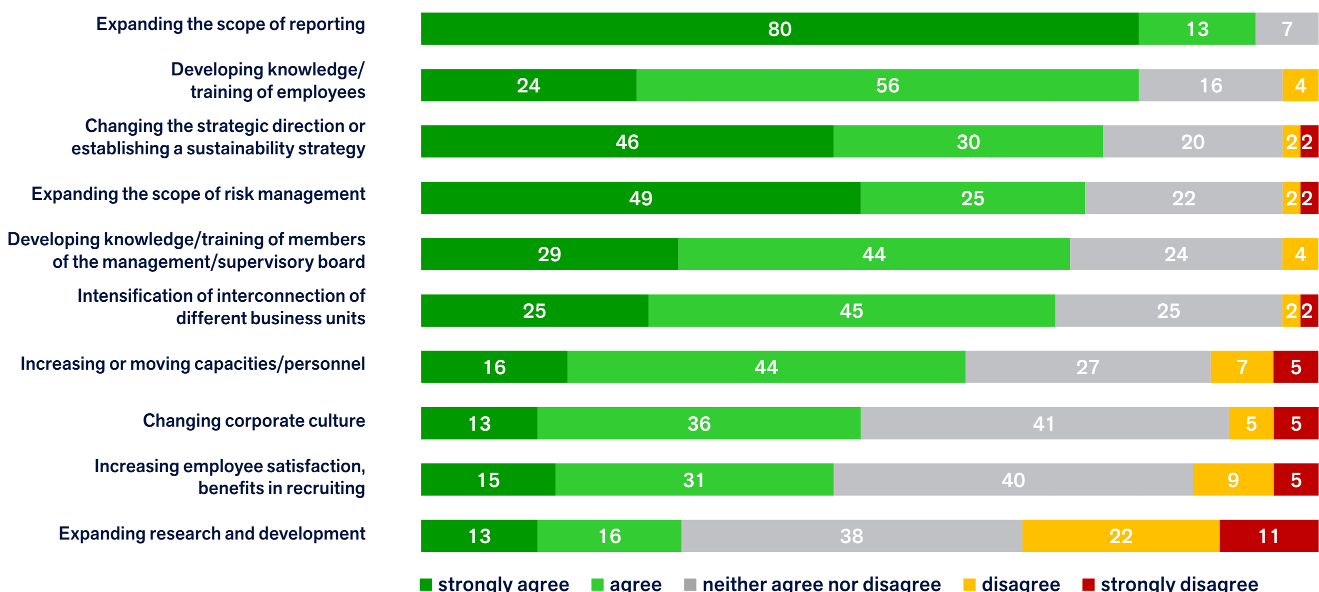
1. Companies in transformation

The first part of the study examines what changes have already taken place overall at companies as a result of ESG development. The central drivers of that development and the means used by companies to achieve their self-set ESG goals have also been analysed. A considerable dynamic was palpable when performing that analysis.

The status quo and its background

Three-quarters of respondents (76%) reported to have changed the strategic orientation of their organisation and to have established a sustainability strategy. Nearly all respondents to the survey (93%) indicated that they have expanded their reporting due to ESG development. The increased awareness of, and commitment to, a more sustainable alignment is also expressed by the expansion of risk management systems, as well as by the creation and enhancement of personnel resources and expertise both at the executive level and among employees. Finally, stronger coordination and collaboration among a company's various business divisions is also a reflection of this clear trend: 70% of respondents confirmed that there is, in general, an intensified internal dialogue taking place within their organisations as a result of sustainability developments.

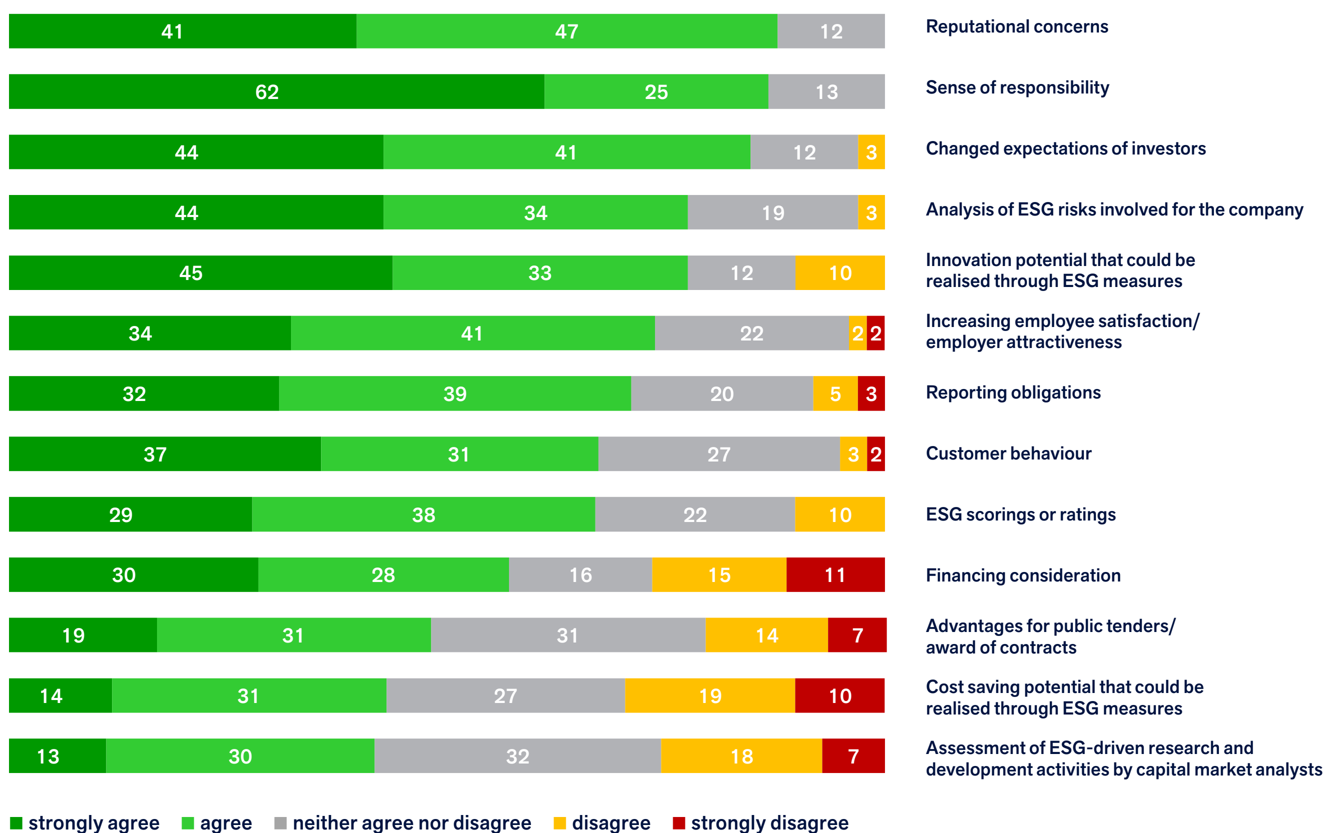
*Table 1: ESG impact on the company (figures in %)**



* *discrepancies in aggregated values in tables 1 to 5 due to roundings*

The causes of this dynamic in the transformational development are found not just in external factors, but also come from internal motives. That is to say, respondents find that, on the one hand, investors and regulators, but also society in general, are increasingly expecting more sustainable approaches from companies. This means that the transformation process is being propelled by companies' own efforts to improve, or at least maintain, their reputation both within society and among potential employees in particular.

*Table 2: Sustainable business motivators (figures in %)**



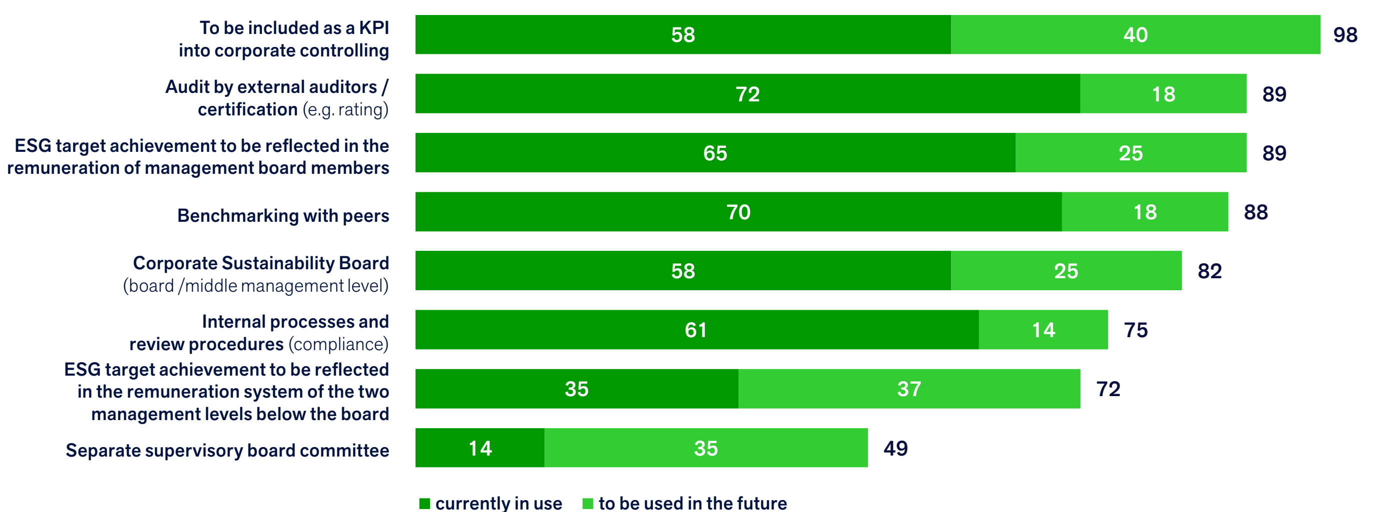
On the other hand, however, nearly two-thirds of respondents confirmed that an increased sense of responsibility on the part of their companies is also proving to be an integral factor. No other factor is ascribed as great an influence by so many companies.

Beyond that, tangible business considerations are also relevant. Nearly half of respondents (45%) expect cost savings in the medium to long term, based on a more sustainable orientation through the implementation of ESG measures – for instance through a reduction of risks that goes along with such measures or by mitigating the negative impacts on corporate earnings associated with the burdens of climate change.

Measuring and evaluating ESG target achievement

Companies are setting concrete ESG goals for themselves and using a wide array of tools to ensure that their sustainability measures do not miss their targets. Ratings and benchmarking are the tools currently used most by respondents to assess their companies' current situation and the progress that has been made. However, the survey signals that integrating ESG key performance indicators (ESG KPIs) into corporate governance will be one method used more often in the future to monitor the advancement towards ESG goals. 98% of the respondents stated that they are already using this method or are planning its use in order to influence how resources are managed and investments are made accordingly. Thus, through their integration into corporate governance, ESG KPIs are having a systematic effect on steering practices and conduct.

*Table 3: Instruments to ensure or measure the success of the strategy and ESG goals (figures in %)**



In addition, companies are also employing organisational elements of corporate governance in order to address the cross-cutting issue of ESG: in over half of the companies surveyed, there is a corporate sustainability board dealing specifically with the subject of ESG. These boards may be composed of management board members and executives from individual business units and central function departments.

Even the tools available to the supervisory board are being devoted to achieving sustainable business practices. While six in ten respondents reported that ESG performance metrics are considered in the determination of management board remuneration, this will be the case at nine out of ten companies in the future. Furthermore, a major leap is imminent in the shape of establishing a special sustainability committee at the level of supervisory boards. The number of ESG committees will more than triple: 14% of companies are currently utilising this tool already and a further 35% wish to use it in the future, bringing the total to 49%. However, this anchoring of ESG topics at the supervisory board level remains far behind the number of companies that have already instituted, or are planning to institute, corporate sustainability boards at management board level: 82%, currently 58% with an additional 25% (rounded) planned. This difference may be due to the fact that supervisory boards delegate reporting duties to the audit committee, but strategic matters to the strategy or investment committee, or deal with them as an entire body. This may also depend strongly on the individual sector and on the innovation intensity of a company or its industry. At any rate, there is no apparent objective justification to treat sustainability on all supervisory boards only in one single, very specific way.

2. Regulatory projects put to the test of actual business practice

The second part of the survey focussed on companies' upcoming challenges that are mounting in the area of sustainability regulation. 3 projects were central in this regard:

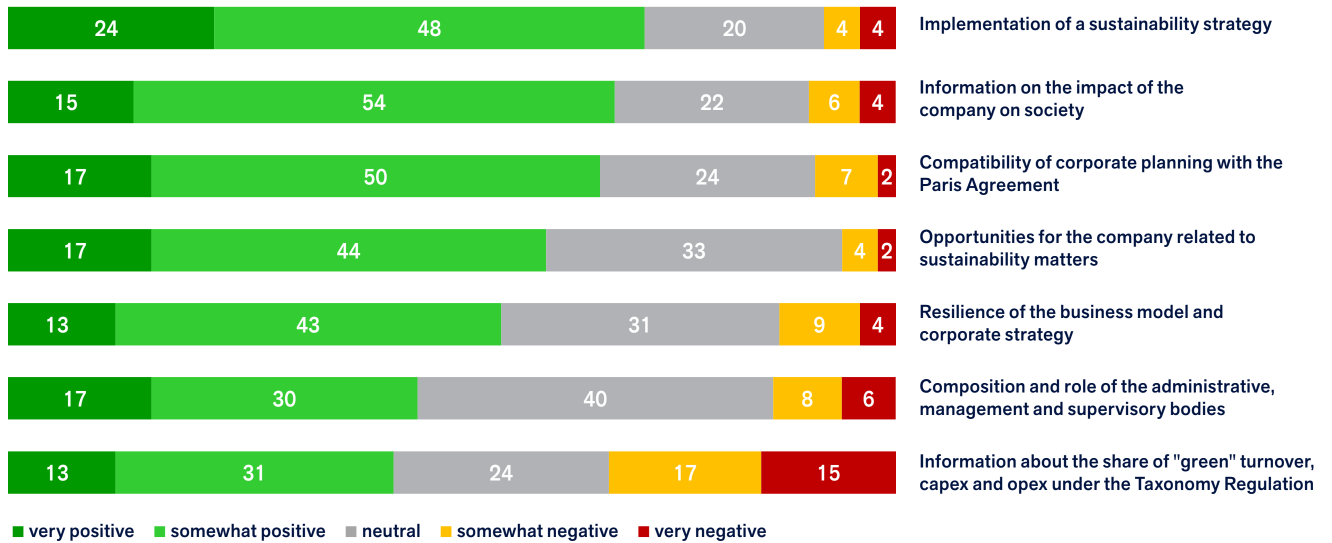
1. In April 2021, the European Commission published a proposal for a Corporate Sustainability Reporting Directive (CSRD) designed to amend and expand the previously applicable corporate social responsibility directive, which was transposed into German law through the CSR Directive Implementation Act. These changes are to take effect by 1 December 2022.
2. In addition, companies are currently preparing for the reporting duties under the EU Taxonomy Regulation.
3. In the summer of 2020, the European Commission announced an initiative on sustainable corporate governance and, following a consultation in February 2022, presented a proposal for a directive now known under the title 'Corporate Sustainability Due Diligence'. The draft of the Corporate Sustainability Due Diligence Directive dated 23 February 2022 was not yet on hand at the time the survey was conducted.

Proposed additional reporting duties

When asked about the CSRD draft, corporate representatives generally show great openness to the proposed expansion of sustainability reporting duties. More than 70% view the indirect obligation to establish a sustainability strategy, which must then be reported on, positively. Even the duties to report information on the company's effects on society and to publish statements on the compatibility of the company's corporate planning with the Paris climate goals are welcomed by more than two-thirds of respondents.

At the same time, however, companies are voicing great uncertainty. Almost one-third of respondents take a negative view on the proposed reporting duty on the proportion of 'green' turnover, capital expenditure (CapEx) and operating expenditure (OpEx) according to EU taxonomy. This is possibly a reflection of the common criticism that the specific requirements of the EU are not tailored to every kind of business activity and, moreover, that they do not cover all of the business activities of all corporate divisions, which is especially problematic in the case of conglomerates. In addition, transition technologies are not given enough consideration.

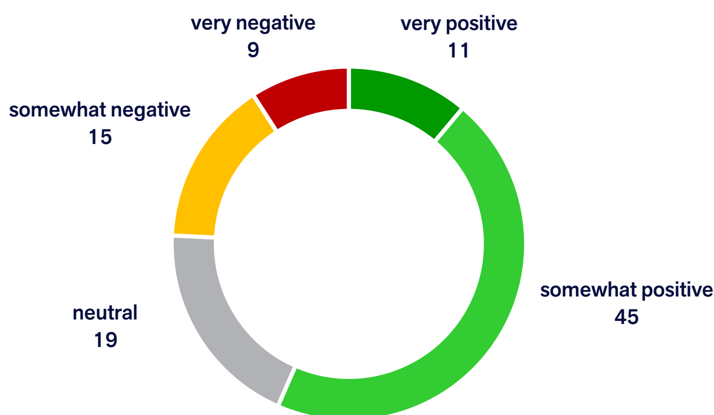
*Table 4: Evaluation of the reporting obligations of the CSRD draft and the taxonomy regulation (figures in %)**



Incorporating sustainability reporting into management reports

The EU Commission intends to make it mandatory for sustainability reporting to be incorporated into management reports in future. More than half of respondents view this allocation (rather) positively, meaning that they deem the expenditure caused by it, as well as the necessary timing coordination with financial reporting, justified by the benefits. One in four companies assesses this differently, however.

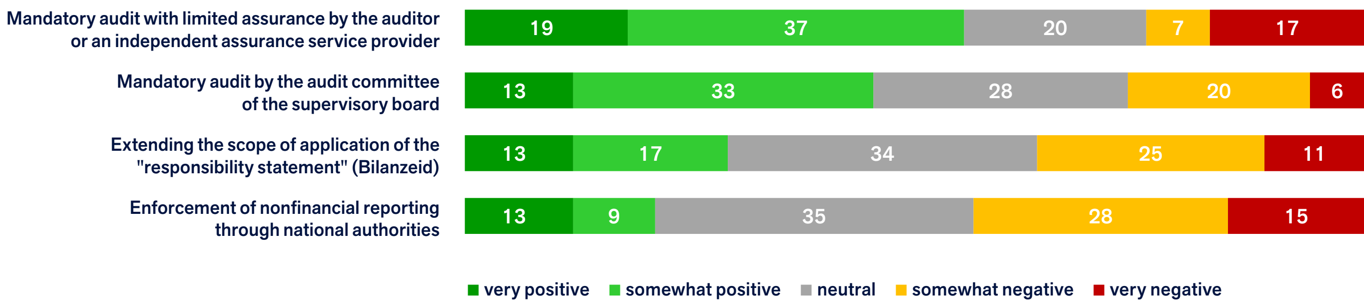
*Table 5: Evaluation of an mandatory incorporation of sustainability reportings into management reports (figures in %)**



Enforcement of reporting obligations

Among all the aspects of the CSRD draft that were surveyed, and companies' perceptions of it, enforcement received the most negative reviews. Bolstering the sustainability report through a review by the company's statutory auditor or an independent assurance services provider with a limited assurance opinion is viewed positively by a narrow majority. Assigning the task of assurance to audit committees, along with the monitoring of the company's quality control system regarding sustainability reporting, is also seen as a positive by many. Extending the scope of the balance sheet oath ('Bilanzeid'), by which the management board explicitly assumes responsibility towards third parties for the reporting, to include the sustainability report received considerably more negative reviews, as did expanding the scope of regulatory enforcement to include sustainability reporting.

Table 6: Evaluation of the enforcement of reporting obligations (figures in %)



Challenges posed by the draft of the CSRD and the EU Taxonomy Regulation

The surveyed company representatives find the adjustment or abandonment of corporate governance KPIs as an indirect effect of the new reporting obligations to be the greatest challenge. These KPIs include, for instance, 'CapEx' as prescribed under the EU Taxonomy Regulation. Companies will be required to report on their CapEx performance. Companies seeking to continuously improve the 'green' proportion of their investments will have to think about compatibility and conformity with the EU Taxonomy Regulation as measured against the prescribed screening criteria. This means that companies' investment decisions may under certain circumstances have to be aligned systematically with EU taxonomy, which is difficult for the reason alone that the technical screening criteria under the Taxonomy Regulation are to be regularly reviewed, i.e. possibly toughened, every three years.

Not only does the question arise as to how companies are dealing with the conflicting aims of improving the three prescribed KPIs (CapEx, OpEx and turnover) and other performance indicators, but also whether there are targeting conflicts between these very three ESG KPIs themselves and how they can be resolved. Another big question will certainly be how investors are positioning themselves on any targeting conflicts between the different KPIs.

In addition, nearly half of respondents deemed the compatibility of corporate planning with the Paris climate goals as particularly challenging. Although companies want to foster these goals, this will likely require a complex analysis of the interdependencies and considerations relating to the specific objectives.

Corporate Sustainability Due Diligence

The European Commission is planning to improve the EU regulatory framework on company law and corporate governance in order to 'enable companies to focus on long-term sustainable value creation rather than short-term benefits'. Although the Commission's legislative proposal on 'Sustainable Corporate Governance' developed to that end was postponed several times, the draft of the directive was published on 23 February 2022 (no longer under the watchword 'Sustainable Corporate Governance' but under the title 'Corporate Sustainability Due Diligence', CSDDD). The draft of the CSDDD, parts of which differ from the version submitted by the EU Commission in the consultation, was not yet available at the time of our survey. Nevertheless, the answers given during our survey remain relevant either because the bill submitted for the EU Commission's consultation period and the current CSDDD draft do not differ, or because the answers also point the way for the CSDDD draft or endorse the view, as revealed by the questions posed during the consultation last year, that corporate managements should be induced to conduct business more sustainably through the imposition of (sanctioned) positive duties (margin no. 21). The new CSDDD draft also provides for this, albeit in altered form. In addition, the CSDDD draft also contains due diligence requirements for companies regarding their supply chains (margin no. 22). Lastly, the latest draft of the CSDDD provides for the greater inclusion of stakeholders in enforcing the new rules: no longer through an advisory committee composed of stakeholders, like the consultation version had proposed and which we had therefore asked about in our survey, but only by requiring their involvement without prescribing its form. A whistleblower mechanism to address/prevent negative ESG effects is also contained in the CSDDD draft. A right of the stakeholders to sue corporate bodies directly (margin nos. 23 et seq.) is no longer found in the current draft of the CSDDD. Companies must provide

a whistleblower mechanism for individuals, trade unions and NGOs and must be available to whistleblowers for discussion. There are provisions for supervision by authorities.

a) Directors' duty of care

For most companies, subjects such as a sustainability strategy are nothing new because they have already devised one voluntarily. An EU directive would therefore in many cases only formalise into law what is already being done. Hence, only six out of ten companies think such a legal obligation makes sense. One in five companies even views this negatively. This may be because, as with the KPIs, they fear a formalisation in this respect – that could proceed all the way to standardisation or even a binding obligation to comply with the EU's taxonomy for the purpose of unifying the definition of sustainability. This possible concern now seems to have materialised in the new draft of the CSDDD. Companies are to no longer be obliged to have a general sustainability strategy. Rather, more concretely, large companies are to formulate a 'plan' that 'ensures' that their business model and strategy are compatible with the limiting of global warming to 1.5°C in line with the Paris Climate Agreement. This explicit, substantive duty of care supplements the reporting obligation found in the CSRD draft we asked about in our survey. If a company is facing or causing climate risks, its plan must contain emission reduction targets. Both are to be taken into account when determining the management board's variable remuneration. Additionally, management boards and supervisory boards are to be required to consider the impacts of their decisions on human rights, climate change and the environment when fulfilling their duty to act in the company's interests, meaning not just as regards strategy, but – as we understand it – quite specifically in their daily decision-making.

b) Due diligence requirements regarding supply chains

More than half of the companies surveyed welcomes a European-level regime of due diligence requirements regarding their supply chains because it might foster more legal clarity and a 'level playing field'. One third of respondents, however, believes it makes little sense to institute such requirements. The reason for this might be that companies run into practical and legal difficulties in ensuring compliance with due diligence requirements outside of their corporate spheres.

c) Enforcement by stakeholders

The considerations to involve stakeholders by mandating the formation of advisory committees and in the enforcement process are viewed negatively to an overwhelming extent. Although many companies see a dialogue with their

stakeholders as a positive, its formalisation in the shape of legally mandated committees meets with wide disapproval. The draft of the CSDDD that has since been published does not provide for any formal advisory bodies but it does impose the obligation on company managements to acknowledge relevant 'input' from stakeholders and civil society organisations when setting up and monitoring their due diligence processes. Only 2% of the respondents to our survey support granting stakeholders a right to sue corporate bodies. This is certainly due to the fact that the outcome of a court review of any entrepreneurial decision is difficult to predict even under 'normal circumstances'. The outcome would become even more difficult to predict in this scenario because, in any review of compliance with the business judgement rule, entrepreneurial decisions would in future require examination of the extent to which sustainability aspects were included in the information that served as the basis of those decisions. Given that sustainability criteria are hardly concretely formulated, such an examination would likely be difficult, if not entirely impossible.

The draft of the CSDDD assigns to corporate bodies the task of setting up and overseeing the implementation of due diligence processes (in supply chains and elsewhere) and integrating due diligence requirements into the corporate strategy. Failing to perform these duties is to be deemed a failure to comply with the due diligence requirements under national law of the Member States, is to result in penalties – and is to entail regulatory supervision. This would be the first instance of there being official supervision of the strategic processes and decisions of corporates.

C. Conclusion

Companies, management boards and supervisory boards see themselves as participants and drivers of the sustainable transformation of our society. They have recognised and taken on the challenges of the transformation of the economy towards more sustainable corporate governance. This goes equally for strategy, organisation, transparency and internal monitoring.

In this context, companies regard ESG as a cross-cutting issue, have modified their strategic orientation, or have developed a sustainability strategy. The inclusion of ESG KPIs in corporate governance and as an anchor in management board remuneration systems has been accepted. Respondents are open to expanded transparency and more due diligence requirements.

However, there are also obvious criticisms. Most of all, companies are expressing scepticism towards regulatory measures already being taken – such as EU taxonomy – and about imminent legislative projects – like the European Commission's proposals relating to sustainable corporate governance.

Based on our survey, we can deduce the following recommendations to government policy-makers:

— Corporate managements have embraced the transformation process. In this respect, corporate regulation may have a more counterproductive and restrictive impact.

— The survey has shown that there is a desire for individual solutions when it comes to organising the work of supervisory boards. There is no recognisable advantage of a statutory regulation in this regard.

— Unclear statutory requirements, inchoate reporting standards, a de facto softening of the business judgment rule and opening up the possibility of direct legal action against corporate bodies could equate to an unrestricted expansion of corporate and D&O liability. There is also the threat of a de facto introduction of a liability for failure, which must be avoided. It is precisely at this moment that courageous entrepreneurial decisions are needed – especially during the transformation process.

— With a view to formulating reporting standards and classification criteria, the following should apply:
  - Involving the private sector in the process is essential.
  - The time frame for formulating and coordinating standards and criteria as well as the initial reporting obligation must be reasonable. To date, this timeframe has always been too short.
  - Only clear, reasonable and reliable criteria justify the effort for taxonomy reporting and guarantee a prudent allocation of resources.
  - To do justice to the global relevance of climate protection, there need to be uniform global reporting standards.

In order to realise the ambitious and necessary international sustainability goals, joint efforts on the part of all stakeholders are imperative. As a society, we will not be able to afford unneeded drag and, as a result, a loss in ESG dynamic. Politicians and companies should therefore come together and develop pragmatic as well as goal-oriented solutions. Our study shows that companies are, at any rate, willing to take this step.

D. The authors

Deutsches Aktieninstitut

Cordula Heldt

Head of Corporate Gover-nance and Company Law

Claudia Royé

Head of Capital Markets Law

BERLIN	Alte Potsdamer Straße 5, 10785 Berlin, T +49 30 25899774
BRUSSELS	Rue Marie de Bourgogne 58, 1000 Brussels, T +32 2 7894100
FRANKFURT	Senckenberganlage 28, 60325 Frankfurt, T +49 69 929 150

www.dai.de

Hengeler Mueller

Lucina Berger

Partner

Daniela Favoccia

Partner

Wolfgang Groß

Partner

BERLIN	Behrenstrasse 42, 10117 Berlin, T +49 30 20374 0
DÜSSELDORF	Benrather Strasse 18 - 20, 40213 Düsseldorf, T +49 211 8304 0
FRANKFURT	Bockenheimer Landstr. 24, 60323 Frankfurt, T +49 69 17095 0
MUNICH	Leopoldstrasse 8 - 10, 80802 Munich, T +49 89 383388 0
BRUSSELS	Square de Meeûs 40, 1000 Brussels, T +32 2 7885 500
LONDON	30 Cannon Street, London EC4M 6XH, T +44 20 7429 0660

www.hengeler.com