SMART DELIVERABLE 2.7

Supporting the Transition to Sustainability

SMART Reform Proposals

We study the barriers and drivers for market actors' contribution to the UN Sustainable Development Goals within planetary boundaries, with the aim of achieving Policy Coherence for Development.

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Project number: 693642	Project acronym: SMART
Start date: 01.03.2016	Duration: 48 months
Deliverable ID: D2.7	Due date of deliverable: 1 November 2019
Lead beneficiary for this deliverable: University of Oslo	Dissemination: Public
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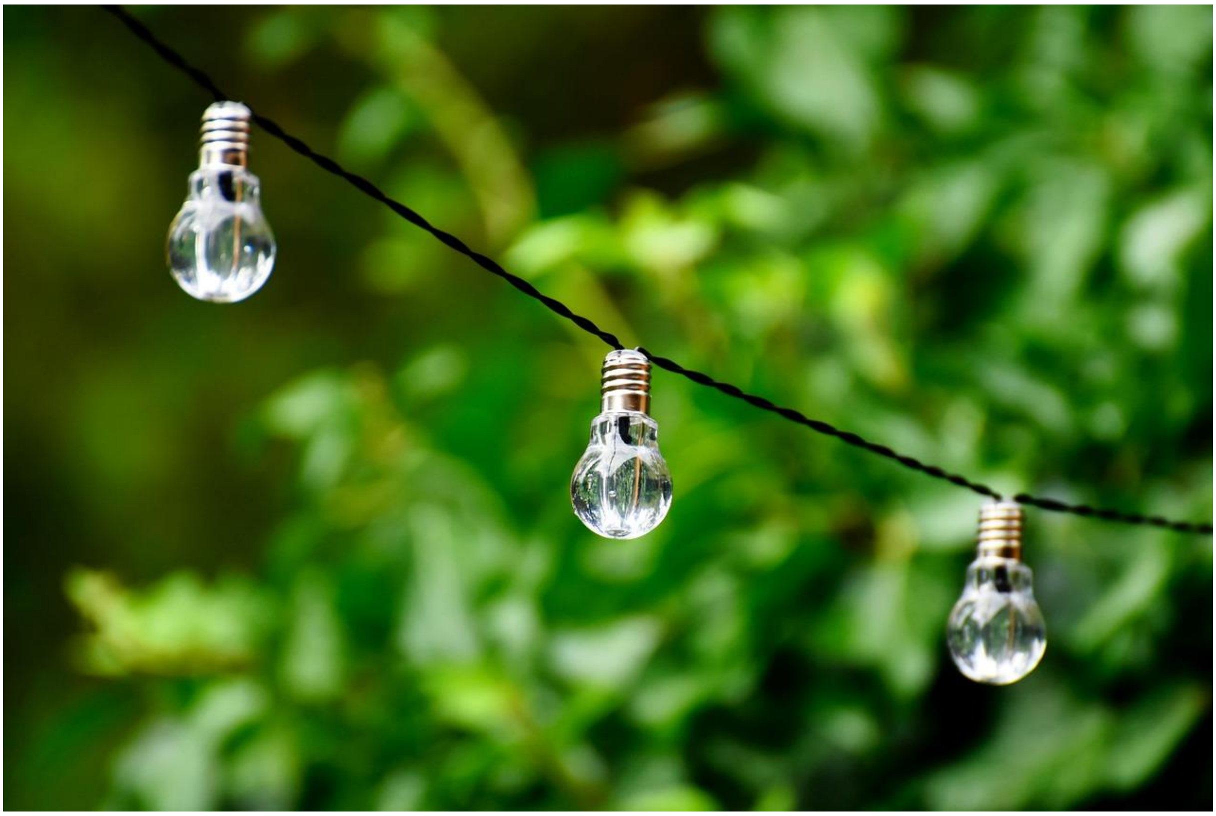
Document history: First version, submitted 14 November 2019	

FUNDED BY THE EUROPEAN UNION

This project has received funding from the European Union's Horizon 2020 research and innovation programme under grant agreement No 693642. The contents of this presentation are the sole responsibility of the SMART project and do not necessarily reflect the views of the European Union.



SMART Deliverable 2.7

Supporting the Transition to Sustainability: SMART Reform Proposals

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Executive summary

Achieving sustainability is possible. The adoption of the UN Sustainable Development Goals (SDGs) in 2015 and the Paris Agreement in the same year created a new impetus for the debate on how to do so. With an emerging recognition of the serious risks of continuing with unsustainability, there is currently unprecedented support for change. This is reflected in the incoming new EU Commission. The transition to sustainability also has strong legal basis in the EU's overarching goals set out in its Treaties, with duties to protect the environment, human rights and human dignity, within the EU and in the EU's relations with the wider world.

To achieve sustainability, we need to change the way business operates. The SMART project supports the transition to sustainability through a set of reform proposals aiming to change the way business and finance operate, and the way products are produced and consumed. We aim to make it possible and easy for *business* and *finance* to create value in a sustainable manner, and for *products* to be produced and consumed in a way that contributes to securing a safe and just space for humanity within planetary boundaries. As such, our reform proposals concern the EU as a global actor, and the EU as a legislator and policymaker.

> To achieve sustainability, we need to change the way business and finance operates, and the way products are produced and consumed

Business must shift to sustainable business models and be encouraged to innovate sustainably. To achieve this, the purpose of business needs to be redefined towards sustainability, to protect the decision-makers in business against the pressure to maximize financial returns. To make sure that it is operationalised properly, we also need to integrate this into the duties of business decision-makers – requiring them to pursue sustainable value within the limits of our planet, and integrating this goal throughout their global value chains.

Finance must be redirected to achieving sustainability and away from unsustainable investments. We propose changes to broaden and strengthen the EU's Sustainable Finance Initiative and we propose changes also to the banking system – vital for the financing of European business. We also suggest changes to the rules governing international trade and investment, to direct business and finance towards sustainability.

Products sold in the EU must be produced in manner that supports sustainable circular production and consumption. Products are the objects of the linear business models based on overconsumption, and sold to private consumers and public procurers. Our proposals aim firstly to broaden and strengthen the EU's Circular Economy initiative, secondly to make it easier to be a sustainability-oriented consumer, and thirdly to reinforce sustainable public procurement.

We invite comments and suggestions to our reform proposals, as presented both in this introductory report and in response to the detailed proposals that we will make available on our SMART website in the final months towards the project's conclusion in February 2020.

1. Drivers for and barriers to the transition to sustainability

Sustainability is an overarching objective of the European Union and meant to be the guiding principle for the EU's policies and activities within Europe and in its relations with the rest of the world. This is set out in the Treaty on the European Union (TEU) Article 3(3) and 3(5), and underlined as concerns what the EU denotes as developing countries, in Article 21 TEU. Article 11 of the Treaty on the Functioning of the European Union (TFEU) requires the implementation of environmental protection requirements in all EU policies where necessary to achieve sustainability. Policy coherence for development (PCD) is set out as an EU legal norm in Article 208 TFEU, requiring that any area of EU law and policy must not work against developmental policies, with the sustainability aim of 'leaving no-one behind'.[1]

The adoption of the United Nations Sustainable Development Goals (SDGS) in 2015, together with the Paris Agreement on Climate Change in the same year, gave a new impetus to the public discourse concerning what we need to do to achieve sustainability. The EU's commitment to implementing the SDGs is elaborated on in the EU's 2017 Consensus on Development. [2] Implementing the SDGs requires an evidence-based framework for understanding what sustainability requires. In SMART, we employ the broadly recognised definition of sustainability as securing the social foundation for humanity now and in the future within planetary boundaries – encapsulated in the goal of a safe and just space for humanity.[3]

A number of initiatives, from policymakers, from thought leaders in business and finance, and from civil society, have contributed to an emerging change in societies' perception of what is necessary and what is feasible.

High-level policy-makers in the EU are increasingly speaking about the necessity of integrating sustainability into decision-making. The incoming Commission emphasises its prioritisation of sustainability, with the President-Elect, Ursula van der Leyen, aiming to implement a European Green Deal, with a 'just transition' that leaves 'nobody behind', and refocusing the coordination of economic policies across the EU to integrate the SDGS. [4] The first Vice-President, Frans Timmermans, underlines the need for an 'ambitious Green New Deal for Europe, which shapes the future for our

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[1] See the 2030 Agenda for Sustainable Development, https://ec.europa.eu/europeaid/policies/european-development-policy/2030-agenda-sustainable-development_en.

[2] European Commission, Commission Staff Working Document '2019 EU Report on Policy Coherence for Development' SWD(2019) 20 Final of 28 January 2010, 6. Joint Statement by the Council and the representatives of the governments of the Member States meeting within the Council, the European Parliament and the Commission on 'The new European Consensus on Development, Our World, Our Dignity, Our Future', Official Journal, (2017/C 210/01) , paras 9 and 10.

[3] This is elaborated on in the SMART Report D2.4, 'Obstacles to Sustainable Global Business. Towards EU Policy Coherence for Sustainable Development', *University of Oslo Faculty of Law Research Paper* No. 2019-02, available at SSRN: https://ssrn.com/abstract=3354401 or http://dx.doi.org/10.2139/ssrn.3354401. See M. Leach, K. Raworth, and J. Rockström, 'Between social and planetary boundaries: Navigating pathways in the safe and just space for humanity' World Social Science Report 2013, (OECD Publishing, 2013), pp. 84–90. See also 'Living well, within the limits of our planet', General Union Environment Action Programme to 2020 (7th EAP), Luxembourg: Publication Office of the European Union, 2014, DOI: 10.2779/68165; for more information, see https://ec.europa.eu/environment/action-programme/. .

[4] 'A Union that strives for more. Political guidelines for the next European Commission', by President-Elect van der Leyen, https://ec.europa.eu/commission/sites/beta-political/files/political-guidelines-next-commission_en.pdf.

children and ensures their health, prosperity and security on a green and thriving planet'.[5] Promising legislative developments in the EU include the Sustainable Finance Initiative as well as the second round of the Circular Economy Package.

The emerging recognition of the financial risks of unsustainability, and especially of climate change, is evident also in business and finance and society at large. Examples include statements by Mark Carney, the governor of the Bank of England, emphasising the unacceptability of ignorance of climate change in business.[6] The international trend of lawsuits against companies and states for environmental and human rights harms are indications of the growing lack of acceptance of status quo.[7] This is echoed in civil society movements including the school strikes 'Fridays for future' and Extinction Rebellion.[8]

Yet, significant barriers to sustainability remain, and the SMART Project's ambition is to contribute to achieving sustainability by supporting and enabling the transition. We do this through proposals aimed at dismantling regulatory barriers and reinforcing positive trends. We recognise that the transition will be driven by a range of economic and social policy measures. Through our reform proposals, we aim to contribute to the shift of European market actors, private, public and hybrid, towards sustainable market activity.

> Pushing back against the social norm of shareholder primacy, the pressure on business to maximize returns for investors, is key to achieving sustainability.

At the heart of the unsustainability of business is the social norm of shareholder primacy in limited liability companies: this norm results in pressure on decision-makers in those companies to maximise returns for investors, especially shareholders. This acts as a systemically entrenched barrier to corporate sustainability. Denoting shareholder primacy as a barrier of such significance is a short form for a complex mix of perceived market signals and economic incentives, informed by path-dependent corporate governance assumptions and postulates from legal-economic theories. While especially strong in listed companies, it affects also non-listed companies, and has knock-on effects on other business forms without personal liability of their members.

In our report Obstacles to Sustainable Global Business, we further identified a lack of willingness to break from entrenched economic beliefs supporting the pressure for short-term maximisation of returns, and a still persistent belief in the self-correcting ability of fully-informed markets. We also found that there is a lack of relevant, reliable and verified information on sustainability impacts of

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5 'Green Deal branded as 'hallmark' of new European Commission', *Euractiv,* 11 Sep. 2019, https://www.euractiv.com/section/energy-environment/news/green-deal-branded-as-hallmark-of-new-european-commission/.

6 'Firms ignoring climate crisis will go bankrupt, says Mark Carney', *The Guardian*, 13 Oct. 2019, https://www.theguardian.com/environment/2019/oct/13/firms-ignoring-climate-crisis-bankrupt-mark-carney-bank-england-governor.

7 Mark B. Taylor, 'The Revolution Will not be Litigated - towards a theory of corporate accountability in the Anthropocene, paper to be presented at the SMART Project Conference 'Social Justice, Business and the Pursuit of Sustainability' (December 2019).

8 See about Fridays for future, https://www.fridaysforfuture.org/, and Extinction Rebellion, https://rebellion.earth/, and see e.g. 'Climate activist Greta Thunberg urges MEPs to put words into action', European Parliament News, 16 April 2019, https://www.europarl.europa.eu/news/en/press-room/20190410IPR37531/climate-activist-greta-thunberg-urges-meps-to-put-words-into-action.

transnational business, which undermines a number of sustainability-oriented initiatives including the Sustainable Finance Initiative and the 2014 reform of the Public Procurement Directives.

In this report, we present the main direction of our reform proposals, outlining them in three sections entitled *Business*, *Finance*, and *Products*.

The section on *Business* addresses the pressure on decision-makers in business to maximize financial returns. We propose to redefine the purpose of business and the duties of the board, to ensure that sustainable value creation is integrated throughout the business. This enables business to move away from linear, unsustainable business models of overconsumption. It also mitigates the fragmentation of responsibility across numerous legal entities organized in groups and networks and across global value chains, an important characteristic of the structure of trade and investment.

In the section on *Finance* we address the interconnected short-term pressure on maximisation of returns within finance and on business in the real economy, through the globalized system of finance. Our reform proposals encompass the banking sector, which provides about 70 percent of EU external finance for Small- and Medium-Sized Enterprises (SMEs),[9] but which is not directly included in the EU's Sustainable Finance Initiative. We also suggest changes to the proposals under the Sustainable Finance Initiative to broaden and strengthen its reach.

The section on *Products* encompasses the regulation of products and of private and public consumption. Products are the objects of the linear business models based on overconsumption, sold to private consumers and public procurers. Our proposals aim firstly to broaden and strengthen the EU's Circular Economy initiative, secondly to make it easier to be a sustainability-oriented consumer, and thirdly to reinforce sustainable public procurement.

The reform proposals are interconnected. The proposals concerning business are prerequisites for the proposals concerning finance and products, forming the basis also for more sustainable investments and lending, and more sustainable private and public consumption. In turn, the proposals concerning finance and products may act as enforcers and drivers for the timely and successful implementation of the changes we suggest in the way business operates.

We welcome your input to our reform proposals.

Each of the proposals outlined in this report is being developed in detailed and concrete suggestions for both relevant legislative changes and guidance for changes in practice by business and by public procurers, as a complement to legislative changes. These proposals will be made available in draft form over the coming months. We encourage input both to this proposals that follow below in summary form and to the concrete proposals as they are made available in the near future.

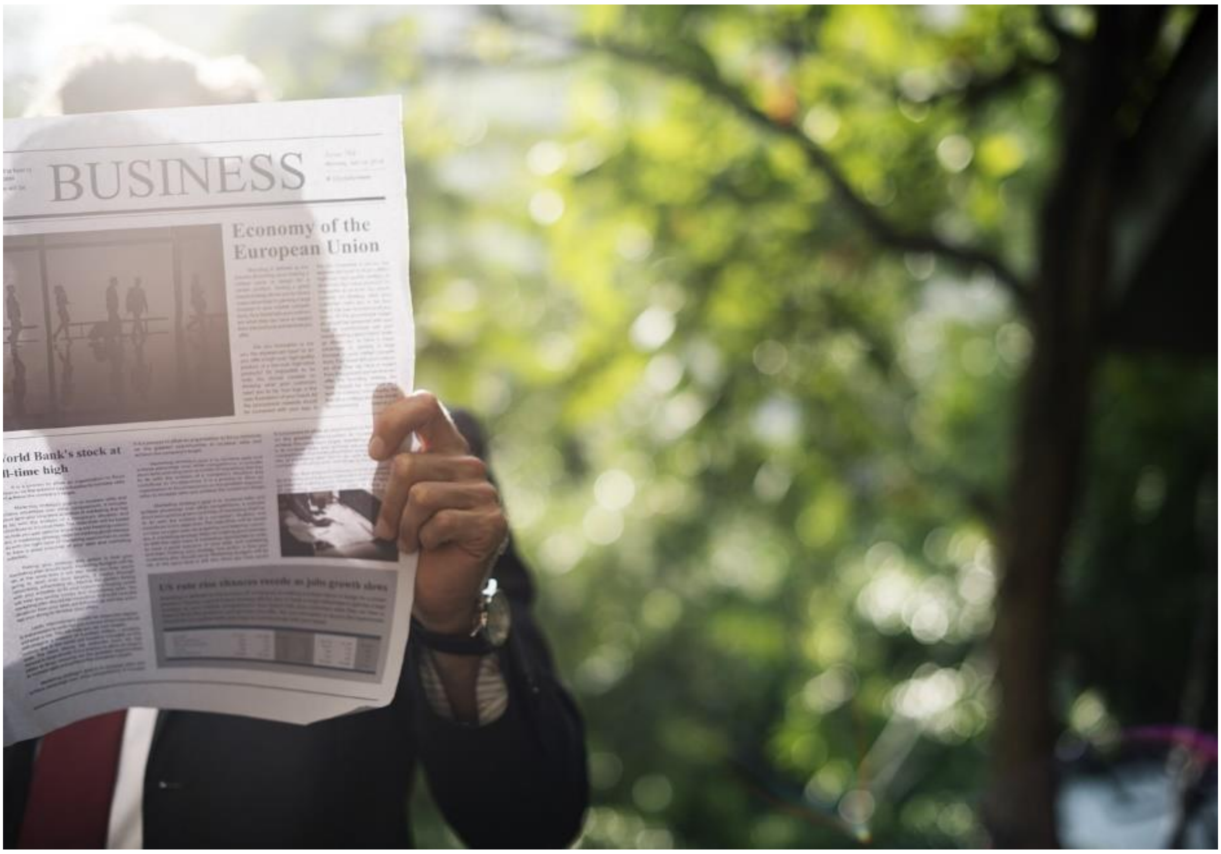
[9] See 'SMEs in Europe lack an estimated 400bn of bank-financing', *Euler* Hermes, 9 April 2019, https://www.eulerhermes.com/en_global/media-news/news/SMEs-in-Europe-lack-an-estimated-400bn-of-bank-financing.html.

2. Business

2.1 Introduction

Achieving sustainability, implementing the SDGs, requires reform of EU laws, policies and practice concerning business. The contribution of business is vital to achieving sustainability, and yet we know that business-as-usual currently undermines sustainability goals. To change this, reform is necessary to ensure sustainable value creation within planetary boundaries. This entails reforms that enable business to positively contribute to transitioning our societies to a *safe* and *just* space for humanity, while at the same time constraining and mitigating the environmental, social and economic harms caused by business. This is fundamental to securing the foundation for human dignity and protecting vulnerable people within Europe and contributing to doing so in low-income countries outside of Europe.

We start out with international trade and investment law as the international context for European business and their global value chains, and move on to the regulatory infrastructure of European business, including company law, reporting requirements and corporate governance codes.



2.2 The unsustainability of international trade and investment

EU-based corporations are involved in global value chain activities that violate both environmental and social sustainability. These can also have economic development implications when they displace wealth from the country that is a site of production or the origin of services. In terms of both trade in goods and trade in services, we note the EU's engagement in free trade agreements (FTAs) made conditional on sustainability and good governance in the State concerned. However, evidence indicates minimal application of these provisions in practice, including evidence that consultative bodies, such as ‘domestic advisory groups’, are not providing the scrutiny required.

The EU has concluded FTAs that now include an Investment Court (including an appellate structure). This may overcome many concerns raised to date regarding the problems with standard investment arbitration. We also note the EU’s attempt to encourage the adoption of a multilateral treaty establishing an investment court through UNCITRAL mechanisms. Inclusion of a right to regulate in investment chapters within FTAs also prevents the potential anti-democratic effects of State obligations to investors to guarantee ‘fair and equitable treatment’ and ‘non-discrimination’, to protect ‘legitimate expectations’ and to guard against ‘expropriation’ whether direct or indirect. Nevertheless, there is a lack of joined up thinking, such that the relationship between investment and sustainability chapters (whether concerning environmental issues or labour standards) remains unclear.

The EU as a global actor can contribute to international trade and investment being a force for achieving the SDGs – rather than undermining them

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Solution: We make six proposals:

1. That the EU identifies the synergies between the different SDGs and seeks to implement its external trade policies in a manner that recognises the intersection(s) between the economic, social and environmental dimensions of sustainable development.

2. That the EU enhances the enforceability of labour and human rights clauses in FTAs in its further work on integrating sustainability into FTAs. The linkages between trade and other issues (like labour standards and environmental protection) are well known and the approach of EU FTAs is to use trade as a leverage to raise standards. However, the implementation of EU-FTAs does not always lead to an improvement of social and environmental standards. Mainstreaming trade to attain sustainable development is a priority of the EU and the WTO but strengthening compliance with sustainability clauses through the existing institutional frameworks established under the FTAs is needed.

3. That the EU elaborates, in its FTAs, the extent to which the terms in sustainability chapters affect the terms of investor protection in investment chapters. For example, there is scope to clarify further the relationship between Chapter 8 (Investment) and Chapters 22 (Trade and Sustainable Development), 23 (Trade and Labour) and 24 (Trade and Environment) of the Comprehensive Economic Trade Agreement between Canada and the EU. The EU has demonstrated a commitment to promoting and encouraging multi-stakeholder engagement in its consultative processes and has made references to corporate social responsibility in its trade agreements. However, we propose that the EU provides explicit protection for non-disputing parties (such as environmental NGOs and trade unions) to intervene in investment proceedings regarding sustainability issues, offering also where appropriate sources of financial support, such as that provided in the context of WTO dispute settlement for developing countries.

4. That the EU continues to support a multilateral approach that promotes sustainable development within the World Trade Organization (WTO), alongside its regional trade strategy.

This could, for example, involve creating a side-agreement on Article XX of the General Agreement on Tariffs and Trade (GATT) to support sustainable trade and/or encouraging international treaty commitments regarding labour rights, such as the International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families (1990), which many EU States have still not ratified. Multilateral agreements need to be fostered and sought by the EU on environmental, social and economic sustainability issues, which are then utilized as a reference point for trade policy.

5. That the EU provides support and resources to ensure capacity for compliance with labour provisions prior to conclusion of FTAs with third countries, learns from the lessons of US Obama administrative action prior to conclusion of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

6. That the EU continue to seek to blend public and private approaches to regulation, as in the 'Smart' regulation of the FLEGT (Forest Law Enforcement, Governance and Trade), but ensure that greater access is available to participatory representative decision-making in the third countries affected.[10] Such an approach would comply with SDG 16.7 concerning 'Responsive, inclusive, participatory and representative decision-making'.

Non-solution: Reliance on 'expert advice' without attention to creation and engagement with wider representative participatory structures. Relying on formal separation between discrete chapters in FTAs and procedural formalities, which have the effect of excluding key sustainability issues from being acknowledged and interested actors excluded from making submissions.

Instruments: The first five proposals above can be implemented through a revision or negotiation of standard terms and drafting conventions for FTAs and investment treaties. Further, meaningful financial support should be offered to assist developing countries from the global South and key NGOs and trade unions that would otherwise lack resources to engage in representative participation. Providing financial assistance to support participation will enhance capacity building activities and further the EU's commitment to democratic and multi-stakeholder dialogue through the institutions created by FTAs. The reforms can be executed through Commission recommendations regarding EU Member State ratifications of international instruments and representation within the WTO, as well as the terms of EU FTAs including implementation/enforcement clauses. Liaison needs to be strengthened between Commission DGs such as DG Devco and DG Trade regarding preparatory measures for conclusion of FTAs in terms of assisting compliance by third countries.

Proposal 5 above, on the relationship between public and private regulation, requires revision of the existing EU measures such as FLEGT and sustainability due diligence requirements for business, including open and participatory processes to include affected communities and persons (see subsection 2.3 below). Examples of measures to be revised include Council Regulation 2173/2005 of 20 December 2005 on the establishment of a FLEGT licensing scheme for imports of timber into the European Community OJ 2005 L 347/1; Regulation (EU) 995/2010 of the European Parliament and of the Council of 20th October 2010 laying down the obligations of operators who place timber and timber products on the market OJ 2010 L 295/23; and the limited due diligence requirements

[10] See also Commission Communication of 25 October 2011, 'A Renewed EU Strategy 2011-2014 for Corporate Social Responsibility' COM(2011)681.

focussed on risk assessment in Regulation (EU) 2017/821 of the European Parliament and of the Council - of 17 May 2017.

2.3 The unsustainability of business

A core problem is the externalization by business of its negative environmental, social, economic governance impacts, with fragmentation of enterprises across corporate groups, networks and global value chains. In addition, the shareholder primacy drive has led to a narrow and short-term pressure, contrary to the goals of European company law. A misconception has become entrenched, namely that the purpose of the leading European business form, the limited liability company, and thereby the duties of its board, are only to maximize returns for shareholders. We have also found this reflected in other business forms with limited liability for its members, such as cooperatives.

> Company law must to take back the power to define what the purpose of the company is and what the duties of the board are

Solution: Company law must to take back the power to define what the purpose of the company and the duties of the board are in Europe. To operationalise this, a key element in the SMART legal reform agenda is to clarify and to redefine the purpose of a company and the role and duties of the board. This should be done in a principle-based manner, while being specific enough on the aspects where correction from the current trajectory is most needed. We suggest not to limit the reform to companies but also to include all forms of undertakings with limited liability for its members. Similarly, our proposal applies to undertakings of all sizes, including small and medium-sized enterprises (SMEs).

We propose that the purpose of the undertaking is defined in law as creating sustainable value within planetary boundaries, balancing the interests of its members and other investors and other involved and affected parties. In the articles of association or equivalent documents a more detailed purpose, specific to the business of the undertaking may be formulated, within the overarching purpose as expressed in the above paragraph.

We propose to operationalize this through a redefinition of the duties of the board. This will include a duty to commit to the overarching purpose of sustainable value creation within planetary boundaries, adjusting the business model of the undertaking, where necessary, and develop a strategy to implement the purpose throughout the business and its internal control and risk management systems, including, where relevant, its global value chains.

To this end, the board shall ensure that a stringent sustainability assessment is undertaken at regular intervals (e.g. every five years), including sustainability due diligence – encompassing environmental, social and governance impacts – and including open and participatory processes with affected communities and persons. This would give a basis for rectifying lack of legal compliance and for a continuous improvement process towards the overarching purpose, on which the undertaking annually shall report as a part of the management report. We propose that the regular assessment be subject to assurance requirements and the annual reporting be subject to full audit.

Through these requirements, which we suggest to be enforced through both public and private means, the potential of sustainability reporting as a driver for change can be realized, through a significant improvement in the relevance and reliability of the reported information.

We propose Commission guidelines on assessment and reporting, assurance and audit, which would replace the current separate two sets of Commission guidelines on 'non-financial' reporting. We will also suggest minor changes to other parts of the Companies Legislation to support the reform proposal above. For SMEs we will suggest a scalability of the board duties. For the listed companies, we will propose changes in securities legislation to reinforce the suggested changes in company law and remove barriers to the shift to sustainability, including changes to the 2004 Directive on Takeover Bids and the 2007 Directive on Shareholder Rights.

Non-solution: Relying solely on the strengthening of compartmentalised specific legislation on environment, product safety and labour, both national and international, or on reporting, or on social norms alone, self-regulation or voluntary improvement.

Instrument: A revision of the Company Law Directive of 2017, which would need to include a reform of the Annex to widen it to include all undertakings with limited liability for their members, supported by Commission guidelines.

2.4 The failure of sustainability reporting

The so-called Non-financial reporting directive (through which Article 19a was added to the Accounting Directive of 2013) was an important follow up to open the space for a discourse on how to report on the sustainability impacts of business. However, the lack of stringency and of verification requirements in the Directive mean that it is difficult for businesses attempting to be sustainable, to show this to their potential contractual parties and society at large. It also remains possible for unsustainable businesses to greenwash – or now, SDG-wash. That the unsustainable businesses thereby still often have the competitive advantage is especially detrimental for European companies who have the potential of becoming the market-leaders of tomorrow if they have a regulatory framework that support their attempts at creating value in a sustainable way.

> European businesses can become the market-leaders of tomorrow, if they have a regulatory framework that supports sustainable value creation

Solutions: Clarify and strengthen sustainability reporting requirements, to make them more stringent, and with requirements for external verification. This needs to be tied closely to the redefined duties of the board and the tools of sustainability assessment and sustainability due diligence (see above). As shown below, we suggest the inclusion of sustainability requirements in Article 19 of the Accounting Directive on the management report to clarify that sustainability reporting is not something that is 'non-financial' and left to the company to report what they wish to say. At the same time, the information should be under full audit according to Article 34(1) first paragraph of the Accounting Directive. Sustainability reporting needs to be taken as seriously and be subject to equivalent requirements as those that apply to financial statements and consolidated financial statements, not according to the superficial 'consistency check' of Article 34(1) second paragraph. Also these proposals apply to all undertakings, with scalability in applying in reporting and auditing according to the applicable standards.

Non-solution: Relying on sustainability standards such as the Global Reporting Initiative (GRI) and Integrated Reporting, <IR>, without clear regulatory requirements and clear requirements for compulsory assurance.

Instruments: A revision of the Accounting Directive (2013/34 EU) by repealing the Non-Financial Reporting Directive (Article 19a on non-financial statement). This includes firstly amending the mandatory provisions of Article 19 on management report and audit of Article 34 (primary). Secondly, it entails amending Auditing Directive of 2006 (as amended by Directive of 2014) by adding international assurance standards to the European auditing framework to include management report under full audit.

2.5 Corporate governance codes as drivers of shareholder primacy

Corporate governance codes are created by the financial actors themselves without legislative control and without a sound research-basis for the substance of the codes. Rather, they are informed by and further reinforce the shareholder primacy drive. Typically they contain provisions that contradict European company law by promoting the unsustainable, short-term pressure of the shareholder primacy drive. The tentative inclusion of certain sustainability aspects in a number of codes is generally only on a superficial level, varying from Member State to Member State, which does not promote more sustainable business.

The EU considered whether to adopt an EU-wide corporate governance code, but has made key assumptions without a proper study. These include the assumption that codes represent best practice, that a convergence of codes is positive, and that it is sufficient to adopt accounting requirements to reinforce the comply or explain mechanism of the codes.

Solution: A revision of corporate governance codes in the Member States (we believe abolishment of the self-regulated corporate governance codes is currently not feasible). This could be achieved through the elaboration of a pan-European code, including scope for adaptations under the auspices of different stock exchanges, but with guarantees that certain key provisions are implemented.

Non-solution: To continue relying on the investor groups behind the codes to implement sustainability in a meaningful manner.

Instrument: A Commission Regulation, with minimum requirements for a European corporate governance code, supporting the changes proposed above in the 2017 Company Law Directive.

3. Finance

3.1 Introduction

European financial markets provide the credit and financing required for businesses in the EU and beyond. Financial markets will be fundamental to a successful transition to sustainable market activity. Addressing the contribution of EU financial markets to unsustainable business practices is vital to realizing the EU's commitments on sustainability.

The EU has committed to implementing the SDGs, including for example the decarbonising of its economy completely by 2050. However, such an objective requires rapid and meaningful policy interventions, including the introduction of heightened monitoring and regulation of financial markets and their contribution to environmental degradation – and channelling investments into sustainability. Yet, patterns of investment in unsustainable projects – routinely funded by large EU banks – have not been addressed sufficiently by EU financial regulators, in spite of the introduction of the Sustainable Finance Initiative. The Sustainable Finance Initiative (based on the March 2018 Sustainable Finance Action Plan) relies too much on the existing incentive structures for private actors in financial markets. Such reliance is unlikely to deliver sufficient sustainable investments.

The implication is that immediate and substantial reforms to the regulations governing the funding of investments should be introduced. These regulations should focus in particular on the banking system, given that the banking system remains by far the largest source of funds for EU businesses. However, the principles underpinning these reforms could also be applied to other funders of these business practices, including insurance companies, and shadow banking entities. Moreover, adjustments to the institutional mandate of the ECB (specifically concerning bank supervision and monetary policy) to facilitate its role in meeting sustainability goals should also be considered.

3.2 The unsustainability of financial markets

Much of the short-term and narrow pressure for maximization of returns to investors comes from the investment supply chains of financial markets and institutional investors. Financial markets as they function do not now sufficiently understand and attempt to mitigate the financial risks of unsustainability including the increased risk of new financial crises. The intermediaries in the financial market supply chains, including rating agencies, proxy advisers, fund and assets managers and analysists, are currently not able (or willing) to base their decisions and advice on a coherent concept of sustainability and follow this up in a way that leads to more sustainable business and less capital investment in unsustainable business.

The EU has made considerable progress regarding its adoption in principle of a Sustainable Finance Initiative to prevent 'greenwashing' of financial products, so that in future their merits can be reliably ascertained. However, there is a danger the Commission Sustainable Finance Initiative will not achieve its goals, due to limitations in the proposals under the Initiative. Further, the development of consultative processes and an expert group speaks of a genuine commitment to deliver, which may be realized in the next EU Parliament and Commission. However, the legitimacy and effectiveness of this EU action needs to be assured.

Banks, which are not directly included in the Sustainable Finance Initiative, have a crucial role to play in both increasing and mitigating ESG risks, for instance climate risks in financing energy production. Due to the importance of central bank monetary policies and bank financing, banks must be included in a reform of finance towards sustainability. New regulatory mechanisms are needed to penalize 'brown' borrowing and integrate sustainability to banks' capital maintenance rules.

Central bank monetary programmes should be channelled to promoting sustainable investments. The Eurosystem's asset purchase programme (APP) forms part of the broad programmes under which private securities and public sector securities are purchased to prevent deflation. However, the APP exhibits a tendency to support high-carbon projects. There is a growing consensus that the approach taken by the ECB to monetary policy - via its collateral policies and the APP - fails to support the general economic policy of the EU, which is to promote environmental goals and the transition to a low-carbon economy.

> Broader regulatory reform is needed to ensure that financial markets, including banks, channel their investments and lending to sustainable business

Solutions:

1. Revision of financial markets and securities regulation to connect with the clarification and redefinition of the purpose of the undertaking and duties of the board (2.2 above), and to contribute to long-term stability of financial markets and to the steady returns for pension funds, etc.

2. Broadening and strengthening the Sustainable Finance Initiative. There needs to be a swift elaboration of the 'taxonomy'[11] beyond climate change objectives, which are only one aspect of the planetary boundaries that we need to stay within. Further, an engagement with a richer understanding of 'minimal social safeguards' envisaged as an aspect of the screening criteria. These should not only include the ILO's eight fundamental Conventions but also broader decent work objectives as set out in SDG 8, including for example health and safety requirements in SDG 3 and social dialogue as per SDG 16. Caution in elaborating the taxonomy so that it does not become an overly elaborate tick-box exercise that is so complex that only professional risk managers can understand the technicalities.

3. Including banks: In addition to the sustainability disclosure obligations in the draft Disclosure Regulation[12] being expanded to include banks, the duties of the board members and

[11] Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment, 24.5.2018 (COM(2018) 353 final).
[12] Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341, 24.5.2018 (COM(2018) 354 final).

managers in banks need to be revised to fully integrate sustainability into the banks' decision-making. Further, while incentives to invest sustainably are important, more may be needed to deter unsustainability. We suggest the introduction of brown capital requirements to European capital regulation frameworks to penalise so-called 'brown' projects, or those that carry high risks for unsustainability.

4. We propose that the mandate of the European Central Bank (ECB) be re-interpreted or modified to integrate sustainability. Such sustainability considerations are material factors in determining economic development and in improving the social market economy and the quality of the environment. As a minimum, where this does not conflict with its primary objective of maintaining price stability, the ECB should use its mandate to support the financing of sustainable investments.

5. EU monetary policy should be amended to support the shift to sustainability. This can be achieved through changing the ECB's collateral framework and through amendments to the corporate sector APPs.

6. The Commission should include wider participation in future consultative processes, including greater engagement with environmental and trade union representatives globally, so as to ensure that interests in third countries likely to be affected are also taken on board.

Instruments: Reforms will be proposed to several financial market and securities instruments, and changes to improve the proposals flowing from the Sustainable Finance Action Plan of March 2018, as well as revision of the Non-Financial Reporting Directive (see above). This includes considering amendments to the draft Taxonomy Regulation, and adopting supplementary Commission proposals, going beyond the scope of the draft Disclosure Regulation applied only to asset managers and advisors, and the climate change limited draft Carbon Benchmark Regulation.[13] Amendments to the Capital Requirements Directive (CRD IV) should be introduced to include 'brown' penalising charges against specific non-sustainable investments. The current CRD IV neglects sustainability impacts of particular lending forms. The empirical evidence is strong that such an intervention would be significantly more effective than the introduction of a 'green supporting factor' for loan assets, a reform which is currently under consideration by the Commission in the context of climate-related bank lending risk.[14]

Adjustments to the legal mandate of the ECB should also be explored. This could take one of two forms, either: (i) reinterpreting the existing mandate of the ECB on broader lines to take into account the financial stability implications of unsustainability; or (ii) redefining the mandate to include sustainability explicitly. In either case, the ECB should be able to pro-actively engage its tools in reducing risks to the environment and align its operations with the EU's and its Member States' sustainability commitments, including the SDGs and the Paris Agreement. This would allow it to adjust its monetary policies, which would be reflected in modifications to its collateral framework, its liquidity operations, and its operations under the APP.

[13] Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks, 24.5.2018 (COM(2018) 355 final).

[14] See under 'Commission action plan on sustainable finance' on the website 'Green finance', *European Commission*, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/green-finance_en (information as per 14 Nov. 2019).

Non-solution: Relying on financial markets and their self-regulation as they are, to understand what sustainability means, to shift finance from unsustainable to sustainable business, and to influence businesses to become more sustainable. Presupposing that it is sufficient to shift equity investments towards sustainability and not including banks in a full regulatory reform. Continuing to rely on self-regulation of institutional investors through stewardship codes and of banks through principles of responsible investment. Now is a timely juncture to reconsider the purpose of the exercise and the most suitable means for its achievement.

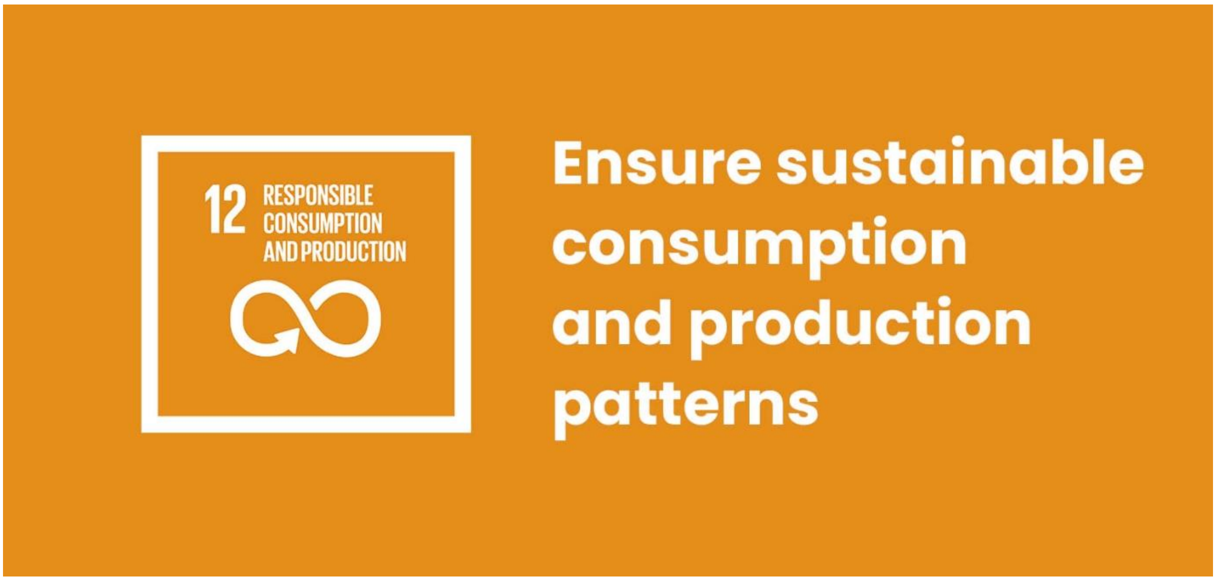
4. Products

4.1 Introduction

As is reflected in SDG Goal 12, meeting the challenge of sustainability will require transforming patterns of production and consumption. To that end, policies and law must address both the supply of and demand for products sold in the EU. Ensuring sustainability in the supply of products means finding the right mix of policies and regulation to ensure that the production of goods sold in Europe – which often takes place across global value chains - respects the social foundations and planetary boundaries of our biosphere. Similarly, shaping demand for sustainable production and consumption requires ensuring that sustainability is integrated in the decisions made by both private and public consumers. To these ends, our proposals aim firstly to broaden and strengthen the EU's Circular Economy initiative, secondly to increase the power of citizens to make sustainability-oriented decisions, and thirdly to reinforce sustainable public procurement.

4.2 The unsustainability of products sold in the EU

The transition towards a Circular Economy (CE) is presented as the way to solve the unsustainability of the current models of production and consumption. Moving from a linear to a circular economy – and thus imitating nature's way – may contribute to efficiency of production, and limit the wasteful use of resources. However, efficiencies are unlikely to be sufficient to ensure production and consumption remains now and in the future within planetary boundaries. Policy and law shaping the CE will also have to respond to the need for an absolute reduction in production and consumption, which is necessary to achieving a safe space for humanity and to ensure increased welfare for all.



The EU's 2015 and 2019 plans for a CE are promising in terms of looking at products from a holistic, (e.g. product lifecycle) perspective and improving the efficiency of production and waste management. However, the specific CE policies and regulations adopted will determine whether the CE is truly sustainable. In particular, waste law has become too prominent in promoting an increasing flow of material rather than a reduction in material use. Extended Produce Responsibility (EPR) has been effective at increasing collection and recovery, but not in increasing the sustainability of production. Moreover, existing EU policies aimed at the transition to the CE are in fact displacing externalities to foreign markets, putting increasing pressure on developing countries, with regards to both environmental and social concerns (e.g. EPR policies exported to countries where informal markets dominate production and consumption). Moving from ownership to access-based consumption has long been at the heart of a circularity approach. Although there are clear opportunities in services, they may nonetheless lead to unsustainable user behaviours (lack of care; quick replacement) and business decisions (not based on product's quality and lifetime).

> We propose to broaden the EU's Circular Economy Initiative through a smart regulatory mix to promote more sustainable production and consumption.

Solution: A smart regulatory mix governing products sold in the EU. This should be designed to achieve coherence and integration of the existing fragmentation of product rules and consumer protection and trade rules. It should also aim to increase efficiencies in production systems, extends the lifetime of products, and promote sustainable consumption. To this end, regulation should enable access to repair, promote the right to repair, and ensure the internalization of the social and environmental risks prevalent in global value chains. This regulatory mix should aim to re-claim policies that aim at constraining consumption and effectively extending product lifetimes and where necessary establish new regulations to these ends.

Non-solution: Assuming the CE is by definition sustainable; Relying on economic incentives (such as EPR) and high recovery targets to bring about fundamental change; taking for granted the sustainability of models based on product-as-a-service.

Instruments: Introduction of a new framework directive for products that integrates the existing rules to ensure the sustainability of all products produced within and brought to market in the EU (while ensuring compliance with WTO rules); establishing a hierarchy of resource use, i.e. moving up the hierarchy of waste management; developing pre-market responsibilities/duties to prevent, disclose and collaborate; framing product policies with a strong precautionary principle including a low risk threshold and a burden of proof on the producers; revising the 2008 Waste Framework Directive to clarify the definition of waste and second-hand goods – possibly by introducing a new 're-use product' exception; extending eco-design and labelling requirements to include durability, reparability, reusability and recoverability, and also to cover more product types (e.g. textiles); monitoring and constraining product-service systems to ensure their sustainability. In addition, a fitness check of other areas of EU law will have to be made to ensure their compatibility with a proposed product directive.

4.3 Empowering citizen sustainability

European residents are part of global product lifecycles. We buy, use and dispose of products that may have components or origins in several countries of production and may end their lives as waste in yet other developing countries. While price and quality of products are important factors for consumer choice, the final purchasing decision often depends on a wide range of factors including professional and personal circumstances, and individual habits and tastes. However, the lack of clear information about the sustainability of products and, worse, the lack of trust in claims about sustainability, undermines the ability of residents of Europe the engage in decision-making about sustainability, including in their roles as consumers and workers.

The lack of information and trust has several negative consequences. First, it makes it hard to price sustainability: there is no reason for consumers to pay a premium for sustainable products if they do not know whether the products are in fact produced sustainably or if there is no trustworthy way separate the best performers from the worst. This also undermines attempts to build trust through certification of sustainability best practice. Second, it affects companies who attempt to do the right thing, including in their relations to workers and labour markets: companies seeking to source or operate sustainably are not able to effectively distinguish themselves from those that do not, and this harms their ability to attract employees concerned about ethical company behaviour. Third, it contributes to a polarized debate between social movements driving responsible business and the private sector that sees no evidentiary reason for change, which in turn makes policy-making more difficult. Finally, it weakens consumer buying power and the incentive for businesses to act accordingly. In sum, if we cannot trust the information we receive about products, we are less likely to buy sustainably or push for sustainable practices at work. In turn, companies are more likely to continue to rely on price and quality as the determining factors in consumer demand and low factor inputs as the basis for production decisions.

> Sustainability needs to be an integrated element of consumer protection.

Moreover, even when information is clear and trustworthy, the lack of rights to access affordable repair is likely to make consumers wary of investing in more durable (and more expensive) products. Change in consumption habits requires that reliable sustainability information (see subsection 2.3 above) is backed by a number of measures that provides confidence to consumers when opting for the most durable but also more expensive product and contributes to turning quick consumption into long-term use and reuse. A product that is advertised to consumers as durable and reparable must be accompanied by a legal guarantee that covers that long lifespan and affordable repair and spare parts must be available for the duration of the product lifespan.

Moving from ownership to access-based consumption has long been at the heart of a circularity approach. Although there are clear opportunities in services, they may nonetheless lead to unsustainable user behaviours (lack of care; quick replacement) and unsustainable business decisions (not based on product's quality and lifetime).

Solution: Integrate sustainability to the definition of consumer protection, including its integration in the possibility of consumer remedies under the EU's 'New Deal for Consumers' (COM/2018/0183); Empowering consumers, workers and citizen's organisations; Developing a strict legal framework for the collaborative economy to ensure the sustainability of such initiatives.

Non-solution: Expecting consumers to act sustainably solely based on choice (price and quality) with no constraints (for sustainability); Assuming that citizens, as consumers or workers or small businesses, will enforce sustainability on producers in the absence of information and institutional mechanisms governed by public agencies; Assuming that consumers will opt for durable products and keep them in use longer without guarantee they can access repair in the long term; Relying on new forms of consumption (such as sharing or leasing) to bring about sustainable consumption.

Instruments: Adopting information requirements about durability and reparability accompanied by rights to access repair (e.g. ensuring spare parts availability and affordability); extended legal guarantees to products' expected lifespans and to the expected wear and tear of long-term use; conditioning access to the replacement of defaulted products upon attempting repair first; creating a right to know about social and environmental impacts of the process which produced products sold in the EU, and a corresponding duty on the part of business to disclose such information on demand.

4.4 Making procurement sustainable

Public procurement amounts to about 16 per cent of the Member States' GDP. A major contribution to the achievement of the SDGs is possible by enhancing sustainable procurement practices. The EU Public Procurement Directives of 2014 (Directives 2014/23/EU, 2014/24/EU and 2014/25/EU) have largely clarified the scope for permissible sustainable procurement decisions but the uptake of Sustainable Public Procurement (SPP) is still limited. The rules could be more permissible and thoroughly take into account all the different aspects of sustainability. Even more urgent and essential is to push for behavioural and organisational changes in the ways contracting authorities perform their buying functions so as to maximise positive, sustainable impacts. It is critical to change procurement management practices so that sustainability demanded in contracts is properly verified along the entire supply chain and remedial actions are taken where non-compliance is detected.

> Realising the power of sustainable public procurement as a driver for sustainable business requires investing in capacity-building as well as regulatory reform.

Solution: We make three proposals:

1. That the EU invest significantly in the capacity of contracting officials, procurement strategists and financial auditors by (a) encouraging the institution of Sustainable Public Procurement (SPP) knowledge centres at EU, national and regional levels following the model already provided by virtuous Central Purchasing Bodies; (b) creating a network of knowledge centres working closely together in developing and disseminating best practices on SPP, including through training materials, and in collecting information and data on the uptake of SPP and the difficulties encountered in applying the relevant EU rules, and (c) providing financial and technical assistance targeted to specific SPP formation for ground-level contracting officials.

2. That the EU make it mandatory for contracting authorities to map and monitor their supply chains for risks of breaches of environmental and social rules, including those protecting human rights. That the EU takes those breaches seriously, mandating the exclusion from award procedures of those found in violation and the taking of appropriate remedial actions in case of violations during contract performance. That the EU makes it easier for contracting authorities to

know about the economic operators having breached environmental and social rules, including those protecting human rights.

3. That the EU makes the legislative environment more 'SPP friendly'. Contracting authorities must be allowed to require suppliers to have effective sustainability policies in place. A shift is needed from enabling the Member States to pursue SPP to requiring them to buy sustainably by increasing the number of mandatory sectoral legislation and by requiring contracting authority to take into account the life-cycle costs associated with their purchases.

Non-solution: Simply relying on the goodwill of individual procurement officers or policy makers without providing training and networking opportunities on SPP and information and communication tools; leaving the regulatory burden to push SPP forward on the shoulders of Member States.

Instruments: The Commission, including DG Devco in its procurement activities in Official Development Assistance (ODA) and other EU institutions should lead by example concerning the capacity of procurement officials and the creation of competence centres. The Commission should act as a catalyst of the network of competence centres, and adequate funds should be released to fund the actions recommended under proposal 1 above. The Commission, possibly together with OECD, should collect and make available to contracting authorities data on breaches of environmental and social rules, including those protecting human rights. The other solutions under 2 and solutions under 3 mainly require amendments to Directives 2014/23/EU, 2014/24/EU and 2014/25/EU. Ad hoc regulations need to be adopted to enact further sectoral mandatory legislation.

5. Looking forward

The EU is committed to implementing the SDGs, and it has a strong Treaty basis in its objectives and rules on environmental protection, protection of human rights and human dignity, and on achieving policy coherence for development. However, the findings of the SMART Project show that sustainability can only be achieved if we dismantle regulatory barriers and reinforce positive trends.

The SMART reform proposals, briefly outlined in this report, are interconnected aspects of the changes that need to be put into place to achieve the transition to sustainability, to remove the systemically entrenched barriers to sustainable business and finance. The time is right for fundamental change, and we welcome input and comments to our proposals over the coming months.

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