SMART DELIVERABLE D2.4

Obstacles to Sustainable Global Business

Towards EU Policy Coherence for Sustainable Development

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 Sustainable Development.

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SMART

Sustainable Market Actors for Responsible Trade

Obstacles to Sustainable Global Business: Towards EU Policy Coherence for Sustainable Development

SMART Highlights

- Coherence on sustainability objectives is improving: UN Sustainable Development Goals resonate with EU Treaty goals on sustainability
- Emerging norms on responsibility of transnational business & finance offer options for channelling business activity into a shift to sustainability
- Innovative regulatory initiatives such as Sustainable Finance Initiative and Circular Economy Package need to be improved if they are to achieve their goals
- The evidence base for monitoring and evaluating sustainability is growing, including at the level of sectors and product life-cycles
- Yet, a lack of coherence across policy areas threatens sustainability goals
- The lack of coherence is exacerbating the unsustainable aspects of existing business regulation

- Main obstacles include:
    - Lacking willingness to break from entrenched economic beliefs
    - Short-term & narrow drive for maximisation of returns to investors
    - Persistent belief in self-correcting ability of fully-informed markets
    - Lack of relevant, reliable and verified information on sustainability impacts of transnational business & finance
    - Lacking understanding of the planetary, systemic & complex nature of sustainability

- Moving forward requires:
    - Regulation of business & finance to support the shift to sustainability
    - Consistent, evidence-based and systemic approaches to regulatory initiatives
    - Understanding economic aims as instrumental to other sustainability goals
    - Acting on fundamental nature of financial risks of unsustainability
    - Developing the evidence base for monitoring and evaluation of business impacts
    - Ensuring the effectiveness of policy and law in promoting sustainability

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Executive summary

This SMART report identifies significant obstacles standing between European businesses, investors and financial institutions, public procurers and consumers, and their contribution to sustainable development. Drawing on an in-depth analysis of the regulatory complexity governing European businesses and the global value chains of products sold in Europe, the report shows how much still needs to be done to realise the potential of sustainable business.

While the adoption of the UN Sustainable Development Goals (the SDGs) is a notable example of high-level policy support for sustainability, SMART pinpoints the lack of a comprehensive and consistent understanding of what this entails – of what is necessary to actually achieve sustainability.

Silo-thinking and path-dependent, outdated economic models are keeping us on a track towards an unsustainable, and therefore a very uncertain future. On the international level, trade and investment law and policy have a stronger regulatory framework and better support than environmental and human rights law and policy. This is reflected at the EU level and in Member States.

The analysis is undertaken through the lens of policy coherence for sustainable development, and in light of the EU's aim of implementing the SDGs. Drawing on natural science, including a recent report written for the European Environment Agency, we show that a more systemic, comprehensive, and evidence-based approach to sustainability is needed to achieve policy coherence and to implement the SDGs.

> An evidence-based approach to implementing SDGs is necessary to achieve sustainability.

We define sustainability as securing the social foundation for people everywhere both now and in the future, while staying within planetary boundaries. This encompasses protecting human rights and other fundamental social rights, ensuring good governance, contributing to securing the economic basis for functioning societies, and doing this in a way that protects the very basis of our existence – living well within the limits of our planet, in the EU terminology.

> Sustainability: securing the social foundation for humanity within planetary boundaries.

The law that governs the economy constitutes a number of barriers to sustainability. Some barriers are real in the sense that they require changes in the law, while in other cases we see that misconceptions of what the law requires may also constitute a barrier to change. A notable example is the myth that shareholders own corporations and that corporate boards have a duty to maximise returns to them (a norm which we denote 'shareholder primacy'). Indeed, this widespread – but legally incorrect assumption –operates as one of the main barriers to the necessary shift to sustainable business.

> The legal myth of shareholder primacy remains a main barrier to sustainable business.

There are a number of significant initiatives for sustainability at the international level including the SDGs themselves, and for promoting sustainable business, such as the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles for Business and Human Rights. These policy instruments have contributed to the development emerging norms that require that business and finance to contribute to global sustainability – or at least do no harm.

At the EU level, there are several laudable initiatives, including legislative instruments, such as the Public Procurement Reform of 2014, the Circular Economy packages of 2016 and 2018, and most recently the Sustainable Finance Initiative (with the first proposals emerging in 2018). Together with new reporting requirements for the largest businesses, which reflect the EU's paradigm shift in defining business responsibility towards society, this has opened up a space for discussing how business and finance should respond to society's aim of securing sustainability.

> Emerging norms and laudable EU initiatives bring hope for a shift to sustainability.

In their capacity as consumers, individual people have the potential to contribute to sustainability, but their demands are conflicting. Most business models are still based on overconsumption, with resources spent to encourage consumers to purchase indiscriminately. Consumers are generally not in a position to obtain reliable and relevant information about the global value chains of products, and for this reason too have limited ability to influence business.

Individual people may contribute in their capacity as workers, pressing their employers to take environmental measures which contribute to health and safety at work, and making demands of their communities. Individuals can also seek 'just transitions' to 'green jobs', so that the economic shocks they experience can be mitigated over time.

In the public sector, procurement is potentially an important driver of sustainability. However, while there is scope for it to have these effects, it must be used in a much more consistent manner.

To secure the contribution of business and finance to sustainability, emphasis needs to be on regulating businesses and financial institutions. Market pressure from consumers and public procurers, and the influence of civil society, can only be complementary and should not be relied on as main driving forces.

> Main emphasis should be on business & finance, not on 'consumer power'.

Generally, a number of barriers prevent business and finance from transitioning towards sustainable business models and these need to be dealt with in a more comprehensive, consistent, and forceful way than we have seen up to now. The short-term pressure for maximisation of financial returns to investors, together with a general tendency to see economic growth as a main policy target (rather than a means to an end), is an impediment to sustainability. The lack of relevant, reliable and verified information on sustainability impacts across global value chains is a hindrance to businesses and sustainability-oriented investors. It also acts as a barrier for sustainability-oriented citizens as consumers and workers and for the public sector when acting as procurer.

Policy-makers, businesses and investors alike are just beginning to understand the complexity of the sustainability challenge. Lacking knowledge and a lack of systems to deal with this complexity present barriers to a successful implementation of the SDGs and to achieving sustainability.

Lack of reliable, relevant & verified information about sustainability impacts of business and finance is a barrier to change.

In order to mitigate these problems, the SMART Project will in its next phase, develop reform proposals, including a sustainable governance model for businesses that encompasses sustainable value chain governance and a stringent and evidence-based sustainability assessment. This is just one part of a larger set of reform proposals that we will be working on, and we welcome discussion and collaboration on these issues.

In this report, we outline what sustainable market actors for responsible trade would look like, and what kind of policy framework would be needed to support market actors contributing to sustainable development.

We move from analysing the regulatory complexity for large transnational corporations to discussing small- and medium-sized enterprises (SMEs) and the topical issue of social enterprises. We find that each type of organisation has its own barriers and possibilities in terms of becoming sustainable businesses, and all of these need to be addressed through broad regulatory initiatives if the EU is to achieve its sustainability goals.

1 Introduction

This report is a deliverable from the international research project Sustainable Market Actors for Responsible Trade (SMART). SMART is funded under the H2020 programme 'Europe as a Global Actor', with the specific aim of contributing to policy coherence for development. SMART positions the pursuit of policy coherence for development into the broader context of achieving sustainability, which we define as securing the social foundation for humanity everywhere, now and in the future, while staying within planetary boundaries. This encompasses protecting human rights and other fundamental social rights, ensuring good governance, contributing to securing the economic basis for functioning societies, and doing this in a way that protects the very basis of our existence – living well within the limits of our planet, in the EU terminology.

SMART studies 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 Sustainable Development.

Our research concerns the market actors involved in global value chains of products. Our focus is on European businesses selling products to European consumers and public procurers, in particular what influences the decisions of these market actors: notably the businesses themselves, their investors and financiers, whether private, public or hybrid, and the purchasers of the products, whether consumers or public procurers. This is in line with the EU's emphasis on private sector engagement in development.[1] The decisions by the market actors must, on aggregate, be both development-friendly and contribute to sustainability, if participating in global value chains is to contribute to the sustainable development of low and lowest-income countries (what the EU denotes as developing and least-developed countries).[2]

Global value chains are central to globalized business and finance. EU policy is to promote responsible and sustainable global value chains 'in accordance with international standards and

[1] See https://ec.europa.eu/europeaid/sectors/economic-growth/private-sector-development/funding_en [under Overview]
[2] See https://ec.europa.eu/europeaid/sectors/economic-growth/trade/global-value-chains_en (under Overview)

guidelines in the areas of human rights, labour, environment and anti-corruption'.[3] Yet there is ample evidence that global value chains, as an intrinsic element of globalized business and finance, do not contribute to sustainability, whether in its social, environmental, governance or economic dimensions. The transnational nature of global value chains means that if this aspect is not adequately addressed, (other) national and regional attempts at facilitating sustainability will be undermined.

An important step to achieving sustainability is to understand why global value chains of products sold and bought in Europe continue to be informed by decisions that undermine sustainable development. In this report, we analyse the regulatory complexity faced by the European market actors involved in these global value chains: the businesses, their investors and financiers, the consumers, and public procurers.

We identify what hinders sustainability and reflect on possible options to better ensuring sustainability. With the aim of policy coherence for sustainable development, we identify the incoherencies and the gaps in law and policy. We identify specific barriers and explore how well-intended legislative initiatives and EU-supported international norm developments may be insufficient.

The report forms a part of the basis for suggesting reform proposals at a later stage in the project. The report draws on a larger work-in-progress research paper, which pulls together research from a number of involved scholars. The research has been generated through a number of SMART events in the first two years of the project, with contributions from the SMART team and the broader academic community with which SMART has engaged.[4] The SMART Investor and Business Forums[5] have provided important feedback to our tentative results, while SMART's Advisory Board have given guidance and valuable suggestions to the

[3] See https://ec.europa.eu/europeaid/sectors/economic-growth/trade/global-value-chains_en (under Policy)
[4] See SMART events: https://www.smart.uio.no/events/events/, SMART publications: https://www.smart.uio.no/publications/and other SMART reports: https://www.smart.uio.no/resources/reports/
[5] See about both SMART Forums: https://www.smart.uio.no/creating-change/

development of this report and the research on which it draws.[6] The research paper will be made available later in 2018.

In the report we start in Section 2 with an analysis of what sustainability entails, engaging with the SDGs as the strongest indicator of a global consensus on the aims of achieving sustainability. Thereafter, in Section 3, we present the market actors we concentrate on in the analysis in this Report. We go in depth into these market actors in Sections 4-10, with Sections 4-8 devoted to the large corporation, and SMEs and social enterprises discussed in Sections 9 and 10, respectively. Section 11 presents our general findings, while Section 12 summaries and concludes with a discussion of what sustainable business and a policy framework for sustainability would look like, and reflects on the way forward.

[6] See about SMART Advisory Board: https://www.smart.uio.no/team/index.html

2 Sustainability, the SDGs, and the EU

The adoption of the UN Sustainable Development Goals (SDGs), in 2015, has given new impetus to the debate on how to achieve sustainable development. The SDGs express a global consensus for a new approach to sustainable development and have the potential of promoting significant changes if implemented properly.

The EU as a global actor has played an important role in this process and strongly supports the SDGs. As stated in the new European Consensus on Development (2017), the shift from the Millennium Development Goals to the SDGs reflects a change in the global approach, which resonates with EU values and principles.[7] The EU rightly envisages that Europe continues to take a lead position, which can further strengthen its role as a global actor.[8] Sustainability is already recognized as a European brand.[9]

EU action towards achieving sustainable development for all requires policy coherence. The SDGs need to be interpreted within a holistic and evidence-based concept of sustainable development, in order to make their achievement possible. To implement the SDGs in a way that actually facilitates sustainability, we have to draw on understandings from the natural and social sciences, and integrate the economic, social, and governance goals of the SDGs within such an understanding. This resonates with the EU Treaty Goals and EU Treaty requirements for policy coherence with respect to economic and social progress as well as environmental protection requirements in all policies and activities.[10] In addition, the EU has recognised the necessity of

[7] See the Council Conclusions available at http://data.consilium.europa.eu/doc/document/ST-13202-2015-INIT/en/pdf, para. 8. See also in the Commission Communication on the Next Steps for a Sustainable European Future, COM(2016) 739 final,

[8] The new EU Consensus on Development signed in June 2017 available at https://ec.europa.eu/europeaid/sites/devco/files/european-consensus-on-development-final-20170626_en.pdf, at para. 4.

[9] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions
Next steps for a sustainable European future: European Union action for sustainability, COM(2016) 739 final.

[10] Articles 3(3) and 21(3) TEU, and 11 and 208 TFEU.

achieving sustainability in general, and the SDGs in particular, within the limits of our planet.[11] As the first monitoring report of the EU's implementation of the SDGs emphasises, Earth's natural resources are finite, so work to achieve the global social goals cannot continue in the same way as it has been done so far.[12]

In short, the EU has a Treaty-based framework for taking an evidence-based perspective to the concept of sustainable development (or sustainability – the concepts are now used interchangeably, also in this report) as a basis for implementing the SDGs.[13] This is also in line with other EU initiatives, such as a proposal for a taxonomy of sustainable investments.[14] An evidence-based understanding of sustainability is also important for measuring progress towards the SDGs. In order to reach the long-term achievement for each of the individual SDGs and their sub-goals, this needs to be progress that is sustainable; environmentally, socially, and economically.

2.1 Sustainability entails operating within the limits of our planet

The SDGs, while containing most of the individual aspects of sustainable development, do not in themselves provide a conceptual framework drawing on an evidence-based understanding of sustainability. Indeed, it may be questioned whether the formulation of some goals – read independently – would work against the achievement of others.[15] An evidence-based understanding of sustainability therefore provides the basis for interpreting the SDGs in a way

[11] Decision No 1386/2013/EU of the European Parliament and of the Council of 20 November 2013 on a General Union Environment Action Programme to 2020 'Living well, within the limits of our planet', https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013D1386 – as also highlighted in the the Commission Communication on the Next steps for a Sustainable European Future, COM(2016) 739 final.
[12] That would, looking forwards to 2050, require 'almost three planets', Eurostat, 'Sustainable Development in the European Union — Monitoring report on progress towards the SDGs in an EU context', 20 Nov. 2017, DOI: 10.2785/237722, p. 237.
[13] Article 11 of the Treaty on the Functioning of the European Union (TFEU)
[14] See subsection 2.2 below.
[15] International Council for Science 2017. A GUIDE TO SDG INTERACTIONS: FROM SCIENCE TO IMPLEMENTATION. https://council.science/cms/2017/05/SDGs-Guide-to-Interactions.pdf

that allows for their implementation, including the understanding that some goals may be prerequisites to the achievement of others.

A general prerequisite to the achievement of the SDGs, and of the EU Treaty goals of sustainable development, is that we manage to stay within our planet's limits for natural resources, waste assimilation, and the maintenance of ecological life-support systems.[16] Scientifically, this may be explained with the concept of 'planetary boundaries'. Planetary boundaries, as a term used for the limits of our planet, is the result of the work of an international multidisciplinary group of environmental scientists, who, in 2009, pooled their knowledge of different Earth system processes to inform the world about the space for sustainable action within planetary boundaries.[17] Their work reflects the growing scientific understanding that life and its physical environment co-evolve. This pioneering effort brought together evidence of rising and interconnected global risks in several different contexts where environmental processes are being changed by human activities. The planetary boundaries framework flags a set of sustainability-critical issues. It presents policy makers with a dashboard of issues which arise from the collective impacts of humanity, impacts that are is changing profoundly the fundamental dynamics of the Earth system upon which humans rely for our lives and livelihoods.[18]

Through the planetary boundaries work it is estimated that humanity has already transgressed or is at risk of transgressing at least four of the currently identified nine planetary boundaries, including climate change, biosphere integrity (biodiversity), biogeochemical flows, and land-

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[16] *The New European Consensus on Development: Our World, Our Dignity, Our Future*, https://ec.europa.eu/europeaid/sites/devco/files/european-consensus-on-development-final-20170626_en.pdf, Accessed 3 August 2018

[17] J. Rockström et al., 'Planetary boundaries: exploring the safe operating space for humanity' (2009) 14 (2) *Ecology and Society*, available at ecologyandsociety.org/vol14/iss2/art32/, and since revised and updated by W. Steffen et al., 'Planetary Boundaries: Guiding human development on a changing planet' (2015) 347 (6223) *Science*, available at sciencemag.org/content/347/6223/1259855.abstract (last accessed 24 July 2015).
See about the background S. Cornell, 'Planetary Boundaries and Business: putting the operating into the Safe Operating Space for Humanity' (draft paper on file with current authors).

[18] Cornell, ibid.

system integrity.[19] At least two of these planetary boundaries, climate change and biodiversity, are what may be denoted as core boundaries, where transgression of each of them may in itself be sufficient to bring the Earth system out of the relatively stable state of the past few millennia, which the planetary boundaries scientists refer to as a 'safe operating space for humanity'.[20]

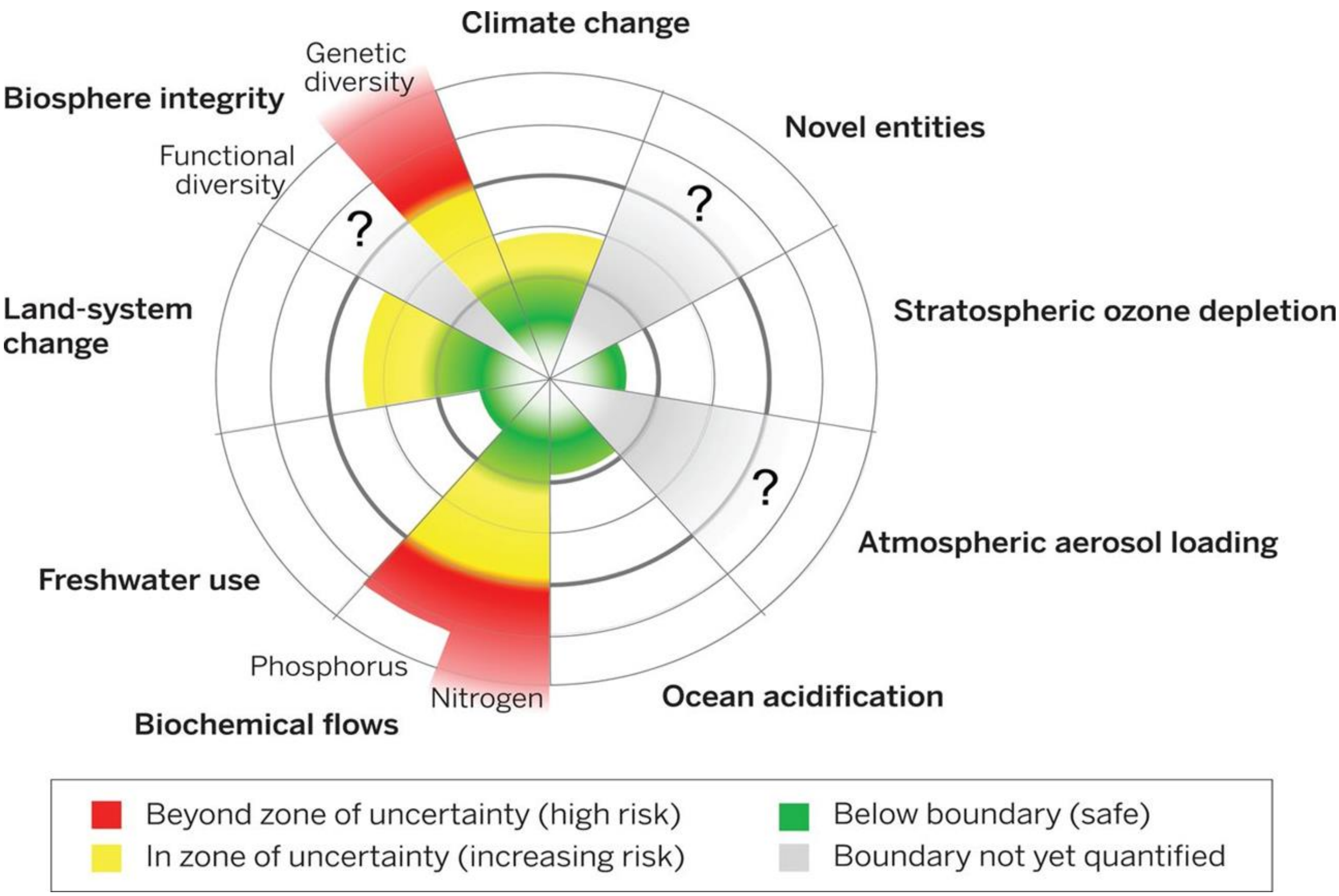

Figure 1: planetary boundaries. Source: *Steffen et al. (2015).*

[19] The other five being global freshwater use, ocean acidification, atmospheric aerosol loading, stratospheric ozone depletion, and cycling of the impact of novel entities; Steffen et al. As more expert communities worldwide engage with putting the concept into practice, discussions continue (and become scientifically better evidenced) about the best control variables and the best placing of a truly precautionary boundary, as we see in this report, which indicates that the freshwater boundary is also transgressed, see Campbell, B. M., et al. (2017), 'Agriculture production as a major driver of the Earth system exceeding planetary boundaries'(2017) 22(4):8 *Ecology and Society* https://doi.org/10.5751/ES-09595-220408

[20] Rockström et al., 'Planetary boundaries'

The planetary boundaries work is a continuous work-in-progress, as scientists gradually understand more of the complex interactions and feedback mechanisms in the global ecological systems.[21] Planetary boundaries as a concept forms the rationale by which new boundaries may be identified and better quantifications or metrics adopted. In line with this, the conceptual framework for planetary boundaries itself proposes a strongly precautionary approach, by 'setting the discrete boundary value at the lower and more conservative bound of the uncertainty range'.[22]

The precautionary approach is in line with the EU´s own precautionary principle.[23] Working to stay within planetary boundaries is in line with EU Treaty objectives of sustainable development including a high level of environmental protection. It is also in line with the EU's and the Member States' international obligations and commitments, including the Paris Agreement. However, the evidence of existing breaches of the climate, biodiversity and other planetary boundaries suggests these EU commitments may be insufficient to ensure respect for the limits imposed by these boundaries.

A recent report commissioned by the European Environment Agency, co-authored by SMART-partner Stockholm Resilience Centre, concludes, based on an equal global per capita distribution of the global safe operating space for humanity, that the EU does not appear to be 'living within the limits of our planet', for most of the boundaries analysed.[24] Not only do Europeans have a per-capita environmental footprint that is significantly higher than the global average, there is also an externalization of further environmental impacts. This includes the impacts of global supply chains of products sold in Europe, the effects of which are not accounted for in measures of the European environmental footprint. This means that some of the positive tendencies in the

[21] See also T Häyhä, PL Lucas, DP van Vuuren, SE Cornell, H Hoff, 'From Planetary Boundaries to national fair shares of the global safe operating space — How can the scales be bridged?' (2016) 40 *Global Environmental Change*, 60.
[22] Rockström et al.
[23] Communication from the Commission on the precautionary principle /COM/2000/0001 final, https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52000DC0001&from=EN Accessed 3 August,
[24] T. Häyhä, S.E. Cornell, H. Hoff, P. Lucas and D. van Vuuren, *Operationalizing the concept of a safe operating space at the EU level - first steps and explorations*, Stockholm Resilience Centre, July 2018.

EU are outweighed by increased pressure in other regions of the world, and that EU market actors' decisions about production and consumption contribute to these pressures. Also, the social and ecological impact of pressures on planetary boundaries can be more severe in the locations to which the pressures are externalised, compared to the effect if the same pressure were exerted within Europe.

In spite of the EU being recognised as a global leader in regard to environmental protection, EU efforts in this regard require strengthening, not least with respect to coherence between sustainability efforts within the EU and the impacts of EU policy and practice externally. This bring into focus two important policy implications arising from European involvement in global value chains of products:

First, the impacts on global planetary boundaries of European consumption and production should be taken into account in the EU's work to implement the SDGs and to fulfil obligations such as those of the Paris Agreement.

Second, the impact of European consumption and production on regionally specific planetary boundaries (such as fresh water access) is crucial for low and lowest-income countries; where European consumption or production undermines access to key resources necessary to positive social development in particular regions or countries, this kind of consumption will be in conflict with the EU's own development policy aims.

These two points are interconnected, as the impacts of transgression of the global planetary boundaries may pose the greatest barriers to social development in low and lowest-income countries, both because global impacts will have greater significance for some countries due to their geographic position, and because those countries may have fewer economic resources available for adaption.

2.2 Sustainability challenges the role of economic growth as an overarching goal

A tendency to set economic growth as an overarching goal, or a target that trumps all others, is one of the barriers to the necessary transition to sustainability. This is reflected also in the SDG goal of continued ('sustained') economic growth for all countries (expressed without reservation, other than those implicit in the words 'inclusive and sustainable'). If continued economic growth is to be compatible with staying within the planetary boundaries, it would require a full decoupling of economic growth from natural resource exploitation. Whether this is possible, is strongly contested.[25] The EU's Seventh Environment Action Programme 'Living well, within the limits of our planet', clearly recognises that there are planetary limits, but indicates that it may be possible to totally decouple growth from resource use, 'setting the pace for a safe and sustainable global society'.[26] The EU's Agenda 2020, with its goal of smart, sustainable, and inclusive growth, does not explicitly discuss how this decoupling is to be achieved.[27]

Tim Jackson argues that sufficient total decoupling is not possible,[28] while Kate Raworth posits that we must become agnostic about growth, focusing rather on the important question of how we can ensure that humanity can thrive and prosper, independently of whether the economy grows, shrinks or levels out.[29] For the EU to continue to be a global actor for sustainability, it needs to engage with this issue and confront its own fixation on economic growth as a target or measurement of success. It is beyond the scope of this report to explore in depth the economic implications of transforming the relationship between growth and sustainability. Nevertheless, the recognition that economic growth is a means to societal ends, and not a goal in itself, is vital.

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[25] T. Jackson, *Prosperity without Growth: Economics for a Finite Planet* (Earthscan, 2nd edn., 2017); B. Sjåfjell, 'Redefining the Corporation for a Sustainable New Economy' (2018) 45(1) *Journal of Law and Society*, 29-45.
[26] Environment Action Programme to 2020, Decision No 1386/2013/EU of the European Parliament and of the Council of 20 November 2013 on a General Union Environment Action Programme to 2020, *Living well, within the limits of our planet*, OJ L 354, 28.12.2013, p. 171–200. See also the Eurostat report on the SDGs.
[27] European Commission, *EUROPE 2020 A strategy for smart, sustainable and inclusive growth*, COM/2010/2020 final.
[28] T. Jackson, *Prosperity without Growth*
[29] K. Raworth, *Doughnut Economics : Seven Ways to Think Like a 21st-Century Economist* (2017).

Dethroning economic growth as an overarching goal is not in contradiction with the instrumental aim of securing a resilient economic and financial system that provides the economic basis for the achievement of social goals. Rather it recognises that the limits of our planet cannot safely be subordinated to economic aims, and that the achievement of economic aims needs to be instrumental to the social goals, if we are to have a chance to achieve sustainable development.

Indeed, an overly strong focus on economic growth puts the economy at risk, with potential negative effects both for financial stability and for the possibility of the economy providing a stable basis for continued social progress in Europe and abroad. This gives rise to questions about the functioning of the financial system, and whether it is able to provide the financial and economic stability required to support social progress.

2.3 Sustainability requires recognising the financial risks of unsustainability

The financial risks of continued unsustainable economic activity is an emerging driver for sustainable business practice. SMART partner Cicero Centre for International Climate and Environmental Research in Oslo has in 2017 issued the report 'Shades of Climate Risks' for investors.[30]The CICERO report complements the recommendations from the Financial Stability Board's Task Force on Climate-Related Financial Disclosure[31] by describing climate risks as an important driver for businesses to begin the process of internalising environmental, social impacts of business into their decision-making, reshaping and redesigning business models to make them fit for purpose in the 21st century. This is directly relevant for businesses in the real economy, notably for corporate boards.

[30] C. Clapp et al., 'Shades of Climate Risk. Categorizing climate risk for investors', (2017) 1, *CICERO Report;* http://hdl.handle.net/11250/2430660

[31] Final Report: Recommendations of the Task Force on Climate-Related Financial Disclosures (June 2017); https://www.fsb-tcfd.org/publications/final-recommendations-report/

The CICERO report gives guidance on scenarios for stress-testing based on two groups of risks: *physical risks* and *transition risks*. The *physical risks* are those that a changing climate entail in terms of sudden and gradual changes to our natural environment, including warmer, wetter and wilder weather, floods and landslides, sea level rise, droughts and heat stress. Ignoring these predictions may lead corporate boards to make financially risky investment decisions, for example in property that will not be possible to develop, or failure to ensure investments that need to be made, for example to fortify factories against the changing physical environment. A similar picture may be drawn for other environmental issues, for example other forms of pollution, loss of biodiversity, ocean acidification, deforestation and other land change, and pressure on fresh water (and these are complex, interconnected processes). The physical impacts of continued environmental degradation may have direct financial consequences for corporations and projects in various sectors, and decision-makers lacking in awareness or knowledge about these issues may increase the financial impact both on the investment level and directly for the corporation through the decisions they make or fail to make.

The *transition risks* described in the 'Shades of Climate Risk' report include *policy risks, liability risks,* and *technology risks*. *Policy risks* concern the 'risk' of changes in policy intended to mitigate climate change, which will impact in varying degrees on different sectors and individual corporations. Anticipating and adapting to changes in the regulatory environment through policy-making is clearly also a part of financial risk management within corporations. Corporate decision-makers taking the more cynical approach of betting against climate change mitigation by expecting no policy changes in that direction, may be making a correct judgment call in that respect. They will then, however, need to consider the financial implications of the physical risks of climate change, which are likely be profound in the absence of action by policy-makers.

On the aggregate level of business lobbying, financial risk management may be better dealt with by a more active approach, demanding policy action which mitigates the physical risk of climate change and applies to all businesses. This will also give a higher degree of certainty in terms of policy developments. Conversely, corporations involved in working against necessary policies, carry financial risk in the form of liability risks.

Liability risks may take the form of investors suing corporations or directly the board members for loss of profit for failing to anticipate or adapt to climate change or other environmental degradation. It may also take the form of lawsuits, brought against the corporation or the board members directly, for damage caused by the corporation's contribution to climate change or other environmental degradation. This is equally applicable to the social and broader governance dimensions of sustainability. The claimants may be individual people, civil society organisations, other businesses, or governments.[32]

Such lawsuits entail a varying degree of financial risk for the corporation, both arising from the lawsuit itself (lawyer's fees, time spent, possible damages that have to be paid), and in the form of negative reputational impacts, which may lead to lower profit because of negative reactions from potential customers, contractual parties and investors. The international trend of lawsuits against corporations, including against parent corporations for environmental or social harm allegedly caused by their subsidiaries and against lead corporations for negative environmental or social impacts in their global value chains, shows that this risk is materialising.[33] While many cases are rejected for procedural reasons, and many are lost, some are won, and the sheer multitude of cases makes them a driver for change – and in our context, shows that there is

[32] For a list of cases see 'Legal Case Map', Business and Human Rights Resource Centre, https://www.business-humanrights.org/en/corporate-legal-accountability ; see also Jennifer Zerk 'Corporate liability for gross human rights abuses - Towards a fairer and more effective system of domestic law remedies, A report prepared for the Office of the UN High Commissioner for Human Rights', (OHCHR, 2014).

[33]For example: Californian local authorities have sued 37 other petroleum corporations for damages in relation to costs to be incurred in response to sea level rise. A farmer from Peru has sued a German energy company for the cost of securing his village against flooding. See generally 'Global trends in climate change legislation and litigation: 2017 update' Sabin Center on Climate Change Law (2017).

growing recognition of the financial risk of ignoring sustainability – in itself. The financial risk of carrying on with mainstream governance models in corporate groups or of global value chains is also illustrated through these cases.

The third type of transition risk discussed in the Shades of Climate Risk report is that of *technology* changes. The 'stranded assets' discussion for any corporation involved in exploiting fossil fuels is the obvious example here, as the shift from fossil fuels to renewables presents a financial risk to corporations planning to make profit in the long run on oil, gas or coal. However, this also impacts on corporations indirectly relying on these resources, such as manufacturers of fossil-fuelled cars.

Indeed, the broader context of a shift from unsustainable linear business models to a sustainable circular model, involves financial risk for corporations not anticipating and adapting to this shift. In this sense, 'technology change' is too narrow to capture this fully – *systems change* may be the more appropriate term

In light of the above, the EU's Sustainable Finance Initiative is especially welcome, as it indicates recognition of the financial risks of continued unsustainability. We discuss this further below in Sections 4 and 5.

2.4 Sustainability entails living well, and leaving no-one behind

Within the framework of the planetary boundaries, the social and social-economic goals of the SDGs may be presented figuratively, as the social foundation we wish to secure for all people.

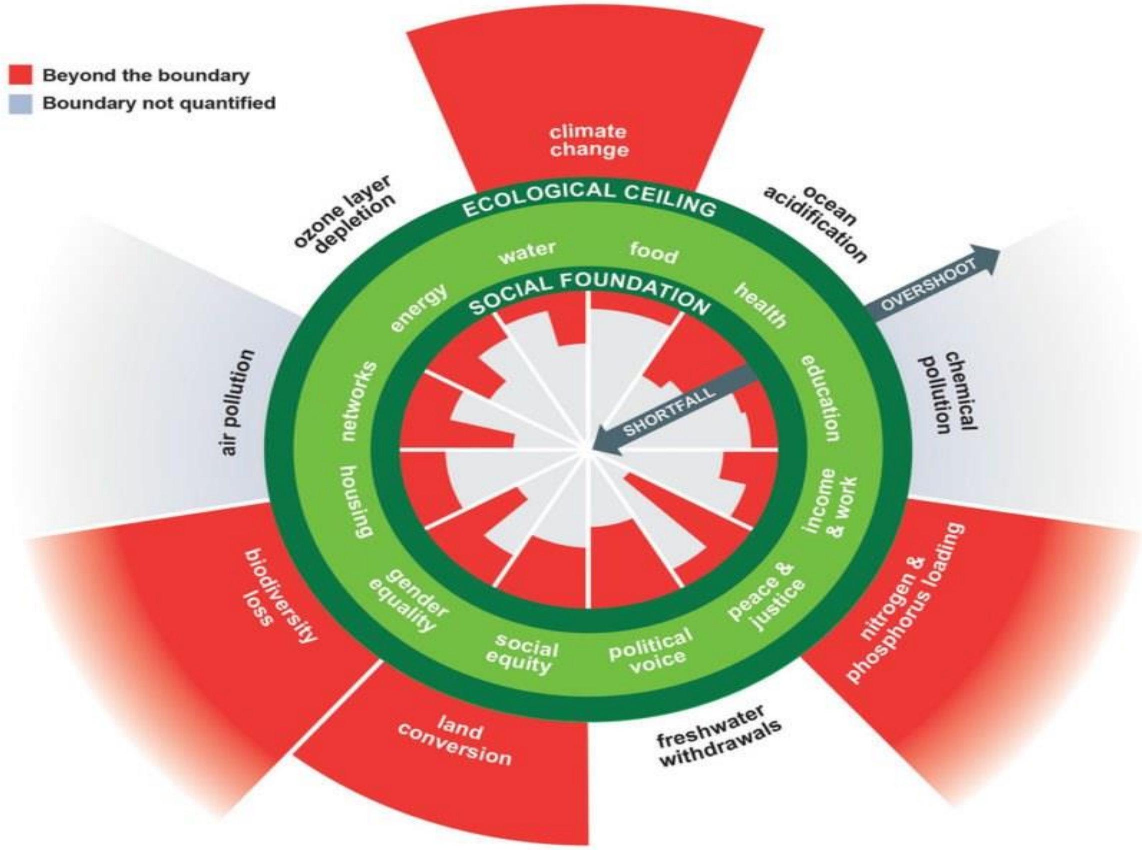

Figure 2: The social foundation within the ecological ceiling of planetary boundaries. Source: [Raworth (2017)](#).

The image of the safe and just space for humanity, within the social foundation and planetary boundaries, is a visual representation of the goal of sustainability. The twelve aspects of the social foundation correspond with the social and social-economic goals of the SDGs, and are also supported by the EU Treaty goals of human rights and other vital aspects of social development, as well as the EU's and the Member States' human rights obligations and commitments.[34]

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[34] K. Raworth, *Doughnut Economics.* See also SMART Deliverable D4.1, Maja van der Velden and Mark Taylor, University of Oslo, 'Sustainability Hotspots Analysis of the Mobile Phone Lifecycle' (2017), available at https://www.smart.uio.no/resources/reports/reports/sustainability-hotspots-analysis-of-the-mobile-phone-lifecycle.pdf and SMART Deliverable D2.2, Tonia Novitz and Clair Gammage, University of Bristol , 'Report on International Regulatory Complexity of EU Trade and Investment – mapping and analysis: *Analysis of international and EU law for trade and investment flows between the EU and other countries of various levels of development* (2017), available at https://www.smart.uio.no/resources/reports/d2.2-smart-report-on-international-complexity.pdf

There is not a complete overlap, with some aspects of the social SDGs arguably going beyond the EU's and Member States' international treaty obligations, and other aspects, notably treaty commitments concerning indigenous peoples, perhaps not being fully encompassed by the SDGs. Implementing the social targets of the SDGs therefore requires going beyond existing international treaty obligations, while the focus on SDGs must not be allowed to deflect attention away from international obligations that are not adequately encompassed by the SDGs. Rather, the apt image of securing the social foundation within planetary boundaries should be interpreted so as to include also wider international obligations towards indigenous peoples, which also has potential environmental linkages and effects.[35] This is especially relevant and important from the perspective of policy coherence for sustainable development.

2.5 Sustainability requires sustainable business

The implication of this framework is that the achievement of particular SDGs must be pursued in such a way does not undermine, and preferably supports, the achievement of the overarching goal of sustainability. This may be illustrated through a visual restructuring of the SDGs, where SDGs 6, 13, 14 and 15 represent the framework of planetary boundaries, within which the social SDGs 1, 2, 3, 4, 5, 7, 11 and 16 must be sought to be achieved. It is within this double framework of the planetary boundaries and the social foundation that the economic-related SDGs 8, 9, 10 and 12 must be interpreted, and which SDG 17, on partnership, should work to support.

[35] P O'B Lyver et al, *Indigenous peoples: Conservation paradox Science* Vol. 357, Issue 6347, (2017), pages 142-143.

Sustainability may thus be defined as securing the social foundation for people everywhere now and in the future, while staying within planetary boundaries. This entails satisfying the economic needs necessary for stable and resilient societies, while respecting human rights and securing the fundamental social foundation for human welfare, and doing this in a way that ensures the long-term stability and resilience of the ecosystems that support human life, 'on which the welfare of current and future generations depends'.[36]

Figure 3: An evidence-based approach to the SDGs. Source: *Azote Images for Stockholm Resilience Centre*

[36] D. Griggs et al, *Policy: Sustainable development goals for people and planet*, *Nature* volume 495, pages 305–307 (21 March 2013), https://www.nature.com/articles/495305a

This framework helps to visualize the point made above about the need to reconcile the demand for economic growth with the imperative of long-term sustainability. This framework is a way of visualizing what it means to be 'agnostic about growth', as Raworth suggests. The point is not to reject the significance of economic development, but to locate it in relation to the other factors that are vital to human survival and welfare.

In practice, the framework make clear that the policy and practice of efforts to obtain the SDGs must engage with the existence of planetary boundaries, or risk promoting the attainment of goals that will ultimately undermine sustainability. This suggests, in turn, that the indicators of planetary boundaries and social foundations should be used as a basis to assess SDG policy and practice, whether on a global, regional (EU) or national level. That is currently not done, neither on the UN level nor on the EU level.[37] For example, the assessment of the EU's progress on SDG 12, on Sustainable Consumption and Production, discusses the progress concerning energy and chemical use and resource efficiency, but does not relate this to any definition of limits or boundaries, in spite of the recognition that we are living on a planet with finite resources and that a decoupling of natural resource use is necessary.[38]

The framework also indicates that any contribution of business to attaining the SDGs should face a similar test. It is generally assumed that business will be the primary engine of value creation that will help countries meet the SDGs. However, there is little concrete analysis of how business can contribute – or obstruct – realizing to the SDGs.[39] This may in part be explained by the tendency towards policy compartmentalization in a complex world, where it is implicitly assumed to be sufficient that each policy area concentrates on its own aims. This ignores the limitations of

[37] UN indicators: https://unstats.un.org/sdgs/indicators/indicators-list/. EU indicators: http://ec.europa.eu/eurostat/documents/276524/7736915/EU-SDG-indicator-set-with-cover-note-170531.pdf

[38] Eurostat, 'Sustainable Development in the European Union — Monitoring report on progress towards the SDGs in an EU context', 20 Nov. 2017, DOI: 10.2785/237722, p. 239.

[39] In the UN set of indicators for the SDGs, the only indicator under SGD12 on sustainable consumption and production patterns directly mentioning companies, is 12.6.1: Number of companies publishing sustainability reports. As we return to below under Section 5, sustainability reports are not necessarily a proxy for sustainability performance, and the mere existence of sustainability reports does not indicate that business is becoming more sustainable.

for example environmental law, and that policy areas can work against each other's purposes if they are not aligned. This silo-thinking is one of the general barriers to sustainability.[40] At the same time, business is very diverse in its forms and interests, both across sectors and countries, and this presents a real analytical challenge. The SMART project has sought to address the challenge by focusing on the global value chains of products sold in the EU. In what follows, we present the various market actors which arise in these value chains as the basis for the analysis presented in this report.

[40] B. Sjåfjell and M. Taylor, 'Planetary Boundaries and Company Law: Towards a Regulatory Ecology of Corporate Sustainability' (2015) 11, *University of Oslo Faculty of Law Research Paper*.

3 Who are the main actors?

3.1 The significance of global value chains

Today, major industrial sectors are organized along the lines of global value chains. In 2013, UNCTAD's *World Investment Report* stated:

> Today's global economy is characterized by global value chains (GVCs), in which intermediate goods and services are traded in fragmented and internationally dispersed production processes. GVCs are typically coordinated by [transnational corporations] TNCs, with cross-border trade of inputs and outputs taking place within their networks of affiliates, contractual partners and arm's-length suppliers. TNC-coordinated GVCs account for some 80 per cent of global trade.[41]

Global value chains involve a range of business entities, including lead firms, which are often transnational corporations, subsidiaries, partners, agents and suppliers. However, because global value chain processes are organised as 'networks' and are 'fragmented' and 'dispersed' between firms and countries, they need coordination. Profitable GVCs became dependent upon effective coordination to manage the transaction costs between suppliers and buyers, coordinate access to material assets, and maximize competitive dynamics. These concerns have been summed up as being concerned with the 'governance' of GVCs.[42]

3.2 Corporations, SMEs and social enterprises

Large European businesses are often in the position of having some degree of influence or leverage over the global value chains of products sold in Europe, as they control or strongly influence one or more tiers of the global value chains. The barriers to and possibilities for large

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[41] UNCTAD 2013, Global value chains: Investment and trade for development, http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf

[42] G. Gereffi, 'Global value chains in a post-Washington Consensus world' (2014) 21 *Review of International Political Economy*, 9. ; L. Seabrooke and D. Wigan, 'Global wealth chains in the international political economy' (2014) 21 *Review of International Political Economy*, 257.; P. Gibbon, J. Bair and S. Ponte, 'Governing global value chains: An introduction' (2008) 37 *Economy and Society*, 315.

European businesses transitioning to sustainable business models is therefore a crucial issue to analyse.

In addition to large multinationals, small and medium enterprises (SMEs) are a vital part of the global economy. SMEs constitute a significant part of the European economy domestically (99 per cent of all businesses),[43] and an important part of global value chains.

Recently, much attention has been devoted to facilitating 'social entrepreneurship' as a more inclusive and sustainable way of doing business. What is included in the popular concept of social entrepreneurship is unclear, yet its topicality and the attention given to social entrepreneurs by policy-makers, civil society and to a certain extent, academia, calls for deeper analysis.

SMEs and social enterprises are not two distinct groups, nor is there a hard line between the listed parent company and social enterprises. We will, however, discuss SMEs and social enterprises separately, to bring out their particularities, while some aspects of the discussion regarding listed parent companies also apply to these two other types of business.

In this report, we accordingly focus on ***three types of businesses***, to be able to analyse a representative range of business forms:

- A large listed parent company of a transnational corporate group, with some degree of influence over a global value chain
- An SME, involved in but not necessarily influencing a global value chain
- A social entrepreneurship understood as a small European business attempting to achieve a sustainable production through a global value chain

Naturally, each of these forms has a number of variations, both as legal forms and in practice. Through our analysis below we will discuss some of the variations.

[43] European Commission, What is an SME?, http://ec.europa.eu/growth/smes/business-friendly-environment/sme-definition_en.

3.3 The importance of finance

Businesses need capital, and investors - whether private, public or hybrid - are significant market actors.[44] Institutional investors are equity investors with a significant shareholding, and the target of much regulatory focus. However, for SMEs and social entrepreneurships in particular, debt financing is an important source of capital. The EU's Sustainable Finance Initiative underlines the topicality of analysis of these actors. We have selected ***two ideal types of financial market actors***, to analyse in-depth what drives their decisions and their influence on businesses:

- A large bank
- A large institutional investor

Banks and institutional investors are the most influential and significant in our context, and we have kept the analysis in this report to these two types for simplicity and accessibility of our report. There are, however, also ***other significant investor types***, which we analyse elsewhere. This includes Sovereign Wealth Funds, which one might expect to have greater motivation and more potential to promote sustainable business models. However, our analysis shows that even these investors, notably the Norwegian Government Pension Fund Global, which are traditionally regarded as the leading lights of socially responsible investment, have some way to go before their investment profile and fund management can be said to promote sustainability.[45] It also includes individual shareholders and private equity investors, which we briefly discuss in connection with SMEs.

In the interaction between investors and businesses, we find a number of other actors, including notably rating agencies, proxy advisors and fund managers, data providers, and various types of facilitators. We return to their significance in the analysis below.

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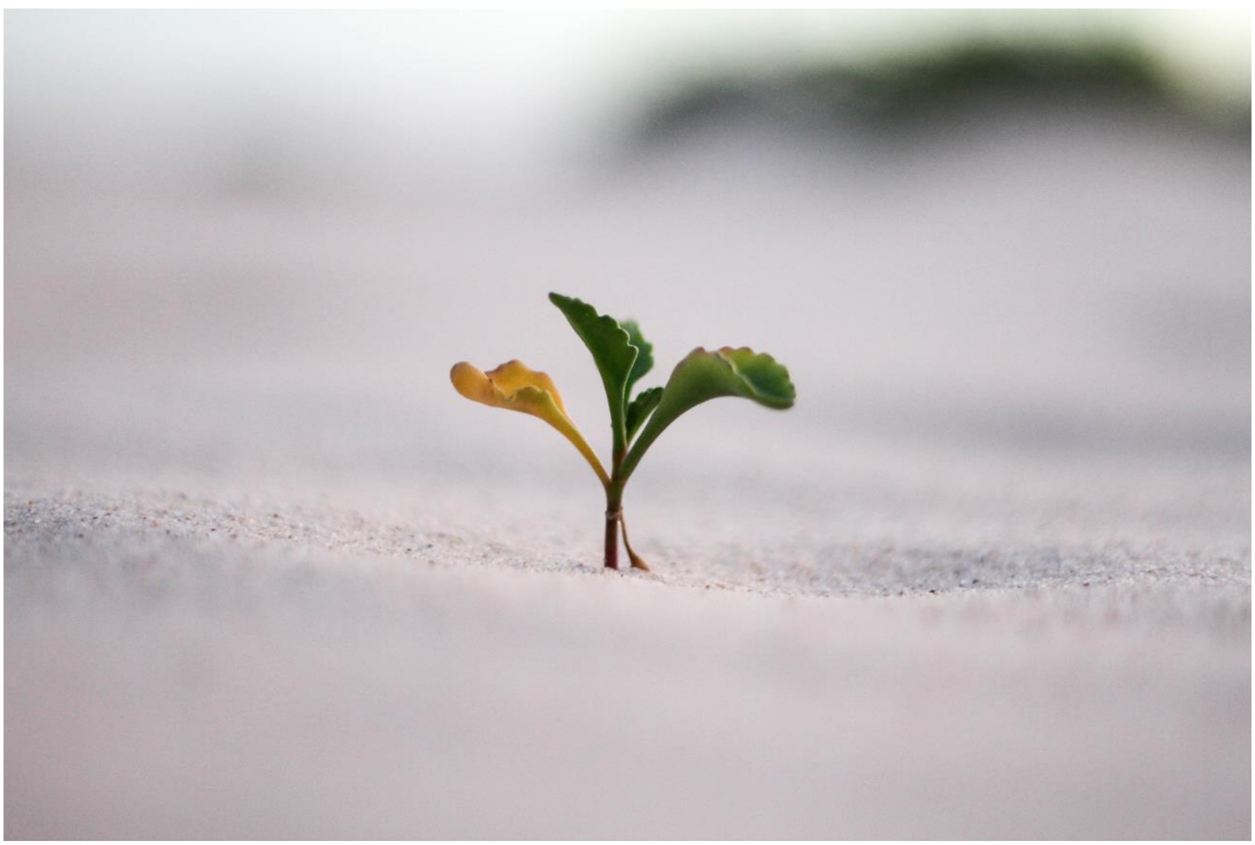
[44] This is increasingly recognized by the general public and civil society movements; see for example the complaints against banks to the Dutch National Contact Point for the regarding their impact via projects they finance on the environment, see 'Netherlands: National Contact Point accepts first OECD guidelines complaint linked to climate change against ING Bank', at https://www.business-humanrights.org/en/netherlands-national-contact-point-accepts-first-oecd-guidelines-complaint-linked-to-climate-change-against-ing-bank

[45] B. Sjåfjell, H. Rapp Nilsen, B.J. Richardson, 'Investing in Sustainability or Feeding on Stranded Assets. The Norwegian Government Pension Fund Global', (2017) 52(4) *Wake Forest Law Review*, pp. 949-979; http://dx.doi.org/10.2139/ssrn.2988816

3.4 Consumers and procurers

The purchasers of the products are also significant market actors influencing the businesses. SMART concentrates on *consumers and public procurers* as purchasers.

We move now to the in-depth analysis of these selected market actors and their regulatory frameworks.



4. The listed parent company

Our first ideal type is the *listed parent company of the transnational corporate group,* which also has some influence over a global value chain. The group is likely to consist of a worldwide network of corporate entities, linked by shareholdings and incorporated in different jurisdictions according to the parent company's preferences as to tax, regulation, transparency, availability of professional services, and so on. The group's brand is likely to be globally recognized, but the intellectual property which gives the group the sole right to use the brand is likely to be owned by a subsidiary controlled by the parent company, and licensed for use to other subsidiaries within the group. This provides administrative convenience, but also tax advantages, as it allows profits to be shifted to the low-tax jurisdiction in which the subsidiary, which owns the intellectual property, is incorporated. Although there is no room in this report to go in-depth into the tax issue, it is an area for SMART research and one that is increasingly clear as both a barrier to sustainable global business and finance, and a potential driver for sustainability.[46]

Much of the group's production will not be carried out by subsidiaries, but by third party companies (suppliers), linked to the group through short and long-term contracts, and often economically highly dependent on the group. This allows the group to reallocate production flexibly and quickly around the world. It also greatly limits the prospect of the group facing liability for the actions of these third

SECTION 4 AT A GLANCE

- Listed parent companies at the head of enormous global value chains
- Boards operate to hold executives accountable to shareholders and to reinforce a focus on shareholder value, with sustainability much lower priority
- Considerable reliance on disclosure to harness market forces to drive companies towards greater sustaina-bility, but piecemeal and incomplete

[46] As is illustrated by this recent report from SMART partner Stockholm Resilience Centre: Galaz, V., Crona, B., Dauriach, A., Jouffray, J-B., Österblom, H., and Fichtner, J. 2018. Tax havens and global environmental degradation. Nature Ecology and Evolution (Perspective). https://doi.org/10.1038/s41559-018-0497-3

companies. Civil society has since the 1980s applied pressure to selected corporate groups, leading to the development of codes of conduct, in which the parent company undertakes to carry out some degree of due diligence in relation to the observance of human rights, labour, and environmental standards at the establishments of their contractors. It is increasingly common for those commitments to extend to sub-contractors. However, the narrow scope and often insufficient time involved in the audits of the contractors and suppliers bring with them the risk of low impact.[47]

In this section, we will focus on the core decision makers in the parent company, that is, the board and senior management. In the following sections we explore the wider influence of institutional investors, financial markets and banks on the core decision makers.

4.1 The board and senior management

As decision-makers for the company, the board and senior management (also referred to as executives) are influenced by signals from the law, by market pressures, and by emerging norms. The legal infrastructure for the company, the relevant national company legislation, gives scope for, but only limited (if any) direction to, managerial discretion. As a matter of company law, the corporate board has a crucial role in determining the strategy and the direction of the

[47] See for example the case against TUV Rheinland regarding Rana Plaza pre-tragedy audits, discussed at https://www.ecchr.eu/nc/en/press-release/german-ministry-of-economic-affairs-acknowledges-need-for-reform-of-factory-audits-in-the-textile-industry/

corporation.[48] As the European Commission has observed, boards have a 'vital part to play in the development of responsible companies'[49] and businesses should:

> have in place a process to integrate social, environmental, ethical, human rights and consumer concerns into their business operations and core strategy in close collaboration with their stakeholders, with the aim of: maximising the creation of shared value for their owners/shareholders and for their other stakeholders and society at large; and identifying, preventing and mitigating their possible adverse impacts.[50]

4.2 No significant sustainability drivers in corporate governance

Whilst the board has discretion in law to take account of these concerns and impacts, the likelihood of this occurring is greatly reduced by the corporate governance system. Non-binding corporate governance codes, which were promoted by financial interests and operate in all major jurisdictions, require part-time, independent, non-executive directors to form the majority of the board, in order to ensure accountability of the executives (full-time managers) to shareholders. This development, which was driven by financial actors in the UK from the 1970s, may improve the quality of internal controls (although it did not do so in banks or other financial institutions in the build-up to the 2008 financial crisis).

However, time constraints mean that it focuses attention on headline financial results, with more qualitative indicators of the sustainability of corporate performance side-lined.

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[48] The board is used in this chapter as a general term encompassing the German *two-tier system*, consisting of a management board and a supervisory board, the British board of directors (with a majority of independent non-executive directors as required by the UK Corporate Governance Code) and the board as constituted in the Nordic countries. Trying to fit these quite different systems into one picture of a board level and a management level requires some simplifications, as the one tier board in the UK is expected both to act as the head of management as well as a supervisory body, whereas these functions are strictly split in the German system, with the *Vorstand* ('management board') alone empowered to manage, whilst the *Aufsichtsrat* ('supervisory board'), which will normally include both shareholder and employee representatives, supervising its decisions.
[49] COM (2011) 681 final, at 5.
[50] COM (2011) 681 final, at 6. The OECD Guidelines for Multinational Enterprises also support the formulation of such duties; OECD, *OECD Guidelines for Multinational Enterprises* (2011), http://www.oecd.org/corporate/mne/48004323.pdf (accessed 27 June 2016), at 42–46.

Moreover, non-executive directors play a crucial role (with advice from remuneration consultants) in making decisions about executive remuneration. This in effect aligns executive interests with the financial interests of shareholders in the short- to medium-term, and paying little attention to incentivising sustainability performance.

Since these governance structures and practices are the result of deliberate choices, reform intended to bring about greater consideration of sustainability is certainly possible. Policy-makers could consider requiring changes in the composition and the role and duties of the board; encourage or require the use of wider metrics in setting executive pay; limit the use of remuneration consultants, and so on.

4.3 Shareholder primacy as a main barrier

The most pervasive constraint on the discretion of the corporate board to shift the companies over to more sustainable business models is the social norm of shareholder primacy with its narrow and short-term fixation on increasing – or even maximizing – returns to shareholders.[51] Informed by a misleading dichotomy between economics and ethics, corporate boards are caught between their perceived duty to maximize returns for shareholders (wrongly perceived as a legal duty) and society's expectations of corporate sustainability (normally perceived as merely a means to the end of shareholder value, and therefore only voluntary).

Much of the negative impact of shareholder primacy is entirely lawful. Corporate executives, under the influence of non-executives, shareholders, financial markets and their incentives, have sufficient managerial discretion in law to increase short-term returns by externalising environmental and social concerns, by using loopholes and grey areas and by taking advantage of the lack of international regulation of business, and by leaving the responsibility to take care of workers and protect the environment to the state. However, lack of legal compliance with for

[51] See the multijurisdictional comparative analysis in B. Sjåfjell et al, 'Shareholder primacy: the main barrier to sustainable companies', in B. Sjåfjell and B.J. Richardson, *Company Law and Sustainability* (Cambridge University Press, 2015), pp. 79-147.

example environmental law and labour law is also an issue, and brings to the point the significance of ensuring that various areas of law and policy support each other's objectives and do not work counterproductively.

The powerful barriers to corporate sustainability erected by the shareholder primacy norm are exacerbated by the chasm between corporate law's approach to corporate groups and the dominance and practice of such groups. While corporations are 'creatures of national law',[52] corporate groups are transnational, making holistic regulation of heterogeneous groups across national borders extremely difficult.

Perversely, the parent company's relatively significant ability to control the group in practice is matched by the significantly limited possibilities for holding the parent company legally liable for subsidiaries' environmental and social transgressions.[53]

The possibilities for holding companies influencing global value chains liable for abuses in these value chains, which encompass third party companies – often economically dependent on powerful corporate groups, but not connected to them by equity shareholdings – is even more limited.[54]

4.4 Overreliance on sustainability reporting

The general expectation is that civil society and market pressure will act as a countervailing force, making executives take greater account of sustainability. This explains why, to date, the legislative response to corporate unsustainability has mainly taken the form of a patchwork of

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[52] As repeatedly emphasised by the Court of Justice of the European Union, see *Daily Mail*, Case 81/87 [1988] ECR 5483 para. 19: 'companies are creatures of the law' and 'exist only by virtue of [...] national legislation which determines their incorporation and functioning'; repeated *inter alia* in *Überseering*, Case C-208/00 [2002] ECR I-9919 para. 81.

[53] See B. Sjåfjell et al, 'Shareholder primacy: the main barrier to sustainable companies'. This is further exacerbated through the use of financial instruments, making corporate control increasingly opaque, which entails challenges to the identification of corporate control; Anker-Sørensen, Linn, Financial Engineering as an Alternative Veil for the Corporate Group (February 8, 2016).

[54] See B. Sjåfjell et al, ibid.

mandatory and voluntary reporting requirements at the national and supranational levels.[55] This pragmatic approach reflects a persistent belief in the self-correcting properties of fully informed markets. The aim is to harness the full range of market forces in order to bring the operation of corporate groups and global value chains into line with social expectations in relation to sustainability.

In spite of good intentions of bringing sustainability concerns into the boardroom, and much hard work in this area, reporting requirements have so far proven to be insufficient to overcome pressures for short-term shareholder value and to influence corporations and their investors to prioritise sustainability. Notably, while the new EU non-financial reporting requirements[56] may be perceived as an intermediary step towards the internalisation of social and environmental impacts, they currently lack the scope and the necessary verification requirements to be a real game-changer.[57]

At the global level, the weaknesses are even more pronounced, with reporting driven by voluntary and discretionary measures, leading to risks of corporate capture, lack of comparability, lack of consistency, and uncertainty in benchmarking.[58]

The recent Recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) are a perfect example of this, being highly ambitious, and receiving widespread support from business, but very difficult to operationalise.[59]

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[55] See also the multijurisdictional comparative analysis in C. Villiers and J. Mähönen, 'Accounting, Auditing and Reporting: Supporting or Obstructing the Sustainable Companies Objective?', 175–225 in B. Sjåfjell and B.J. Richardson (eds), *Company Law and Sustainability* (Cambridge, Cambridge University Press, 2015).

[56] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups Text with EEA relevance, OJ L 330, 15.11.2014, p. 1–9.

[57] C. Villiers and J. Mähönen, 'Article 11: Integrated Reporting or Non-Financial Reporting?', in B. Sjåfjell and A. Wiesbrock, *The Greening of European Business under EU Law* (Oxon, Routledge, 2015), pp. 274-311.

[58] Ibid.

[59] A. Johnston, 'Climate-Related Financial Disclosures: What Next for Environmental Sustainability?' University of Oslo Faculty of Law Research Paper No. 2018-02 (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3122259)

There is little coherent and stringent regulation of sustainability reporting and no requirements for external verification of sustainability claims. The result is a great deal of 'noise', which must be filtered by those who want to express their preferences as consumers or shareholders, with most of this promotional material being at worst green-washing, or, more recently, 'SDG-washing', and at best well-intended initiatives that are insufficient to mitigate the unsustainability of 'business as usual'.

4.5 Emerging shift of norms

At the same time, the rise of sustainability declarations from business may indicate a gradual shift in social norms. While transnational business still lacks, to a great extent, a comprehensive and enforceable regulatory framework promoting corporate sustainability, the uptake of measures like TCFD may provide evidence of a shift. Further, international initiatives such as the OECD Guidelines for Multinational Enterprises (OECD Guidelines) and the UN Guiding Principles for Business and Human Rights (UNGPs) are becoming increasingly influential.

The OECD Guidelines institutionalise an extra-judicial system of National Contact Points, which, to the extent they function well (as they do, for example, in Norway or in the Netherlands), offer not only mediation between complainant and corporation, but also authoritative statements on what is regarded as acceptable business behaviour. This has potential to put a brake on the unrestricted ability of corporations to make sustainability claims,[60] but its impacts are limited through the non-judicial nature of the system, the low number of complaints and even lower number of cases in which remedy actually has been granted.[61]

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[60] Interestingly, the Norwegian National Contact Point's decision in the Posco case also raised awareness of the significance of the OECD Guidelines for minority investors. In the Posco case a complaint was filed against the Norwegian Government Pension Fund Global, for its lack of action to prevent human rights violations. While the Fund rejected even discussing the complaint, the Norwegian Contact Point issued a statement speaking to the responsibility of the Fund. See the guidance from the OECD for minority investors.

[61] See 'OECD watchdog calls for reform of failing complaint system', regarding the report *Remedy Remains Rare*, Daniel, C., J. Wilde Ramsing, K.M.G Genovese, V. Sandjojo, OECD Watch 2015, at https://www.oecdwatch.org/news-en/oecd-watchdog-calls-for-reform-of-failing-complaint-system

The UNGPs rose from the ashes of earlier failed attempts to put into place UN binding norms for transnational business, notably the 'Draft Norms on the Responsibilities of Transnational Corporations' in the early 2000s.[62] The reaction to the UNGPs has been mixed, from being lauded as the most significant step forward in the area of business and human rights to criticism for not creating binding international legal obligations on corporations.[63] The last decade has seen renewed efforts aimed at developing a binding treaty regulating corporate accountability for human rights. A third round of international negotiations regarding the potential treaty was concluded in 2017, and laid the ground for the publication of the 'Zero draft treaty' in July 2018.[64]

Leaving the ongoing treaty negotiations aside, we see that the response has also been a boost aimed at proving that UNGPs are useful and practical, while the discussion continues as to whether they are sufficient. Certainly the UNGPs have kept business and human rights on the policy agenda, and have played a major role in the definition of responsible business conduct with respect to human rights and in the promotion of due diligence as the dominant way to both operationalise and assess business responsibility to respect human rights across corporate groups and global value chains. However, the national implementation of the UNGPs, through

[62]D. Weissbrodt and M. Kruger, 'Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights' (2003) 97 Am. J. Int'l L. 901, available at http://scholarship.law.umn.edu/faculty_articles/243.; D. Kinley, R. Chambers, 'The UN Human Rights Norms for Corporations: The Private Implications of Public International Law' (2006)6(3), *Human Rights Law Review*, , 447–497; https://doi.org/10.1093/hrlr/ngl020

[63] C. O'Brien and S. Shanarajan, 'The Corporate Responsibility to Respect Human Rights: A Status Review', (2016) 4, *Accounting, Auditing and Accountability* 29, 542–67.

[64] Legally Binding Instrument to regulate, in Human Rights Law, the Activities of Transnational Corporations and other Business Enterprises', (Zero Draft, 16 July 2018); see 'Reflections on the Zero Draft | Business & Human Rights Resource Centre', accessed August 30, 2018, https://www.business-humanrights.org/en/about-us/blog/debate-the-treaty/reflections-on-the-zero-draft. For an early commentary on the Zero Draft see: Carlos Lopez, Towards an International Convention on Business and Human Rights (Part I & II), Opinio Juris, 23 July 2018, available at http://opiniojuris.org/2018/07/23/towards-an-international-convention-on-business-and-human-rights-part-i/ and http://opiniojuris.org/2018/07/23/towards-an-international-convention-on-business-and-human-rights-part-ii/

National Action Plans, has been criticized as representing a missed opportunity for integrating the UNGPS through national legislation, policies and regulation.[65]

Amongst the positive impacts have been the integrations of UNGPs in the *OECD Guidelines for Multinational Enterprises*,[66] and the development of a set of Due Diligence Guidance documents for several industrial sectors developed by the OECD.[67] These international norms mark a significant step beyond initiatives such as the UN Global Compact, in that they communicate practical guidance to companies about the nature of responsible business conduct in specific value chains. Together, these initiatives may be seen as facilitating a gradual clarification of society's expectation of business and of how business perceives its relationship with - and responsibilities to - society.

There is also some reaction from the investor community, which – given the vacuum when it comes to benchmarking companies from the human rights point of view – co-financed the creation of the Corporate Human Rights Benchmark.[68]

4.6 First movers amongst Member States

These norms are also beginning to make their way into national law, with France imposing a *loi de vigilance* on multinational companies incorporated in France, requiring them to establish, implement, and report on a vigilance plan relating to human rights, health, security and environmental issues, both within the corporate group and across other entities with which it has established business relations.[69] Companies can be forced to comply by injunction and face

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[65] See an early assessment by SHIFT at https://www.shiftproject.org/resources/viewpoints/taking-stock-progress-guiding-principles/ - and this is also confirmed by later work, including the SMART mapping and analysis of selected jurisdictions.

[66] OECD Guidelines for Multinational Enterprises (2011), http://www.oecd.org/corporate/mne/48004323.pdf

[67] 'OECD Due Diligence Guidance for Responsible Business Conduct', Responsible Business Conduct, OECD Guidelines for Multinational Enterprises, May 31, 2018, http://mneguidelines.oecd.org/due-diligence-guidance-for-responsible-business-conduct.htm.

[68] Corporate Human Rights Benchmark https://www.corporatebenchmark.org/

[69] http://www.assemblee-nationale.fr/14/dossiers/devoir_vigilance_entreprises_donneuses_ordre.asp

liability in damages for tort where the plan is poorly implemented and a causal link with serious harm is established.[70]

The French law goes considerably further than the UK's Modern Slavery Act 2015, which relies on market forces rather than legal sanction to improve corporate performance. It requires disclosure of due diligence in relation to supply chains (something which tends to be done in a perfunctory, pro forma manner), but does not actually require companies to engage in due diligence and compliance is poorly enforced.[71] It remains to be seen, of course, how the French initiative will play out in practice.

4.7 Financial risks as driver for sustainability

The financial risks of unsustainability, discussed in Section 2.3 above, are potentially very significant drivers for change. Increasingly, as the physical, transitional and systems change effects materialise, these will translate into financial risks for the corporation and potentially for members of corporate boards. To deal with these risks, changes are required on the level of the individual corporation to anticipate and adapt as far as possible. This may involve changes in insurance levels, in investments or in the very business model of the corporation.

For large corporations or at the aggregate sectoral level, this may require changes to ensure the continued viability of the business or the sector. For example, companies and sectors may act pre-emptively to mitigate climate change or other environmental degradation, and take steps to

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[70] France : Loi no. 2017-399 du 27 Mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre / The French Law on Duty of Care of parent and subcontracting companies (so called the French Corporate Duty of Vigilance), available at https://www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000034290626&categorieLien=id (accessed 4 April 2017). See also: S. Cossart, J. Chaplier and T. Beau de Lomenie, 'The French Law on Duty of Care: A Historic Step Towards Making Globalization Work for All', The Business and Human Rights Journal, (2017), 2(2), pp. 317-323, available at https://doi.org/10.1017/bhj.2017.14

[71] A recent report in one sector finds very low compliance rates: 'Agriculture and Modern Slavery Act Reporting: Poor Performance Despite High Risks', A research report from the Office of the Independent Anti-Slavery Commissioner and the University of Nottingham's Rights Lab; see press release 15 August 2018, http://www.antislavery-commissioner.co.uk/news-insights/new-report-finds-low-compliance-with-modern-slavery-act-in-uk-agricultural-sector/

improve the protection of human rights of workers across global value chains. An agricultural sector dependent on bees, wasps and other pollinators may collectively work to reduce use of pesticides and mitigate other threats to pollinators. Conversely, not doing so, while continuing with the same line of business, involves the financial risk of reduced crops. Anticipating, adapting and where possible mitigating change is therefore an intrinsic part of the corporate board's risk management in the core financial sense.

While corporate law may have as a starting point that a parent corporation is not responsible for its subsidiaries' actions, and even less so a lead corporation for that of its global value chains, modern financial risk management will increasingly need to take a broader – arguably a life-cycle-based – approach.

In light of the uncertainties surrounding the effectiveness of information disclosure in steering companies towards greater sustainability and how corporate boards are to respond to the financial risks of unsustainability, we welcome the Commission's recent proposal to explore the possibility of requiring boards to develop and disclose a sustainability strategy and of clarifying the scope of the boards' obligation to act in the long term interests of company.[72] These are proposals which would go far beyond previous efforts to address the dysfunctionalities in the corporate governance system. Questions of course remain, including as to the possibility of enforcement, but this potentially represents an important push-back against the social norm of shareholder primacy.

Corporate boards will need guidance in how to transition towards sustainable business models. The social norm of shareholder primacy is so deeply entrenched that it has taken on a life of its own, detached from but undermining corporate law. This makes reform of corporate law a priority, with the legislator taking back the power of defining corporate purpose and the role and duties of the board. This would complement emergent pressure from investors for a shift towards sustainable finance, which might also contribute to the emergence of more sustainable

[72] European Commission, *Action Plan: Financing Sustainable Growth*, Action 10, COM(2018) 97 final, 8.3.2018

business models. We discuss this below, in Section 5, before we in Sections 6 and 7 turn to consumer power and public procurement as possible drivers for corporate sustainability.

5 Influence of actors in the financial markets

5.1 Misleading distinction between financial and non-financial

Fundamentally, the distinction between financial considerations, which boards and investors must consider, and 'non-financial'[73] considerations, which should be dealt with by specific laws and regulations, governed by market forces or left where they fall, is no longer tenable. As we also discuss above, an emerging literature emphasises that ignoring sustainability gives rise to financial risk.[74] A core premise of the Task Force on Climate-Related Financial Disclosures (TCFD), for example, is that physical climate change risks are also serious financial risks, as are potential regulatory responses to climate change. However, this goes beyond climate and environmental risks. This new and wider understanding of financial risk should inform all policy actions in this area.

> SECTION 5 AT A GLANCE
>
> **Positive developments:**
>
> - Standardisation of information for investors relating to financial products is necessary to scale-up markets for sustainable investing. Regulatory initiatives such as those under the EU Action Plan in Sustainable Finance to be welcomed.
> - Considerable behavioural change on the part of financial market actors over past decade or more (e.g. rise of SRI). Trends look likely to continue.
> - Financial institutions and bank regulators demonstrate awareness of problems of unsustainability and are beginning to consider materiality of such risks.

Hence we welcome the Commission's proposed legislation on investors' duties of disclosure because its starts from the premise that unsustainable business carries with it significant financial risk, and potentially creates pressure for companies to move towards more sustainable business models. For example, if investors, complying with their fiduciary duty to address financial risk, shift capital from fossil-fuelled and unsustainable business

[73] Illustrated by the EU Directive of 2014 on 'non-financial' reporting.

[74] See Cambridge Institute of Sustainability Leadership, Unhedgeable Risk: Stress Testing Sentiment in a Changing Climate, 2015; M Aglietta and É Espagne, 'Climate and Finance Systemic Risks, more than an Analogy? The Climate Fragility Hypothesis', (2016) 10, CEPII Working Paper.

and into renewables-based and sustainable enterprises, this, coupled with public disclosure of their approach to ESG issues, potentially signals to corporate boards the preferences of institutional investors and financial markets for a shift towards sustainable business models.

Recognising the financial risks of unsustainability is a potential game changer. Its implications are far-reaching because it entails that sustainability issues must be considered by boards and executives as part of their fiduciary duties to the company, and by institutional investors and asset managers as part of their fiduciary duties to their end investors and clients. Ultimately, such financial risk is existential: if we do not manage to find out how to reposition our economies and societies within planetary boundaries, and in a way that secures a safe and just operating space for everybody now and in the future, we risk societal collapse. There are a number of scenarios that can lead to such collapse, including climate change and other environmental degradation, and social unrest caused by social inequality and the corporate undermining of the economic basis of our welfare systems. There are no such social collapse scenarios where investors are likely to receive stable, long-term returns on their investments. This underlines that we cannot settle for a mainstream 'business case' approach.

SECTION 5 AT A GLANCE, cont´d

Remaining issues:

- Financial markets remain highly-short-term and fail in most instances to price in long-term effects of unsustainable behaviour; private initiatives insufficient.
- Tendency amongst large investors and institutions – including banks – to pay lip-service to market 'best practices' and 'codes' relating to sustainability.
- Mechanisms relied upon to encourage sustainability, e.g. increased transparency and disclosure, limited in changing investor behaviour for a number of reasons.
- Significant structural impediments to incorporating sustainable investment principles, including long investor chains and high institutional investor diversification limiting their incentives to push for more sustainable business

5.2 Market-driven socially-responsible investment and its limitations

Socially-responsible investing (SRI) has grown rapidly over the past twenty years, mostly undertaken by large investors.[75] The United Nations Principles for Responsible Investment (UNPRI) in particular, has been influential in galvanising the SRI movement.[76] Industry-based codes of conduct relating to SRI have developed, and almost all large asset managers are signatories to the UNPRI, which is encouraging. In the EU, reforms under the Capital Markets Union project, discussed further below, are likely to result in even greater levels of investment in sustainable funds and products. However, serious challenges remain in ensuring that asset managers do more than pay lip-service to such commitments: recent research, for example, suggests that in the EU, despite public commitments to SRI, there is considerable variability in the actual quality of SRI performance, whilst disclosure levels vary widely amongst major asset managers.[77] Similar issues arise in the context of ensuring that human rights are taken into consideration in SRI investing. NYU Stern argues that the following gaps relating to human rights persist: (i) measurement issues; (ii) flaws in disclosure; (iii) inconsistent standards in defining SRI investment; and (iv) problems in scaling SRI because measurement of outcomes is amorphous.[78]

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[75] Eurosif, European SRI Study 2016. The last Global Sustainable Investment Review (2016) found that amongst Europe, the United States, Canada, Asia, Japan, Australia and New Zealand, there were $22.89 trillion of assets being professionally managed under SRI strategies, an increase of 25 percent since 2014. See Global Sustainable Investment Alliance, Global Sustainable Investment Review, 2016. In relative terms, SRI now comprises 26 percent of all professionally managed assets.

[76] Since its inception in 2006, the UNPRI have grown to over 1300 signatories representing over $45 trillion.The six PRIs are: «1: We will incorporate ESG issues into investment analysis and decision-making processes; 2: We will be active owners and incorporate ESG issues into our ownership policies and practices; 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest; 4: We will promote acceptance and implementation of the Principles within the investment industry; 5: We will work together to enhance our effectiveness in implementing the Principles; 6: We will each report on our activities and progress towards implementing the Principles.» See United Nations, Principles for Responsible Investment, https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment

[77] ShareAction, Lifting the Lid: Responsible Investment Performance of European Asset Managers, The 2017 ShareAction Survey, March 2017.

[78] C. O'Connor and S.H Labowitz, 'Putting the "S" in ESG: Measuring Human Rights Performance for Investors', (March 2017) NYU Stern Center for Business and Human Rights.

Arguably, this reflects a major limitation of the approach taken to integrating sustainability into the decisions of financial market actors, namely that the regulatory framework which seeks to increase the influence of shareholders and financial markets over corporate boards is still informed by legal-economic theories of information-efficiency and of the market for corporate control. The assumption is that the share price is the best available indicator of the alignment of corporate performance with the common good. Companies which are the most successful are, according to this view, those which are meeting societal expectations.[79] This can be questioned from a number of perspectives:

1. First, as the financial crisis showed, share prices can be affected by bubbles, sending the wrong signals to corporate management.
2. Second, as central banks flooded the markets with liquidity following the financial crisis, share prices can depart from the performance of the real economy.
3. Third, as the share price has become the central focus of corporate boards, the imperative is to increase it in the short-term, regardless of the long-term implications for the company and its stakeholders of lower investment, increased leverage and greater distributions to shareholders; and
4. Fourth, traditional mechanisms designed to influence board behaviour, such as mandating information disclosure and increasing transparency, are limited in producing more sustainable approaches to corporate strategies.

Expecting financial markets to stimulate sustainability seems then to be an even further stretch. For example, is it really plausible to believe that corporate boards will be able to observe the trajectory of the company's share price and extract information about the sustainability preferences of institutional investors?

[79] See for example ISO 26000, which makes precisely this assumption. For criticial analysis, see A. Johnston, 'Constructing Sustainability through CSR: A Critical Appraisal of ISO 26000' (2013) 9(2) *International and Comparative Corporate Law Journal* 25-54 (available online at https://ssrn.com/abstract=1928397

A commonly adopted solution to this conundrum is to encourage more dialogue between shareholders and boards, something which the stewardship agenda, and the Shareholder Rights Directive in particular, seeks to achieve. However, empowering shareholders carries with it a risk of creating greater pressure for short-term returns, as investors chase yields in a low-interest rate environment. Whilst the number of investors adopting SRI criteria continues to grow, they are far outweighed by conventional investors. Moreover, it creates a behind-the-scenes shareholder influence that is difficult to reconcile with expectations of greater transparency, and it will be hard for policymakers to obtain evidence as to whether this mechanism is operating to encourage more sustainability in business. Another possibility is that information technology and new metrics may develop to allow the production and dissemination of more accurate and more reliable information about the sustainability performance of businesses. The question then is whether financial market actors will act on that information and use the possibility of engagement to press for greater sustainability.

There are also structural aspects of markets which act to limit shareholder empowerment initiatives in driving greater sustainability. The structure of institutional investment, for example, features long chains of intermediaries between investor company and end beneficiary. Informational intermediaries in the investment chain, such as proxy advisors and credit rating agencies, do not systematically take account of sustainability in their activities. Similarly, clear mandates as to the extent to which, for example, sustainability issues should be considered by each link in the chain are rare. Indeed, as of 2016, less than one per cent of the capital of the fifteen largest US pension funds is devoted to sustainability-specific investment, despite each being signatories to the UNPRI, and (supposedly) interested in long-term performance.[80] In Europe, there is evidence that fund size matters: small and very large pension funds tend to be engage with socially responsible investing (SRI).[81] However, long-term investors, including

[80] J. Bailey, B. Klempner and J. Zoffer, 'Sustaining Sustainability: What Institutional Investors Should Do Next on ESG', (2016), McKinsey & Company, mckinsey.com/industries/private-equity-and-principal-investors/our-insights/sustaining-sustainability-what-institutional-investors-should-do-next-on-esg.
[81] R. Sievänen, H. Rita and B. Scholtens, 'The Drivers of Responsible Investment: The Case of European Pension Funds' (2013) 117(1) *Journal of Business Ethics,* 137-151

pension funds and insurance companies, increasingly invest across borders, making policy influence on them more difficult, and in a range of 'alternative investments' from hedge funds and private equity to index funds and derivatives. Even if end beneficiaries or investors desire to push investee companies in a more sustainable direction, there can be no guarantee that those desires will be communicated up the chain to the company.

Moreover, most investors and asset managers have very few incentives to incur the costs of engaging in activism or stewardship intended to push companies in a more sustainable direction. In general, institutional investment correlates with high-risk strategies because such investors are generally highly-diversified and focus on portfolio risk, making them comfortable with idiosyncratic firm risk. On this basis, Laeven and Levine demonstrate that the shareholding structure of banks in Anglo-American and EU markets tends to be dominated by diversified shareholdings, which leads to increased risk-taking.[82] The rise of passive index investing threatens to further undermine sustainability as an investment model: when capital providers invest in the entire equity market, or subsection of it (either through exchange-traded funds or index trackers), return-chasing over the short-term is likely to lead money managers allocating capital to corporations which are expected to deliver superior short-term returns.[83]

Information disclosure may provide a limited corrective in terms of steering shareholder decisions to buy or sell shares, or to hold and engage with boards. The lack of reliable, relevant, verified and comparable information complicates the process of sustainable investing, although obviously, investor demand for such corporate information is a potential driver for change. Yet, it is only a *potential* driver: investors must still act on that information, and there is a danger that this will not occur.

[82] L. Laeven and R. Levine 'Bank governance, regulation and risk taking' (2009) 93(2) *Journal of Financial Economics,* 259-275.
[83] The rise of passive investing may be overstated. According to BlackRock, the world's largest passive fund manager, as of 2017, less than 18 percent of global stocks were owned by passive investors. According to the data, there are $22 dollars traded by active stockpickers for every $1 traded by index funds. See BlackRock, Index Investing Supports Vibrant Capital Markets, October 2017.

Thus, investor demands for corporate compliance with TCFD may be a precursor to a shift in investment patterns towards greater sustainability; only time will tell how investors respond to TCFD disclosures. So-called ESG ratings,[84] aiming to provide sustainability-related information about the corporations, and also informing sustainability indices, are increasingly influential.[85] Yet, these ratings are based at least partly on information from corporations themselves, and the assessments carried out by rating agencies do not seem to take an evidence-based sustainability concept as their starting point.[86]

5.3 The EU's Sustainable Finance Initiative

Altering investor behaviour thus becomes pivotal in achieving change. If corporate boards and managers are met with sustainability requirements from investors, this may reduce the short-term and narrow pressure to maximise returns. Certainly, there are indications that there is a stronger interest for sustainability amongst investors, where gender may play a role too.[87] Large investors regularly make statements about sustainability and engagement with the SDGs. As with companies, this creates a degree of noise which makes it difficult to identify whether, despite

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[84] ESG stands for environmental, social and governance.

[85] B. Huber and M. Comstock, 'ESG Reports and Ratings: What They Are, Why They Matter', (2017), Harvard Law School Forum on Corporate Governance and Financial Regulation, https://corpgov.law.harvard.edu/2017/07/27/esg-reports-and-ratings-what-they-are-why-they-matter/ and to Escrig et. al, 'Corporate Sustainability Promoted by the Assessment Process of Socially Responsible Investment', presented at the 20th Conference of the Environmental and Sustainability Management Accounting Network, Lüneberg, 2016, also showing a significant change from 2008 to 2015, through mergers and acquisitions, leading to formerly independent ESG rating agencies being controlled by large mainstream rating agencies. See also Escrig et. al, 'Can environmental, social and governance rating agencies favor more Sustainable Business Models?' (draft paper on file with current authors), which shows an interesting shift in the issues the ESG ratings emphasise, both for exclusion and for positive screening, including ESG risk management as a relatively new category.

[86] Escrig et al., 'Can environmental, social and governance rating agencies favor more Sustainable Business Models?'

[87] See for example G Unruh, et al., 'Investing For a Sustainable Future. Investors Care More About Sustainability than Many Executives Believe', MIT Sloan Report May 2016, drawing on findings from the 2016 Sustainability & Innovation Global Executive Study and Research Project. Summary available here: http://sloanreview.mit.edu/projects/investing-for-a-sustainable-future/ and M. Hower, 'Survey: Millennials and Women Leading the Sustainable Investing Charge', (2015), Sustainable Brands, https://www.sustainablebrands.com/news_and_views/behavior_change/mike_hower/survey_millennials_women_leading_sustainable_investing_cha (study that indicates that female investors are more likely to prioritise sustainability).

the coordination problems in the investment chain, drivers for sustainability are actually emerging.

Hence, changes to the regulatory framework for finance are likely to be crucial in terms of stimulating a shift towards sustainability. The EU's Sustainable Finance initiative is a potentially promising development, with the EU Action Plan following up the advice of the High Level Group of Experts, appointed by the European Commission. The goals for the EU's sustainable finance agenda, as enshrined in the Action Plan, set high-level principles for future financial regulatory reform:

(i) reorient capital flows towards sustainable investment, in order to achieve 'sustainable and inclusive growth';

(ii) manage financial risks stemming from climate change, environmental degradation and social issues; and

(iii) foster transparency and long-termism in financial and economic activity.[88]

It remains to be seen how this will be followed up by the European Commission. To date, three official proposals have been brought forward, namely: establishing a unified EU classification system of sustainable economic activities ('taxonomy'); improving disclosure requirements on how institutional investors integrate environmental, social and governance (ESG) factors in their risk processes; and creating a new category of benchmarks, which will help investors compare the carbon footprint of their investments.[89]

In many ways, therefore, the EU's Action Plan applies tried-and-trusted mechanisms in order to assist in the scaling-up of sustainable finance markets. Such mechanisms are designed to provide, inter alia, higher levels of information, standardisation and disclosure. The thinking goes that increasing information flows to investors and allowing them to compare products and instruments on a case-by-case basis will spur investment in these asset classes, in particular large

[88] EC Commission, Communication From The Commission To The European Parliament, The European Council, The Council, The European Central Bank, The European Economic And Social Committee and the Committee of the Regions - Action Plan: Financing Sustainable Growth, Brussels, 8.3.2018 COM(2018) 97 final, p.2

[89] European Commission, Commission legislative proposals on sustainable finance, Brussels, 24 May 2018.

institutional investors who have complained in the past that green financial product markets (such as those for green bonds) have been too opaque. Further, requiring large investors to disclose their approach to ESG risk provides some reassurance to potential end-investors that their sustainability preferences will be respected, and also potentially transmits investor preferences to corporate boards. The draft Regulation also requires large investors to disclose how the remuneration of financial market participants and financial advisors is tied to sustainability risks.[90]

Private markets have to some extent filled the innovation gap in financial instruments. Levels of innovation in the green bond market, for example, are high. Green mortgages, for example, which are a financial instrument likely to form part of the taxonomy, have been promoted by DG Climate Action.[91] The momentum in favour of divestment from non-ESG-friendly sectors and corporates, together with investors' yield hunger mean that green bonds have the potential to form huge fractions of investor portfolios. Concerted and collaborative action is necessary from global standards setters and individual state legislatures to ensure that higher levels of standardisation and transparency are provided, so investors are presented with the requisite level of information to use to guide their portfolio constructions and asset allocation.

In spite of this, the Action Plan recognises a regulatory framework is likely to spur further capital investment. Scaling up such markets requires a more transparent and information-rich market: investors, for example, must have sufficient information to judge whether or not a particular investment is sustainable. Identifying relevant assets, which might be justifiably categorised as 'green' or 'sustainable' for sale as bonds or other financial instruments, is currently problematic, and the lack of uniformity in international standard-setting may act as a brake on further

[90] 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 Brussels, 24.5.2018 COM(2018) 354 final 2018/0179 (COD) Recital 5.

[91] European Commission and DG Climate Action, Shifting Private Finance Toward Climate-Friendly Investments (March 2015).

development of the market.[92] Standardisation reduces costs by removing the need for extensive certification and verification of financial instruments by third-parties.[93]

In this context, the taxonomy to be established by the EU is a positive step, in particular because it focuses on issues – unlike in many other sustainability regulatory contexts – broader than climate change, including water and marine resources, protection of healthy ecosystems, prevention and control of pollution, and transition to the circular economy, including material recycling and waste reduction. It is hoped that the Commission pushes the agenda in this field, and expands further to include other planetary boundaries, as well as the social dimension of sustainability. Other proposals, concentrating on carbon, should also be broadened. The idea of finding out how to deal with climate change first, and then expanding the policy approaches to other aspects of sustainability, while having a veneer of logic, is not informed by the urgency related also to other planetary boundaries and to securing the social foundation for people within Europe and across global value chains.

Similarly, qualified support should also be offered to the proposal to require institutional investors and asset managers to integrate sustainability considerations into their decision-making and to make disclosure to end investors as to how sustainability factors and risks are integrated into decision-making.[94] However, it is crucial that this goes beyond the approach of existing requirements and recognises the difficulty of integrating sustainability across the growing complexity of investment chains. Similar duties present in other areas of corporate activity and contexts have not provided evidence that they contribute to sustainable corporate investing. For example, in many jurisdictions, board members of companies are already required by law to have regard for ESG factors in their decision-making,[95] yet short-termism remains rife,

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[92] T. Ehlers and F.Packer 'Green Bonds – certification, shades of green and environmental risks', *Bank for International Settlements*, 24 August 2016.
[93] For example, the G20 claim that having a bond certified as green costs between $20,000 and $100,000G20, Green Finance Synthesis Report, 5 September 2016, relying on input paper Green Bonds: Country Experiences, Barriers and Options (OECD/ICMA/CBI/China GFC).
[94] Action 7
[95] S.172 of the Companies Act 2006 in the UK, for example.

and shareholder value almost invariably trumps sustainability considerations in the event of conflict between the two.

With rating agencies as an influential link in the investment chain, the Commission's proposal to consider amending the Credit Rating Agency Regulation to mandate the explicit integration of sustainability factors into their ratings is also to be welcomed.[96] However, other intermediaries, such as proxy advisors and investment consultants appear likely to fall outside the scope of these possible reforms. The impact of these intermediaries – coupled with conservative interpretations of fiduciary duty – can be seen in present tendencies towards herding of investors. Whilst institutional investors might consider sustainability, they will normally be forced through a combination of regulation and social norms to rely on the advice of these intermediaries, and this might lead them away from actually integrating sustainability into their decision-making, where these intermediaries offer 'hard financial advice' to follow a less sustainable route. Hence, we would suggest requiring proxy advisors to explicitly consider sustainability in their advice – this could be done through a simple amendment to the Shareholder Rights Directive, which already regulates proxy advisors. Other investment consultants are harder to define, but one possibility would be to require institutional investors to include a requirement to address sustainability in the mandates they give to their advisors.

5.4 Limitations to sustainability reform

This brings us back to the conventional approach across the whole corporate governance and finance field of relying on market forces to steer companies and investments towards sustainability. Before the financial crisis, policy in many Member States and even at the EU level was focused on steering boards towards greater accountability to shareholders.

For example, the aim (albeit not the result) of the Takeover Directive was to put in place a pan-European market for corporate control. Since 2008, recognition that shareholders played a role

[96] Action 6

in pushing for more risk-taking in financial institutions in the build-up to the financial crisis[97] has not changed the policy agenda, with the recent reform of the Shareholder Rights Directive adopting measures such as 'say on pay' and ideas of shareholder stewardship from the UK. In merely asking institutional investors to make public their policies (or state publicly that they have no investment policy), the Shareholder Rights Directive does not relieve the constant shareholder pressure felt by executives and board members for returns, which results in short-term prioritisation of shareholder value whilst making bold public statements about long-term sustainability. Nor have shareholders used their say-on-pay powers in the UK to demand alignment of executive incentives with sustainability criteria or the long-term interests of the company.

Moreover, many end investors (particularly, but not only, pension beneficiaries) do not monitor their investments from a sustainability, or indeed any, perspective, preferring instead to rely on the regulated professionals to whom they have entrusted their savings. This, combined with other barriers to reallocation, makes it unlikely that disclosure by institutional investors of sustainability strategies will lead to end investors voting with their feet. The limitations of disclosure and transparency as regulatory techniques are well-established, particularly as such measures encourage an excessive-focus on market-driven solutions and cede the impetus for change to private actors.[98] As has been noted in this report, such markets are highly short-term; relying on such techniques to change behaviour radically is therefore a flawed approach. A campaign for divestment from fossil fuels has been under way since 2010, but previous divestment campaigns have had little direct impact on companies as divested assets have to be acquired by other investors, who may positively welcome the opportunity to increase their holdings in fossil fuel companies, particularly at a discount to the current market price.[99] Hence,

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[97] *Report of the High Level Group on Financial Supervision in the EU*, Chaired by Jacques de Larosière, 25 February 2009, Brussels, para 24; *The Kay Review of UK Equity Markets and Long-term Decision Making. Final Report (2012,* London) at 20 and 45; European Commission, 'Green Paper: Corporate governance in financial institutions and remuneration policies (Brussels, 2.6.2010, COM(2010) 284 final) at 8.

[98] J. Cullen and J Mähönen, 'Taming unsustainable finance: the perils of modern risk management'

[99] A. Ansar, B. Caldecott and J. Tilbury, 'Stranded assets and the fossil fuel divestment campaign: what does divestment mean for the valuation of fossil fuel assets?', Stranded Assets Programme, Smith School of Enterprise and the

investors who wish to invest sustainably may continue to be swimming against the tide, and are confronted with a corporate governance system that keeps large companies on the unsustainable business-as-usual track. There is a danger that for all the talk about sustainability, and for all the hopes about shareholder empowerment, one clear message is still delivered to the boards and managers of listed companies: maximize returns to shareholders in the short term.[100] This attitude is even prompting investors to challenge through investor-state dispute settlement (ISDS) the sovereign right to regulate of states, which seek to improve environmental regulation and social standards within a country.[101]

There are also serious conceptual drawbacks in relying upon shareholders acting on information concerning highly uncertain risks to drive businesses towards greater sustainability. Precise predictions of potential financial losses from climate change or from crossing other planetary boundaries are impossible and disclosure will be essentially guesswork.[102] Shareholders will be aware of this, and will discount the information accordingly. Recognition of the limitations of relying primarily on investors, motivated by financial gains, to drive the transition to sustainable business models makes it imperative to develop further regulatory policies based on the precautionary principle and the goal of implementing the SDGs within planetary boundaries.

Environment, University of Oxford, October 2013 at 12 and 30. Interviews of UK and Australian investors carried out by Elizabeth Harnett found that 'Some searched for opportunities in a negative sense by exploiting cheap fossil fuel assets that others were divesting from, or opportunities to "play" or "hedge" regulatory changes in search of profit'. E. Harnett, 'The state of climate change knowledge among UK and Australian institutional investors', Sustainable Finance Programme, Smith School of Enterprise and the Environment, University of Oxford, February 2017, at 19.

[100] See Sjåfjell, 'When the Solution Becomes the Problem: The Triple Failure of Corporate Governance Codes', Jean Jacques Du Plessis and C.K. Low (eds), *Corporate Governance Codes for the 21st Century: International Perspectives and Critical Analyses* (Springer Verlag, 2017), and B. Sjåfjell, H. Rapp Nilsen, B. Richardson, 'Investing in Sustainability or Feeding on Stranded Assets: The Norwegian Government Pension Fund Global'.

[101] For current debates on impacts on the environment though ISDS, see Slater, Tamara L. "Investor-State Arbitration and Domestic Environmental Protection." Wash. U. Global Stud. L. Rev. 14 (2015): 13; Cagnin, Valentina. "Investor-State Dispute Settlement (ISDS) from a Labour Law Perspective." European Labour Law Journal 8.3 (2017): 217-231. .

[102] See J. Cullen, 'After HLEG: EU Banks, Climate Change Abatement and the Precautionary Principle', Cambridge Yearbook of European Legal Studies (forthcoming, 2018)

5.5 Banks as drivers for sustainable business

While the sustainable finance discussion often focuses on shareholders, banks are an important driving force for the direction as business as well. The focus placed by the EU on banks as agents for sustainability is therefore a positive development, and is owed in part to the growing recognition of the sector's crucial role in addressing environmental challenges. In particular, bank investors are becoming more vocal about the contribution of bank activities to climate change, and their exposures to it.[103] Indeed, following on from the UNPRI, the UN is in the process of drawing up asset of Principles for Responsible Banking (PRB). The PRB are currently in draft form, but would require banks and other financial institutions which become signatories to comply with a considerable number of principles, evidenced by the adoption of voluminous targets and standards.[104] The PRB treads the same ground as a multitude of other bank-related SRI initiatives developed in the private sector and by NGOs, However, as detailed above in relation to the UNPRI, many banks simply pay lip-service to such programmes, with BankTrack commenting recently that:

> No [large] banks have disclosed their full greenhouse gas emissions resulting from their financing activities, and many have weak safeguards to prevent further bankrolling the climate crisis and associated ESG risks. In addition to climate risk, their financing of these sectors brings critical environmental, social, and governance (ESG) risks such as land conflict and human rights violations, labor abuses, corruption, illegality, pollution, biodiversity loss, and environmental degradation.[105]

5.6 The risks to bank balance sheets from unsustainable business

A fundamental issue regarding banks relates to the discussion of the financial risks of unsustainability, which tend to concentrate on financial impacts of physical or transition risk

[103] See C. Flood, 'Big investors take aim at banks over climate risk' (14 September 2017), *Financial Times,* https://www.ft.com/content/a2616a52-988b-11e7-a652-cde3f882dd7b
[104] UNEP Finance Iniative, Principles For Responsible Banking: Implementation Guidance, July 2018
[105] BankTrack, "Responsible" investors under scrutiny for investing in climate-destroying banks, 26 Sept 2017, https://www.banktrack.org/news/unpri_signatories_are_fueling_climate_change_and_deforestation_through_their_investments_in_banks

from climate change, or other environmental risks.[106] Importantly, the perspective adopted in such risk assessments usually relates to the direct implications for banks' own balance sheets, rather than the wider negative societal and environmental costs their funding activities may indirectly impose. The most pressing – and arguably studied – of these risks are so-called transition risks which are centred on potential losses from assets which become 'stranded' by regulatory or legal reforms. Several studies indicate that the stability of the financial system would be placed at risk if carbon regulation is altered: in joint research, the Carbon Tracker Initiative and Grantham Research Institute in 2013 showed that at the prevailing capital expenditure of fossil fuel site and field development, at least $6.74trillion would be wasted in developing reserves that are likely to become unburnable.[107] A large proportion of this investment is bank, or capital market, financed.[108] These transition risks have the potential to become systemic in nature.[109]

5.7 EU bank reforms to meet sustainability challenges

On this basis, the Commission plans to explore ways in which capital requirements against certain 'green assets' might be lowered[110] which, it is claimed, are excessively high under the current asset risk-weighting regime.[111] Under the Action Plan, the Commission intends to 'explore the feasibility of recalibrating the capital requirements for banks (so called "green

[106] S. Batten, R. Sowerbutts and M. Tanaka, 'Let's talk about the weather: The impact of climate change on central banks' (2016) 603, *Staff Working Paper Bank of England*.

[107] Carbon Tracker Initiative and Grantham Research Institute, *Unburnable Carbon 2013: Wasted capital and stranded assets* (2013)

[108] The 200 companies making up the sample examined in the research had total outstanding corporate debt (bonds and loans) of $1.27trillion. This was split 74% for oil and gas companies with 26% for coal mining companies' debt (based on revenues derived from coal).

[109] European Systemic Risk Board, Too late, too sudden: Transition to a low-carbon economy and systemic risk Reports of the Advisory Scientific Committee, No 6 / February 2016; F. Weyzig, B. Kuepper, J.W. van Gelder and R. van Tilburg, 'The Price of Doing Too Little Too Late; the Impact of the Carbon Bubble on the European Financial System' (2014) 11, *Green New Deal Series*.

[110] J.Brunsden, 'Brussels looks at easing bank capital rules to spur green investment' *Financial Times*, 10 January 2018.

[111] For example, the HLEG comment that: 'There is… a perception that calibrations on project financing and specialised lending are high. Feedback from banks with a long history of project financing suggests that regulatory capital requirements far exceed economic capital calculations.' See HLEG Final Report p32.

supporting factor") when it is justified from a risk perspective, while ensuring that financial stability is safeguarded'.[112]

That the Commission is willing to countenance such regulatory shifts is encouraging; however, there are some dangers with this approach. The first is that 'green' investments, whilst perhaps more desirable from a public policy standpoint than 'non-green' investments, are no more creditworthy than non-green assets.[113] The second is that research indicates that incentivising loan originations in this way would produce marginal results; banks will simply price loans less aggressively in the event that capital requirements are lowered. It may therefore be more appropriate to examine the treatment of so-called 'brown assets'[114] under prevailing capital regulation. The High-Level Expert Group on Sustainable Finance itself, in its Interim Report, recommended such a path.[115]

Whether one limits the discussion to concentrating on climate change or the broader picture of the financial risks of unsustainability, the problem of operationalisation in the banking sector derives from the design of prudential regulation, which is meant to address specific and measurable risks to the financial institution concerned. For example, capital requirements – regarded as the primary tool to control lending and credit allocation – are focused almost exclusively on the default risk of a credit agreement. These assessments are based upon objective factors such as historical loan and sector performance, the category of borrower and so on. Normative factors are absent from such assessments. Banks are under no explicit legal obligation to consider any other factors and there is currently no express requirement that bank

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[112] European Commission Fact Sheet, Frequently asked questions: Action Plan on financing sustainable growth, Brussels, 8 March 2018, p3.

[113] S. Matikainen, 'Green doesn't mean risk-free: why we should be cautious about a green supporting factor in the EU', 18 December 2017, LSE and Grantham Research Institute on Climate Change and the Environment, Commentary, lse.ac.uk/GranthamInstitute/news/eu-green-supporting-factor-bank-risk.

[114] There is currently no standard definition of a 'brown' asset, but normally such assets include investments which are regarded as unsustainable in character, in particular in relation to the environment. Importantly, this means that companies which are regarded as 'brown' (such as oil and gas companies) may issue green 'use of proceeds' financial instruments, such as green bonds, provided the issue proceeds are used to finance green projects.

[115] EU High-Level Expert Group on Sustainable Finance, Financing a Sustainable European Economy: Interim Report, July 2017.

credit committees or senior executives consider any sustainability factors in their loan extension processes. At board level, directors have no incentive to consider sustainability risks to their institution's balance sheet, beyond those which apply to directors of any company. Of course, bank boards consider reputational risk in their strategies, which may prevent investment in some projects, especially in light of any public campaigning by pressure or lobby groups. It is also true that, especially in the EU, banking institutions have developed processes concerning SRI, or sustainability risk policies.

However, even this element of market discipline is often toothless; there is substantial evidence that European banks continue to lend for environmentally-damaging investments with no discernible reaction from the market. Research shows that of the top thirty funders of 'extreme'[116] fossil fuel activities, twelve were headquartered in the EU, contributing almost $80 billion between them to such activities in the period 2015-2017.[117] Each of these institutions was a signatory to a number of international agreements on sustainability, in spite of their contribution to some of the worst forms of environmental damage.

Another recent report shows that the fifteen largest European banks *inter alia* still carry significant exposures to climate-related liabilities and risk; all (bar one) have no explicit objectives for decreasing such exposures; and none could accurately report on the ratio of high-carbon assets amongst their risk-weighted assets.[118] Such lending behaviour must therefore be attributable to the factors discussed in other parts of this report, in particular, short-termism flowing from the view that bank lending ought to be driven by a 'bottom-line' profitability assessment. There is also pressure on bank executives and loan officers to maintain relationships with existing clients; turning them away for finance may cost the bank more than the profit on the loan concerned if as a result of a refusal for credit, that client's entire portfolio is lost to a

[116] 'Extreme' in this context refers to extreme oil (such as tar sands oil or Arctic drilling); coal mining; coal power (mainly the funding of power stations); and liquefied natural gas export. Many EU banks have pledged to end their funding support for coal mining; however, there are no such pledges in relation to other extreme activities.
[117] BankTrack et al., Banking on Climate Change: Fossil Fuel Finance Report Card, March 2018.
[118] ShareAction, Banking on a Low-Carbon Future, December 2017.

competitor. In short, whilst bank regulation is centred on mechanistic assessments of default risk, decision-making concerning credit extension is not likely to be influenced greatly, if at all.

5.8 Stress-testing for sustainability

Other measures to tackle bank-financing of unsustainable activity must therefore be considered. Stress-testing of bank portfolios to account for the risks associated with climate and environmental change, for example, represents a formidable opportunity to force institutions and regulators to consider the systemic effects of potential negative spillovers from such risks. Imposing high hurdle rates in climate risk tests would reduce the profitability of carbon-related investments penalised by such exercises. As with reforms to asset risk-weighting which the Commission is already exploring, incorporating such factors into the stress-testing regime would be analogous to a tax on the funding of unsustainable activities, addressing the flow of finance toward such projects directly.[119] Such tests could be recommended by the ECB or EBA as best-practice for national regulators, or be implemented directly via EU legislation. With regard to the latter option, such change could be effected via the Capital Requirements Directive, which incorporates the Basel Accord's risk management techniques.[120] The European Systemic Risk Board recommends both short-term and medium-term stress testing of bank portfolios to estimate aggregate losses should losses from carbon-related sectors eventuate. Conducting a viable climate-related stress test requires several inputs:

- The construction of a coherent 'tail-risk' scenario which would impact the financial system to a significant degree;
- Identifying the sectors of the economy most at risk from losses in this scenario;
- Relevant data identification and collection; and
- Modelling the transmission mechanism of shocks to the financial system.[121]

[119] J. Cullen, After HLEG: EU Banks
[120] The Basel regime is based upon three pillars: minimum capital requirements, supervisory review processes and enhanced disclosure (market discipline). See Basel Committee on Banking Supervision, Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010 (rev June 2011).
[121] S. Batten et al., 'Let's talk about the weather'

5.9 Capital regulation for sustainability

Under the Basel Accord, Pillar 2 (Supervisory Review) and Pillar 3 (Disclosure and Market Discipline) could be used to mitigate climate-related risk. Pillar 2 sets out principles of supervisory review which give regulators powers to require banks to comply with corporate governance norms and principles, and to adopt an internal capital adequacy assessment process (ICAAP) in order to enhance the management and measurement of risk. It also provides for a supervisory review enhancement process (SREP), which can be used to measure banks' exposure and contribution to systemic risk and macro prudential risks. This tool, in particular, might be used by EU regulators to force banks under their jurisdiction to consider risks to their portfolios from unsustainable activities. Under Pillar 2, banks must weigh up all 'material' risks in their capital adequacy assessments and must list all potential risk exposures that they face. It is arguable that exposure to economic activity that is 'environmentally unsustainable' ought to fall within the scope of Pillar 2.[122] However the BCBS has failed to yet include environmental sustainability as a material risk; according to Alexander, 'most bank supervisors have not utilised Pillar 2's supervisory approaches to incorporate forward-looking models that estimate the potential stability impact of supplying credit to environmentally unsustainable or sustainable activities over time into their stress tests'.[123] As noted above, the fundamental uncertainties concerning the impacts of transgressing planter boundaries, suggests that forward-looking models developed by bank supervisors would have to be based on the precautionary principle.

Pillar 3 concerns the development of a set of disclosure requirements which will allow investors and other market participants to view and assess relevant information about bank's balance sheets and business models, including information on investments, capital and forward-looking risks. By mandating certain disclosure requirements, Pillar 3 provides capital market investors with information concerning the risks banks and other financial institutions are exposed to,

[122] K. Alexander, 'Stability and Sustainability in Banking Reform: Are Environmental Risks Missing in Basel III?' (CISL & UNEP FI, 2014),
[123] Alexander, ibid.

particularly those of a systemic character.[124] The risks disclosed by these institutions could thereby be evaluated by investors and regulators to determine the banking system's contribution to financing of high-ESG-risk activities. However, being market-driven – and therefore subject to the aforementioned influence of short-termism – such a tool might be less useful in tackling bank financing of unsustainable activity than those under Pillar 2.

5.10 Central bank action

Central banks, in their roles as monetary authorities and bank regulators, enjoy considerable influence in relation to bank activities. Their policies concerning credit and liquidity allocation influence lending channels via private banks significantly. Also, they themselves also have a role to play in promoting sustainable lending, in particular through monetary policy operations they conduct via the commercial banking system.[125]

On this basis, central banks have started to explore how their actions (or inactions) might interact with climate-change and its role in financial stability. Arguably, this reflects the recognition that central banks are amongst the few institutions with the financial capacity to effect and support meaningful change in this arena. There are precedents in several different jurisdictions in which monetary authorities have launched lending schemes to support particular sectors of the economy. In the UK, for example, since 2009, the central bank has used a so-called 'Funding for Lending Scheme' (FLS), which centred on the Bank of England lending money to banks at zero interest to incentivise banks and building societies to boost their lending to the UK real economy, supplemented in 2016 by the Term Funding Scheme (TFS). The TFS operates somewhat differently to the FLS, in that it requires banks to post collateral in exchange for central bank reserves, much like Quantitative Easing (or QE). It is therefore a monetary policy tool of the Monetary Policy

[124] In some countries such as France, all potential ESG risk exposures as they relate to financial performance and soundness must be publicly disclosed by listed companies and financial institutions. See Conseil d'Etat Decree, Regulation, Article 225.
[125] J. Solana, 'The Power of the Eurosystem to Promote Environmental Protection' (2018) 23, *University of Oslo Faculty of Law Research Paper*. Available at SSRN: https://ssrn.com/abstract=3241341

Committee and operates as part of the Asset Purchase Facility. The value of lending in the TFS was initially £100 billion; however, this was extended in summer 2017.

QE is the popular name given to the central bank policy of large-scale asset purchases undertaken with the aim of boosting bank lending. These purchases are generally of government bonds, although the purchase of corporate and mortgage bonds can also play a part in the strategy. Although banks are permitted to sell bonds which they hold on their own account, for the most part the banks are acting as conduits through which pension funds, insurance companies and other holders of bonds sell their holdings to the central bank.

There has been a lot of interest recently in proposals for so-called 'Green QE'.[126] Rather than purchasing government bonds and other high-grade securities, proponents of Green QE argue that the central bank could use its powers to invest in collateral derived from green financial assets, such as green bonds. One proposal, first articulated in the mainstream by Murphy and Hines,[127] relates to the UK. The proposal argues that one way to kick-start investment in green and low-risk-ESG projects would be to charge the central bank with new rounds of a new form of QE;[128] one which does not focus on purchasing government bonds from the private sector, but instead focuses on funding infrastructure investment. Such amendments to QE mechanics could be used to kick-start investments in green infrastructure, by amending the choice of assets bought by central banks in monetary policy. Identifying and remedying these biases is one of the most concrete short-term measures to take. A review of the collateral framework for central bank lending schemes and haircuts might be a good starting point, with the aim of prioritising investment in low-ESG-risk assets.

[126] For example, the Bank of England's Governor Carney has in the past left the question of asset forms underpinning QE open: P. Clark and C. Giles, 'Mark Carney boosts green investment hope', Financial Times, March 18, 2014.
[127] R. Murphy and C. Hines, 'Green quantitative easing: Paying for the economy we need' (2010)
[128] Sir David King, former Chief Scientific Adviser to the UK government has argued that green QE ought to be used to stimulate environmentally-friendly investment: 'Quantitative easing has been relatively passive – why not use it in a way that can be directed?...Why not use it to take us to a sustainable economy and manage the release of private sector money? You could have a quite selective series of tests [to determine where the money should go].' See F. Harvey, Sir D. King: Quantitative easing should be aimed at green economy, The Guardian, 26 June 2012, https://www.theguardian.com/environment/2012/jun/26/david-king-quantitative-easing-green

Arguably, this is all the more pressing considering that conventional QE operations have tended to favour high-carbon assets for investment purposes.[129] According to a study by the LSE of the UK and Eurozone, existing QE policies exhibit a 'high-carbon skew', which could have a long-term impact on environmental sustainability.[130] Because of the scarcity of government bonds referred to earlier, central banks (the ECB in particular) began buying corporate bonds. According to the study, the bulk of these purchase have been made in the two most carbon-intensive sectors of the economy: utilities and manufacturing. It seems curious that government-sponsored programmes such as QE, which are designed inter alia to keep the banking system lending, might be used to support investment in industries which themselves are carbon-intensive, and undermine government targets elsewhere.

[129] A. Barkawi, 'Why monetary policy should go green', FT Alphaville, May 18 2017

[130] S. Matikainen, E. Campiglio and D. Zenghelis, 'The climate impact of quantitative easing', (May 2017) *Grantham Research Institute on Climate Change and the Environment Policy Paper*. Their calculations indicate that 62.1 per cent of ECB corporate bond purchases take place in the sectors of manufacturing and electricity and gas production, which alone are responsible for 58.5 per cent of Eurozone area greenhouse gas emissions, but only 18 per cent of gross value added (GVA). For the Bank of England, manufacturing and electricity production – responsible for 52 per cent of UK emissions – make up 49.2 per cent of the eligible benchmark, but only 11.8 per cent of GVA.

6. The allure of 'consumer power'

Individuals as consumers have the potential to contribute to sustainability, but the potential is limited and the pervasive unsustainability of business as usual cannot be left to 'consumer power' to resolve. The crux of the problem lies in prevailing business models in consumer product sectors, which are based on overconsumption,[131] with planned obsolescence and aggressive marketing ensuring consistent consumer demand. The two sectors on which SMART is undertaking case studies: textiles and mobile phones, are notable examples of this.

Consumers are generally not in a position to obtain reliable and relevant information about the global value chains of products, and also for this reason have limited ability to influence business. Being at the end of the product supply chain hampers their ability to know what is happening further down in the chain, notably in lower-income countries, where much of the negative impacts often occur.

KEY TAKEAWAY

Inadequate information, limited resources and conflicting demands hamper consumer pressure for sustainability

Of course, demands from consumers and civil society more broadly for more transparency about global value chains and the sustainability impacts of the products they purchase, may have some influence on decision-makers in businesses. This may take the form of providing more information, or using various sustainability-related labels, and will tend to be on the spectrum from relevant and reliable information to misleading and SDG-washing. In the best case, decision-makers in businesses will be inspired to exert and perhaps expand their realm of influence over the global value chains of the products they sell and make changes, for example to ensure living wages for workers in their global value chains, reduce use of harmful chemicals, or improve recyclability of their products.

[131] 'With a stronger global economy, in 2018 consumer expenditure is expected to grow at its strongest rate since 2011', Top Ten Global Consumer Trends for 2108, Euromonitor International, Jan. 2018, https://blog.euromonitor.com/2018/01/explore-the-top-10-global-consumer-trends-for-2018.html

However, the result may not necessarily be a change in the business model itself in the sense of a high level commitment in the company to integrating sustainability throughout and ensuring that this is done through stringent assessment and a continuous improvement process of the sustainability impacts of the full life impacts of the products, processes and services of the business. Rather there is a risk that any actual improvements are limited to whatever consumer, civil society or media campaigns concentrate on at any given time.

There are some encouraging indication of the beginning of a gradual shift in the attitude to the relationship between business and society, where the youngest generation appear more willing to emphasise sustainability issues in their choices of what to buy and where to work.[132] Civil society is becoming wiser to the ways of business, and together with journalists, exposing wrong-doings by business in our increasingly globalised society servers to further enhance this trend.

However, consumer power, together with civil society and media, is clearly not sufficient by itself to instigate the fundamental transition that is required for decision-making in business, in part because there is a lack of relevant, reliable and comparable information for consumers and civil society. This limitation may be overcome in the future by digital technologies operating to ensure that consumers have access to more reliable information about quality and provenance.

However, and perhaps more fundamentally, consumers are volatile and complex market actors. Motivations behind consumer behaviour are manifold and vary with time and circumstances. Sustainability considerations may prompt some consumers to favour product that are (or appear) more sustainable, but even consumers who wish to contribute to sustainability may take harmful decisions as the result of their financial situation and balancing of other social goals, notably health, housing and education.[133] Whereas some consumers will always prioritise environmental considerations over other concerns (such as price or convenience), some will never be convinced by the use of ethics and morality in the purchasing decision. Research shows

[132] https://blog.euromonitor.com/2018/01/empowered-consumers-disrupt-business-2018.html
[133] Field and Field 2013

a gap between the purchase intentions and actual purchase decisions of many consumers when it comes to considering sustainability.[134] Much may also depend on consumers' income levels as workers (or entrepreneurs), which if limited by government or market factors, will limit their discretionary choices.[135] This suggests that, even if they had perfect information, consumers would remain an imperfect and unreliable driver of sustainability in business.

Consumer demands will at any time be conflicting: consumers may wish to purchase sustainably but are seldom willing to use the time and extra costs that may be involved in trying to identify and purchase more sustainable products. Instead, consumers may tend to use corporations as moral deflection devices, ready to criticise exploitation of people and the environment, but still looking for cheap and easily accessible products.

Despite those sobering findings, laws could empower so-called 'ethical consumers' (i.e. consumers who prioritise social and environmental concerns over factors such as the price) through private remedies to hold companies accountable that do not put their sustainability promises into practice such as by giving them a right to demand sustainable products.[136]

While the Commission has increased its efforts to ensure a better implementation of the Unfair Commercial Practices Directive, including guidance regulating green and other sustainability related claims,[137] there is a risk that the guidance may inadvertently permit businesses to make

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[134] See M. Carrington, B. Neville and G. Whitwell, 'Why Ethical Consumers Don't Walk Their Talk: Towards a Framework for Understanding the Gap Between the Ethical Purchase Intentions and Actual Buying Behaviour of Ethically Minded Consumers' (2010) 97 *Journal of Business Ethics* 139; G. Eckhardt, R. Belk and T. Devinney, 'Why don't consumers consume ethically?' (2010) 9 *Journal of Consumer Behaviour* 426.

[134] R. Wilkinson and K. Pickett *The Spirit Level: Why more equal societies almost always do better* (2009) Allen Lane/Penguin Press

[135] R Wilkinson and K Pickett (2009) The Spirit Level: Why more equal societies almost always do better, Allen Lane/Penguin Press.

[136] See A. Rühmkorf, SMART Consumer mapping paper: Consumers as sustainable market actors: Opportunities and limitations for the promotion of sustainable development (June 2018) 31 – 42 (on file with the SMART Project).

[137] COMMISSION STAFF WORKING DOCUMENT GUIDANCE ON THE IMPLEMENTATION/APPLICATION OF DIRECTIVE 2005/29/EC ON UNFAIR COMMERCIAL PRACTICES Accompanying the document COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS A comprehensive approach to stimulating cross-border e-Commerce for Europe's citizens and businesses, SWD/2016/0163 final

sustainability claims without necessary improving the actual sustainability impacts of the products, or fundamentally changing their business models.[138] Also, the Guidance does not say much about claims made by companies related to the social dimension of sustainability. Section 5 of the Guidance is entitled 'Application of the UCPD to specific sectors, 5.1 Environmental claims'. While environmental protection is an important component of sustainable development and whilst it is therefore to be commended that they are given such an explicit discussion in the Guidance, the other dimensions of sustainable development (i.e. the social and economic pillar) should also be addressed in the examples in order to avoid companies trying to argue that such claims are beyond the reach of this Directive.[139]

The EU's Circular Economy packages are laudable attempts at shifting business models from linear and unsustainable to circular and sustainable, which may also stimulate a shift in the business-consumer relationship, from emphasis to selling products with the consumer as the end-user (and no business responsibility for the product after sale), to selling to the consumer the service of using the product, where the business may take a more integrated and comprehensive responsibility for the full life of the products.

However, there are limitations to the Circular Economy legislative initiatives, with important sectors, such as the mobile phone sector, currently not regulated: there is at present no Eco-Design Directive regulation applicable to mobile phones. In addition, many companies in the mobile sector presently offer recycling programmes that approximate product-as-a-service business models, encouraging consumers to enter into agreements that secure the consumers a new telephone annually against the company's promise to recycle those phones overseas. While apparently circular in the sense that the phones are recycled to second-hand markets, the end-

[138] European Commission, Guidance on the implementation / application of Directive 2005/29/EC on unfair commercial practices (Brussels, 25.5.2016, SWD (2016) 163 final, p 101.
[139] The Guidance address this point in a different section on page 58 where they state that 'Because there are often significant similarities between ethical/corporate social responsibility claims and environmental claims, the key principles applying to green claims should also apply to ethical and corporate social responsibility claims. These key principles are further discussed in section 5.1 on environmental claims.' However, section 5 could make clearer that it covers both environmental and social claims in order to avoid companies arguing against the applicability of the Directive to aspects of social sustainability.

life of the phones is in effect shifted to countries in the global South, which do not have the capacity to recycle the metals, plastics and hazardous materials (not least in batteries). Those facilities exist in Europe and other industrialised countries. Similar dynamics can be observed in the second hand on-line sales within the EU. The product-as-a-service model promotes a lack of ownership to products, including through consumer-to-consumer examples of the sharing economy, where consumers may tend to take less care of the products, or care less about how those products are used after they leave their possession, and thereby reducing the products lifespan or lowering the social stigma attached to failing to recycle.

7. Sustainable public procurement?

Public procurement is a potentially powerful driver for more sustainable business, and the EU Commission's emphasis on public procurement as a tool for sustainability represents an important step forward. In the European Union, total public expenditure on goods, works and services amounts to approximately 15 per cent of GDP. With such a substantial economic relevance of public procurement (~€2 trillion), the way in which public funds are deployed opens up the potential to push the market towards environmentally friendly, socially responsible and innovative products and services. Clearly, a use of this purchasing power based on the 'Think Sustainability First' principle has the potential for incentivising much of European business to adopt sustainable business models.

KEY TAKEAWAY

Public procurement potentially a powerful driver of change, but much remains to realise its potential

However, sustainable public procurement, even if it realises its potential, cannot by itself change the unsustainable business as usual approach, as procurement will inevitably only cover a limited part of the product and service markets. It may exert some influence towards more sustainable products and services but will most likely leave untouched a major part of businesses that do not engage in procurement competitions.

Turning then to the possibilities of realising the potential of sustainable public procurement, it is encouraging how the last decade has seen a growing recognition of the importance of employing economic drivers to promote overarching societal goals. This is in contract to the main procurement focus in the EU previously, limited to facilitating competition, transparency, non-discrimination and anti-corruption. Next to the objective of increasing the simplicity and flexibility of EU public procurement law, a major aim of the 2014 Procurement Directives of the

EU[140] is to enlarge the possibilities for using public procurement in support of broader social and environmental goals.[141] The EU Commission has defined public procurement as a policy strategic instrument to achieve sustainability, and as an essential contribution to the achievement of the EU 2020 Agenda.[142] Public procurement is seen as a driver to stimulate innovation[143] and resource-efficiency,[144] and as an integral part of an industrial policy for a global, low-carbon economy.[145] Public procurement is also repeatedly mentioned in the context of the SDGs.[146]

Unfortunately, the 2014 procurement directives do not fully realise the potential of such a possible paradigm shift in procurement. Although they open up greater scope for emphasis on sustainability issues than the previous regulation, they leave it to implementation in the Member States and especially to public procurement practice to determine the extent to which procurement will act as a driver of corporate sustainability.[147] The result falls short of what it could have been.

Many large Member States have fairly decentralised structures. For instance, in Germany some 58 per cent of all procurement activity is done at the municipal level and 30 per cent at the level of the federal states, leaving just 12 per cent of procurement to be distributed federally. As a consequence, Germany registers the lowest values of contracts published under EU rules. The

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[140] Directive 2014/24/EU of the European Parliament and of the Council of 26 February 2014 on public procurement and repealing Directive 2004/18/EC Text with EEA relevance; and Directive 2014/25/EU of the European Parliament and of the Council of 26 February 2014 on procurement by entities operating in the water, energy, transport and postal services sectors and repealing Directive 2004/17/EC Text with EEA relevance. We concentrate in this volume on Directive 2014/24/EU, leaving aside the special rules concerning utilities and concessions.
[141] European Commission, *Proposal for a Directive on public procurement*, COM(2011) 896 final, 20 December 2011, p. 2.
[142] Communication from the Commission, *Europe 2020: A strategy for smart, sustainable and inclusive growth*, COM(2010) 2010 final.
[143] Communication from the Commission, *Europe 2020: A strategy for smart, sustainable and inclusive growth*, COM(2010) 2010 final, p. 12.
[144] *Ibid.*, p. 15.
[145] *Ibid.*, p. 16.
[146] E.g. Commission Communication, *A Global Partnership for Poverty Eradication and Sustainable Development after 2015*, COM(2015) 44 final, at https://ec.europa.eu/europeaid/communication-global-partnership-poverty-eradication-and-sustainable-development-after-2015_en.
[147] B . Sjåfjell and A. Wiesbrock (eds), *Sustainable Public Procurement: A New Role for the State as Stakeholder* (Cambridge: Cambridge University Press, 2015)

average value of contracts published under EU procurement Directives amounts to 3.2 per cent of the GDP or 19.1 per cent of the public expenditure.[148] However, in the past decade or so, a number of large countries have increasingly relied on Central Purchasing Bodies. This is the case with England and Wales. The Crown Commercial Service is running framework agreements on behalf of Central Government Departments, their Executive Agencies and Non Departmental Public Bodies, with other contracting authorities being able to decide whether avail themselves of the same agreements.[149] Centralisation has been pushed further in Italy, with municipalities called to avail themselves of State or regional Central Purchasing Bodies for many of their procurements.[150] Because of the sheer mass of contracts they manage, Central Purchasing Bodies may play an important role for sustainable public procurement and thereby for public procurement to function as a driver for more sustainable business.

The 2014 procurement reform brought about numerous changes, additions and updates of previous rules in order to increase flexibility. Particularly from the long-term perspective, the directive introduced a more flexible notion of public procurement, which is intended to promote public procurement as a policy instrument. The Preamble to Directive 2014/24/EU states that '[t]his Directive clarifies how the contracting authorities can contribute to the protection of the environment and the promotion of sustainable development, whilst ensuring that they can obtain the best value for money for their contracts'.[151]

A major part of this new policy approach pertains to so-called 'strategic public procurement' comprising green, social, and innovative public procurement.[152] Sustainable public procurement also plays a key role in the circular economy, and the EU Commission encourages this role through its actions on Green Public Procurement (GPP), where criteria are developed at EU level

[148] See *Public procurement – Study on administrative capacity in the EU - Germany Country Profile*, available at http://ec.europa.eu/regional_policy/sources/policy/how/improving-investment/public-procurement/study/country_profile/de.pdf
[149] https://www.gov.uk/government/organisations/crown-commercial-service
[150] http://ec.europa.eu/internal_market/economic_analysis/docs/presentations/140318_gian-luigi-albano_en.pdf
[151] Directive 2014/24/EU on public procurement, OJ 2014 L 94/65 Recital 91.
[152] See the contributions in B.Sjåfelll and A. Wiesbrock (eds) *Sustainable Public Procurement Under EU Law* (Cambridge: Cambridge University Press, 2016)

and then used by public authorities on a voluntary basis. The Commission places special emphasis on aspects relevant to the circular economy, such as durability and reparability, when setting out or revising criteria (e.g. in the Eco-design Directive).

The modernization of the EU procurement regime provides for a broader sustainable procurement toolbox than ever before. Both the European and national agendas are underlining the need to strike a balance between an efficient spending of public money and environmental protection and social development. It is commonly acknowledged that one of the drivers for the sustainable public procurement is the fact that for the EU's economies to bounce back from the financial crisis, new innovative and cost efficient solutions for spending public money have to be established, jobs need to be created and climate change has to be addressed.

'Social drivers' play an important role as a driver for sustainable public procurement. These social drivers may include trade union and NGO campaigns, media attention (negative publicity) and pressure exerted by science and new knowledge. It is especially the first two that influence the adoption of the sustainable procurement attitude by public sector. NGO and trade union campaigns often led to negative publicity in respect to unethical behaviour within international supply chains.[153] A potentially very important role in the EU is played by local governments ready to pursue sustainable buying beyond what is required by state legislation and policy.

However, for public procurement to realise its full potential as a driver for sustainable business, including sustainable governance of global value chains, the scope of the new EU procurement regime would need to be used in a much more stringent way. The directives expressly allow contracting authorities to choose their contracting parties based on the full life cycle of the

[153] Danwatch exposed human rights violations and forced labour in IT supply chains, at electronics factories that produce servers for brands Danish universities (public buyers) most often use see: Danwatch & Goodelectronics, Servants of Servers: rights violations and forced labour in the supply chain of ICT equipment in European universities (2015), available at https://www.danwatch.dk/en/undersogelse/servants-of-servers/?chapter=1; Plastic gloves purchuased through public procurement in the health-care sector in Denmark have been documented to contain rubber from plantations relying on forced labour see: Danwatch, https://www.danwatch.dk/da/artikler/kritisable-arbejdsforhold-bag- gum-mihandsker-paa-danske-hospitaler/243.

goods or services they are purchasing, including their production methods. The studies have stressed that in many Member States the emphasis on price has hindered the uptake of sustainable public procurement. Having gone some way in abandoning the lowest price award criterion, the 2014 directives also push contracting authorities to rely less on price.[154] Yet, Member States have tended not to use the scope given them by directives, nor follow up on the signals, preferring in many cases to aim for minimum implementation. . For example, in Germany there is no requirement for public procurers to consider social and environmental aspects, which means that it is at their discretion whether or not they consider these issues in their procurement practice.[155] Even where Member States are willing to ensure that their procurement authorities integrate sustainability aspects into their procurement processes, there is often lack of expertise about how to do this in practice, lacking systems and tools for following up any aims of integrating sustainability, and a tendency to fall back on path-dependent ways of carrying out procurement. .

A major obstacle is also mentality and the lack of will on the side of procurement officers to go out of the beaten track and apply social or green clause – as this means risking making sufficient number of public procurement procedures as all things new slow down the process and increase number of queries. Even where the procurement authorities are willing, the problem also remains how to have reliable information about the production of – say – textiles or IT, when their value chains span the whole world.[156] This clearly is linked to companies' governance of their value chains and the information that they through the governance have access to, and whether and how they wish to share this information.

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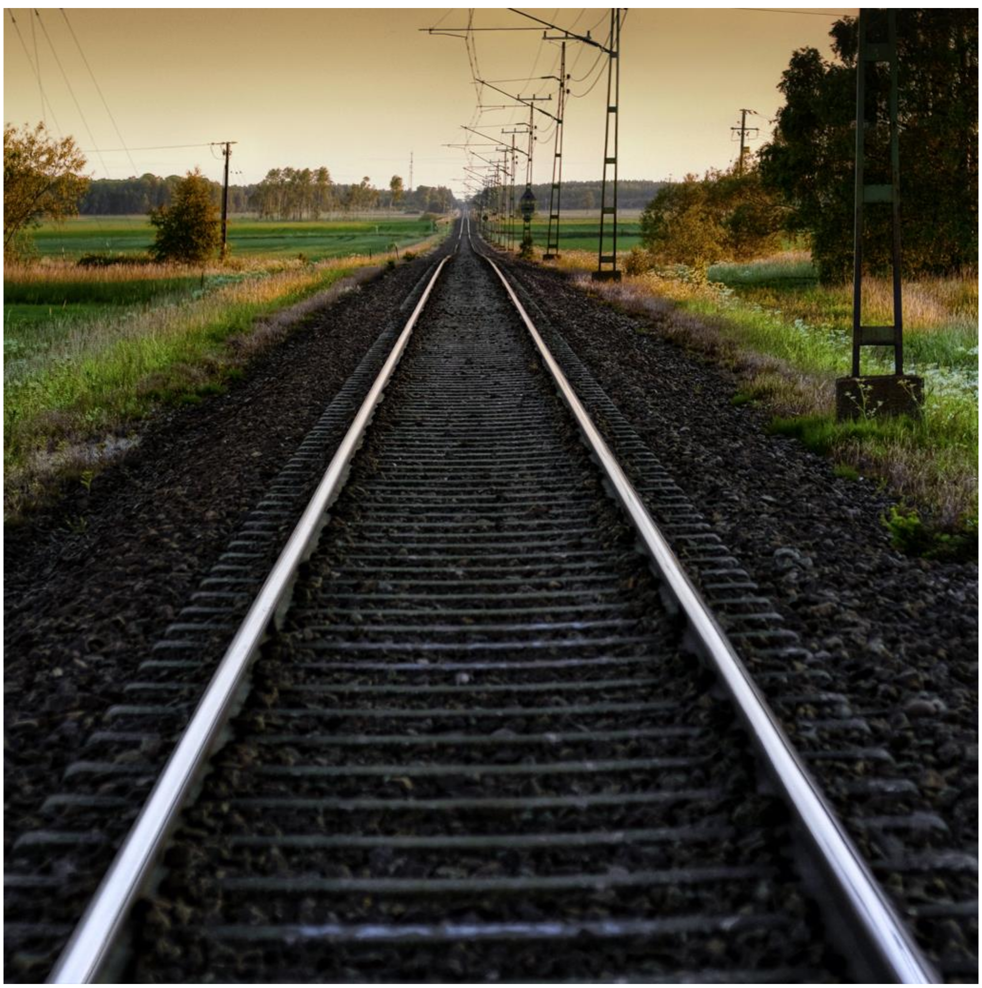
[154] See point 3.4. of *THE UPTAKE OF GREEN PUBLIC PROCUREMENT IN THE EU 27*, available at http://ec.europa.eu/environment/gpp/pdf/CEPS-CoE-GPP%20MAIN%20REPORT.pdf

[155] Germany implemented the 2014 public procurement directives into national law through the Act against Restraints on Competition (Gesetz gegen Wettbewerbsbeschränkungen, GWB). See also the discussion in L Volles, 'Deutschlands „Nationaler Aktionsplan Wirtschaft und Menschenrechte" – Meilenstein oder Papiertiger?' in A Rühmkorf (ed), Nachhaltige Entwicklung im deutschen Recht – Chancen und Grenzen der Förderung 57 – 84.

[156] The 3rd edition of the *Buying Green* guide emphasis the possibility to ask would be contractors to have in place supply chain management measure; para. 4.3.3.; the Guide is available at http://ec.europa.eu/environment/gpp/pdf/Buying-Green-Handbook-3rd-Edition.pdf

Various forms of sustainability labelling or certification may serve as a bridge between procurers wishing to require sustainability of products, services or processes and businesses wishing to compete for such procurement contracts. However, there are no sustainability labels or certification schemes that ensure fully sustainable products in all aspects of sustainability.

In conclusion, EU law is no obstacle to sustainable public procurement, and a number of policy initiatives taken at EU, Member States and local level are leading the way. Weak – or non-existent – political will in some Member States and lack of stringent systems and insufficient enforcement of the requirements that are made, are the main obstacles to the full uptake of sustainable public procurement along with the difficulty to check global value chains.



8 Potential for sustainable companies – more work required

As we have seen above, there are tentative indications of more interest in and dedication to sustainability on the part of both corporations and financial market actors. There is scope within the current regulatory system for boards, for investors and for banks to integrate sustainability into their decision-making and thereby promote sustainable business models, but the combination of uncertainty about this scope and competing social norms, reinforced by economic incentives, tend to keep both corporations, investors and banks on path-dependent, unsustainable tracks.

The generally positive response to the TCFD initiative from large companies and investors, despite the considerable uncertainty associated with scenario analysis,[157] provides evidence that there is appetite for change. However, the TCFD is limited to climate change, and does not address other planetary boundaries or the social and economic aspects of sustainability. The Commission's Sustainable Finance Action Plan potentially goes further. However, social sustainability, and human rights abuses in global value chains continue to depend on soft law and pressure from investors and civil society (although the UK and, especially, French legislation perhaps shows the way forward in terms integrating human rights and environmental protection). Moreover, the chain of intermediaries between end investors and companies makes it much more difficult to transmit a desire for more sustainable investment (if indeed that exists). The proposals in the Commission's Action Plan go some way to improve the situation, but further action is urgently required.

[157] A. Johnston, 'Climate-Related Financial Disclosures: What Next for Environmental Sustainability?' (2018) 2 *University of Oslo Faculty of Law Research Paper* (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3122259)

Increased emphasis amongst consumers, employees and potential employees on the sustainability performance of corporations,[158] does most likely have some, albeit still limited, influence on corporate decision-making but lack of reliable, relevant and verifiable information limits the potential of these drivers. In addition, consumers make conflicting demands of corporations, and the business models of most corporations in the consumer product market remain based on overconsumption. Legislative initiatives such as the Circular Economy packages are important but do not encompass enough sectors nor engage well enough with planetary boundaries.

For the Circular Economy initiative to contribute better to the changing business models towards sustainability, the unsustainability of business models based on overconsumption must be challenged. This can be done via a product life-cycle approach to product regulation. Regulation at the design phase needs to take into consideration the hazardous materials used in the production phase, which then threaten the health of works in manufacturing as well as the end of life phase of the product. A broader approach to regulation is needed to ensure that consumer goods are used for longer periods, reparable and serviceable by wide range of market actors (not just brand shops) and to ensure that socially and environmentally and safe recycling and waste management is enabled, both in European and abroad.

Public procurement is a potentially strong driver for the transition to sustainable business (although also not sufficient by itself), but a number of both legal and non-legal barriers hinder realisation of this potential. Member States have not made use of the opening given them by the EU to adopt more stringent sustainability-promoting procurement rules, and procurement authorities are generally either not prepared to deviate from the path-dependent systems of

[158] See for e.g. D. Montgomery and C. Ramus, 'Corporate social responsibility reputation effects on MBA job choice' (2003)1805 *Stanford GSB Working Paper* (available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=412124) and B. Lis, 'The relevance of corporate social responsibility for a sustainable human resource management: An analysis of organizational attractiveness as a determinant in employees' selection of a (potential) employer.' (2012) *Management Revue* 279-295.

how to undertake procurement, or if they are, they lack knowledge and expertise, and the tools and systems to enable sustainable public procurement are generally not in place.

We see that there are still a number of rules, norms and economic incentives that are barriers to or that do not facilitate and promote sustainability. Legislative initiatives are insufficient; there have been several lost opportunities for more stringent integration of sustainability in the regulatory framework of the market actors. There are some promising norm developments in the right direction but they tend to be limited to climate when they become concrete. A general problem for all market actors is a lack of reliable, relevant and verified information about the sustainability impacts of corporate activity, including of the global value chains of their products, services and processes.

SMART has assessed a broad range of well-established assessment and certification schemes, and none of them are comprehensive and stringent enough to provide a reliable full sustainability assessment.[159] Assessing sustainability impacts and certifying products, processes and businesses has become a business in itself, which in itself may raise concerns about whether the profit motivation in selling assessment, certification or more general consultancy services may become more important than actually contributing to sustainability.

[159] See SMART Deliverable 5.1, M. J. Muñoz-Torres (lead author), M. A. Fernández-Izquierdo, J. M. Rivera-Lirio, I. Ferrero-Ferrero, E. Escrig-Olmedo, J. V. Gisbert-Navarro, M. C. Marullo, 'Lifecycle Thinking: Issues To Be Considered', available at: https://www.smart.uio.no/resources/reports/reports/d5.1.pdf

9. Small and medium-sized enterprises (SMEs)

9.1 SMEs are vitally important for Europe

In the EU, SMEs represent an astonishing 99 per cent of all businesses.[160] In all European countries, the role of SMEs is crucial for the society and the economy. Their significance is expected to increase in the future. The adoption of sustainable business models by SMEs is therefore crucial. What makes SMEs special besides their sheer number is that they are enterprises of humans, not faceless intermediaries as multinational listed companies. They require public support but can arguably not flourish without personal commitment and private direct financing. When successful, SME entrepreneurship has the potential to be a major conduit for sustainable products and processes, and new ventures are viewed as an answer to many social and environmental problems.[161] On the other hand, the original choice of business model may be more crucial to SMEs than multinational corporate groups: if a firm does not begin on a sustainable path, it may very

What about SMEs?

- SMEs are significant for corporate sustainability due to their high number.
- A main problem for a sustainable SME business model is lack of financing
- SMEs are often subcontractors for multinational enterprises
- To decide their own business model, SMEs need to be independent of these larger enterprises
- One way forward may be community-based networks as cooperatives

[160] European Commission, What is an SME?, http://ec.europa.eu/growth/smes/business-friendly-environment/sme-definition_en. Small and medium-sized enterprises (SMEs) are defined in the Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, OJ L 124, 20.5.2003, p. 36–41.

[161] J. K. Hall, G. A. Daneke and M. J. Lenox, 'Sustainable development and entrepreneurship: Past contributions and future directions' (2010) 25 *Journal of Business Venturing* 439-448; N.M.P. Bocken, 'Sustainable venture capital e catalyst for sustainable start-up success?' (2015) 108 *Journal of Cleaner Production* 647-658; D. E. de Lange, 'Start-up sustainability: An insurmountable cost or a life-giving investment?' (2017) 156 *Journal of Cleaner Production* 838-854.

hard to change later. The results of this inability to adjust have been evidenced in financial crises, as we saw in 2008. The EU and Member State governments can choose to solve the problems before another crisis occurs, by implementing policy to support sustainable start-ups.[162]

SMEs play an important role in global value chains and innovation. According to research there is a strong positive relationship between exporting and growth and between exporting and innovation activity.[163] Due to their vast number, a majority of *importers and exporters* in the EU are SMEs and within the group of SMEs the majority are micro-sized enterprises, followed by small and then by medium enterprises. For example, in Germany, SMEs are referred to as the *Mittelstand* and they are considered to be the backbone of the German economy.[164] Yet, while large enterprises are a small minority of the number of enterprises but in many countries account for the largest share in trade value among the four size classes.[165] There is also a direct link not only between internationalization and innovation but also between the level of internationalisation and size of the company: the larger the company, the more it tends to internationalise. Albeit a considerable number of European SMEs are engaged in cross-border activities only a small percentage of SMEs were involved in internationalisation *beyond* the Internal Market. However, the internet has made it easier for SMEs of all sizes to overcome some of the barriers to internationalization,[166] and this trend is expected to continue.

The most important barriers to more cross-border SME activity were *internal* barriers, such as the price of their own product or service and the high cost of internationalization, and *external* barriers, such as lack of capital, lack of adequate information, and lack of adequate public support and the costs of or difficulties associated with transport. Both barriers were more

[162] de Lange, 'Start-up sustainability'.
[163] J. H. Love and S. Roper, 'SME innovation, exporting and growth: A review of existing evidence' (2015) 33 (1) *International Small Business Journal* 28–48
[164] 'German lessons: Many countries want a *Mittelstand* like Germany's. It is not so easy to copy', *The Economist*, 12 July 2014 (available at: http://www.economist.com/news/business/21606834-many-countries-want-mittelstand-germanys-it-not-so-easy-copy-german-lessons) (accessed 22 November 2017
[165] Eurostat, International trade in goods by enterprise size (November 2017), http://ec.europa.eu/eurostat/statistics-explained/index.php?title=International_trade_in_goods_by_enterprise_size.
[166] European Commission, Internationalisation of European SMEs: Final Report (2010).

important the smaller the SME is.[167] To dismantle these barriers is one of main policy goals of the EU. The Commission paints in its White Paper of the Future of Europe a picture of 'European Silicon Valleys', emerging to host clusters of venture capitalists, start-ups, large companies and research centres. Joint public, private and hybrid investment in innovation and research is of great significance; fully integrated capital markets can help mobilise finance for SMEs and major infrastructure projects across the EU.[168] Based on the White Paper, in its Reflection Paper on harnessing globalization, the European Commission emphasizes the quality of goods and services as the competitive edge of exporting European SMEs that count over 80 per cent of European exporting firms in numbers. The societal importance of SMEs for Europe is crucial too: they employ the most of European workers and contribute to local economies through their supply chains and tax payments.[169]

9.2 What makes SMEs special?

To understand SMEs role for sustainable business requires understanding how they differ from multinationals in governance. A typical SME is a family business (company or partnership) or a local cooperative, consisting of humans in face-to-face interaction: entrepreneurs, family members, local communities and private equity investors. What in the economic literature often is denoted as the 'separation of ownership and control' has not taken place (yet): the members are active both in investments and management. The role of the board is also different in listed companies and SMEs, being more a resource for the members than controlling them.[170] National law might compel SMEs to have a board, but members are governing the enterprise directly either as active partners or as board members – or controlling closely the board members.

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[167] European Commission, Internationalisation of European SMEs: Final Report (2010).
[168] European Commission, White paper on the future of Europe and the way forward: Reflections and scenarios for the EU27, COM(2017)2025 of 1 March 2017, p. 12, https://ec.europa.eu/commission/sites/beta-political/files/white_paper_on_the_future_of_europe_en.pdf.
[169] European Commission, Reflection Paper on Harnessing Globalisation, COM(2017) 240 of 10 May 2017, p. 7, https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-globalisation_en.pdf.
[170] M. Neville, 'The role of boards in small and medium sized firms' *Corporate Governance,* (2011), 11(5), pp. 527-540.

‘Shareholder primacy’ in SMEs takes different forms than in listed companies due to this direct participation and control of the ‘owners’. While in listed companies the crucial actors are the full-time asset managers of the investors, and the top executives of the companies, in SMEs it is full-time or nearly-full-time ‘owners’. In both categories board members are part-time, but in different roles: as in listed companies they are supervisors of management, in SMEs they are advisers of the manager-‘owners’. The advisory nature of board members might be crucial for SME sustainability in light of lack of internal resources and competence for evidence-based innovation.[171]

This special ‘ownership’-control mode creates both possibilities and barriers for sustainable decision-making. On the one hand, the direct control solves the investment supply chain problem, connecting the interests of the members and investors, but also employees and other contractual parties to the long-term success of the enterprise. On the other hand, the enterprise is directly influenced by their private interests, such as employees’ short-term wage demands. With a weak or non-existing board, beyond its advisory role, there is no mitigating force in the enterprise.

Especially problematic is the role of private equity investors. According to empirical research,[172] private equity investors prefer to be reassured that the entrepreneur’s priority is their profitable exit (through merger, acquisition or initial public offering), rather than the sustainability mission. Investors choose to avoid business risks rather than respond to the demand for sustainable solutions. They are unsure about value capture when working with entrepreneurs who have other than a profit focus, whether expressed through a sustainable mission or enacted through a sustainable business model. Investors today may therefore tend to avoid sustainable firms for investment.

[171] M. Muñoz-Torres, M. A. Fernandez-Izquierdo, J. M. Rivera-Lirio, I. Ferrero-Ferrero and E. Escrig-Olmedo, Sustainable Business Models to foster circular economy and sustainable development.
[172] de Lange, ‘Start-up sustainability’.

9.3 How to make SMEs more sustainable? Business model and financing

There are two crucial issues involved. Firstly, the sustainability of the SME's business model as such, and secondly, how finance acts as a driver for unsustainability and obstacle for sustainability. As we discuss in more detail in Section 12.2 below, a sustainable business model is based on sustainable value creation in the whole value chain within planetary boundaries. In principle the business model for non-financial firms should be immune to the investment model as it is primary a question of how to use capitals, not of how to acquire them. However, continuing sustainable business with only unsustainable finance might be a major barrier, and finance therefore requires a separate analysis for SMEs.

For SMEs, global value chains are both a challenge and a possibility for a sustainable business model. Technology-based global value chains increase cross-border opportunities for even the smallest companies that are from the beginning 'born global', reaching buyers and suppliers worldwide through the internet. On the other hand, the multinational online platforms are becoming increasingly dominant in the market thanks in part to their ability to track and store personal data.[173] SMEs, non-governmental organisations (NGOs) and individuals are more and more dependent of the oligopoly of these providers (Alphabet, Amazon, Google, Uber, Airbnb, just to name a few) commercializing, privatizing and monopolizing digital commons and through that global value chains.[174] However,, according to the Commission, globalisation may increasingly become more beneficial for SMEs than for multinationals, as digitalisation, robots, artificial intelligence (AI), the internet of things (IoT) and 3D printing revolutionizes how we produce, work, move and consume.[175] Transport may be changed with more sustainable driverless and connected cars, drones and car-sharing, energy with efficient smart grids, renewable energy and distributed generation, agri-food with climate-friendly farming and

[173] European Commission, Reflection Paper on Harnessing Globalisation, p. 10.

[174] See V. Papadimitropoulos, 'Reflections on the Contradictions of the Commons' (2014) *Review of Radical Political Economics* 1-15.

[175] European Commission, Reflection Paper on Harnessing Globalisation, p. 10.

applications to reduce food waste, telecommunications with more powerful networks enabling IoT, virtual reality and virtual workspace, distribution with the growing importance of e-commerce, financial services with virtual banks and insurance and crowdfunding, and factory production with potentially sustainability-enhancing automation. As automation makes labour costs less relevant in decisions on where to locate production, new opportunities arise for SMEs with their local and communitarian skills. As simplistic global supply chains of commodities dominated by states and multinational enterprises are replaced by global value chains, SMEs, non-state actors and individuals may get their chance. [176]

Securing finance is often more difficult than for SMEs than for larger enterprises, and it may be even more challenging for sustainable businesses, which may be seen as unfamiliar and providing more uncertain exit opportunities for investors.[177] The EU recognizes the SME and start-up problem and the European Commission works to improve the financing environment for small businesses in Europe also with regards to private financiers.[178] The Commission works with financial institutions to improve the funding available to SMEs, by stimulating the provision of loans and venture capital through financial instruments.

To achieve sustainability, socially and economically, the EU Member States cannot, however, remain 'market-fixers' only, facilitating private value creation and redistributing it, but they also – and especially – need to be market-makers and market-shapers. States act as active firms and investors co-create value in society in cooperation with private actors. The Chinese government is for instance today the largest global funder of green innovations.[179] Innovation, in energy as in other sectors, requires patient, long-term, committed finance, which many private investors, especially private equity, but also institutional investors, lack. Public and hybrid sources of

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[176] European Commission, Reflection Paper on Harnessing Globalisation, p. 10.

[177] An example of an SME testing out new funding opportunities is the SMART case study SME Fairphone's use of convertible crowdfunded debt, see https://www.oneplanetcrowd.com/en/project/200324/description?utm_source=Fairphonewebsite.

[178] European Commission, Access to finance for SMEs, https://ec.europa.eu/growth/access-to-finance_en.

[179] M. Mazzucato, 'The entrepreneurial state: socializing both risks and rewards' *real-world economics review,* (2018) 84, pp. 201-217.

finance have a crucial role in setting up new markets through their early, risk-taking and patient direct investments rather than only through indirect public incentives supporting private investments.[180]

New sustainability-enabling financing models are especially important for startups, because when firms do not begin on a sustainable path, they are very hard to change later. The European Commission has realized the crucial role of the public as market-maker and -shaper. As an example, 'The investment plan for Europe' is delivering concrete results.[181] There has, however, not been a clear message for sustainability in the public EU funding. As the Multi-Stakeholder Platform on the Implementation of the Sustainable Development Goals in the EU suggests to the Commission, 'social, environmental and climate indicators' should be added to the European structural and investment funds by inter alia adjusting the allocation criteria to better reflect economic, social and environmental aspects.[182]

A major problem of EU sustainability funding is that it does not have a comprehensive planetary boundaries based vision: it is concentrated on climate change (and thus carbon management and the global complex of fossil energy systems), without sufficient attention being given to other planetary boundaries, such as biodiversity, which also pose existential threats to the safe and just operating space for humanity, and present new sustainable business opportunities across a very wide range of natural resource use, waste management and spatial planning issues.[183]

Due to the scarcity of sustainable equity funding, banks (see generally in Section 5 above) and bank-like financial institutions (for example credit unions and building societies) giving debt

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[180] G. Semieniuk and M. Mazzucato, 'Financing green growth', (2018) 4, UCL Institute for Innovation and Public Purpose (IIPP) *Working Paper IIPP*, https://www.ucl.ac.uk/bartlett/public-purpose/publications/2018/jun/financing-green-growth.

[181] European Commission, Reflection paper on harnessing globalisation, , p. 18.

[182] Implementing the Sustainable Development Goals through the next Multi-Annual Financial Framework of the European Union, Advisory report to the European Commission by the Multi-Stakeholder Platform on the Implementation of the Sustainable Development Goals in the EU, March 2018, p. 3, https://ec.europa.eu/info/sites/info/files/adopted-position-paper-on-the-mff_en.pdf.

[183] Implementing the Sustainable Development Goals, p. 11.

finance to firms are still at the epicentre of the European financial system, providing the major source of finance for SMEs in almost all developed jurisdictions. Almost all European economies (with the exception of the UK and France) rely on the banking system for a majority of their credit. EU SMEs receive about 60 per cent of their funding from banks.[184] In financing SMEs, the role of *cooperative banks* especially cannot be underestimated. Cooperative banks have member-customers that are often entrepreneurs and farmers. Cooperative banks account for about 20 per cent of the market of EU bank deposits and loans, and they are thus a major feature of the sector. Overall, they finance one-third of SMEs in Europe.[185] In some countries the percentage is even higher, for instance (in the end of 2016) in Finland 37.8 per cent and in the Netherlands 43 per cent.[186] The aspects discussed above concerning banks and the barriers to more sustainable banking, therefore also apply with full force to the possibility of promoting more sustainable SMEs also.

9.4 SMEs and the product market

The product market, both consumers and public procurers, may be significant in promoting sustainable business models amongst existing SMEs and especially encourage the establishment of new and sustainable SMEs. With local, organic and 'home-made' becoming increasingly trendy amongst consumers who allegedly prefer to shop from businesses they can trust, SMEs are seeing new opportunities.[187] However, as we saw above in Section 6, consumers are volatile and complex decision-makers sending mixed signals to businesses, and it remains to be seen whether local and arguably more sustainable produce can go beyond a niche market.

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[184] J. Cullen, SMART International and European Banking & Securities Markets Mapping Paper (21 November 2017) p. 16, on file with the SMART Project.

[185] European Association of Co-operative Banks, Annual Report 2017 (2018), p 8, http://v3.globalcube.net/clients/eacb/content/medias/publications/annual_reports/final_eacb_annual_report_2017_compressed.pdf.

[186] European Association of Co-operative Banks, Annual Report 2017 (2018), p 41.

[187] https://blog.euromonitor.com/2018/01/empowered-consumers-disrupt-business-2018.html and https://blog.euromonitor.com/2014/09/why-the-consumer-preference-for-things-local.html

As regards SMEs selling products with global value chains, SMEs may find themselves facing similar problems as sustainability-oriented consumers, with lack of influence and possibility to secure reliable information about the global value chain reducing the possibility of ensuring the sustainability of its products. Sustainability-oriented SMEs may also face larger companies outside of Europe, who are controlling production processes in lower-income countries and posing a barrier to SME efforts to improve sustainability across their global value chains.

As regards public procurement as a driver for more sustainable SMEs, a barrier to access to procurement contracts in general has been competition with large and more professional businesses. Through its procurement reform, the EU has aimed at stimulating greater inclusion of SMEs in procurement, through possibilities such as the division of contracts into lots, the reduction of administrative burdens, direct payments to subcontractors, and the prohibition to solicit overly demanding requirements concerning the economic and financial capacity of economic operators. At the same time, the Directive contains several methods to take sustainability into account in public procurement procedures, as indicated above (Section 7).[188]

As Schoenmakers discusses, there is a potentially mutually beneficial relationship between SMEs and sustainability criteria in public procurement: SMEs can benefit economically from a greater focus on sustainability in public procurement, whilst subjecting SMEs to sustainability criteria can have a great impact on key societal objectives.[189] Even though these objectives have often been considered to be contradictory (with a perception that stringent sustainability requirements are a barrier to SMEs), Schoenmakers explain they are complementary: while SMEs have a great potential to boost the use of sustainable public procurement, if they are provided with the right tools, sustainability criteria can be an advantage to increase SMEs' participation in public tendering.[190] By investing in sustainable procurement, SMEs can demonstrate their capabilities,

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[188] S. Schoenmaekers, 'The role of SMEs in promoting sustainable procurement', '8', in B. Sjåfjell and A. Wiesbrock (eds), Sustainable Public Procurement: A New Role for the State as Stakeholder (Cambridge: Cambridge University Press, 2015).
[189] Ibid.
[190] Ibid.

establish their credibility in international markets, prove the viability of new products or services and gain authoritative and essential reference contacts from the public sector.[191] In this way, they can strengthen their competitiveness and create more jobs for themselves in upcoming markets whilst at the same time contributing to achieving the SDGs.

Of course, the barriers to more sustainable public procurement of products with global value chains in terms of problems with access to reliable information and enforcement possibilities may very well be even greater with SMEs. Both in terms of the consumer market and in relationship to procurement processes, the cost of labels or certifications, which may be an easier option for larger businesses, may be prohibitive for SMEs.

The exception, where SMEs could be better placed, would be for SMEs who have managed to establish direct contact, typically with another small business, in another country. In that case, the contact may be of such a nature that the information and possibility for enforcement of sustainability requirements is much improved. This is of course also generally an argument for shorter global value chains, which arguably could be made a requirement by the procurement authority.

9.5 Way forward: SMEs as sustainable communities of value chains

Besides public and bank participation, *value chain participation* seems to be essential for SME sustainable business models. As said above, SMEs' role in global commerce is changing: global supply chains of commodities are replaced by global value chains in which the role small enterprises, non-state actors and individuals grow. [192] In this new environment, it is essential to mitigate the short-termism of private equity investors and venture capitalists and their harsh exit demands with financial models that reflect the distribution of economic costs and benefits

[191] Procurement Innovation Group, *Using Public Procurement to Stimulate Innovation and SME Access to Public Contracts*, Report of July 2009, p. 6.
[192] European Commission, Reflection Paper on Harnessing Globalisation, p. 10.

among actors involved in the value chain.[193] When envisaging a value chain based sustainable SME business model, four general business risks must be overcome: 1) non-excludability of public goods, 2) high transaction costs (the costs of exchange) for dealing with negative externalities 3) market power of incumbent firms, 4) unsupportive public policy, and 5) information asymmetry across producers and consumers.[194] As one reason for sustainable businesses problems has been seen private equity investors' scepticism how well the businesses internalize these risks.[195]

There is a promising body of literature for developing a framework and pursuing research on decision-making on self-organized groups that manage *common-pool resources*.[196] Empirical work has uncovered processes that lead to successful and sustainable governance of common-pool resources.[197] An example is the governance of 'multi-stakeholder cooperatives' (MSC) – as an example may be mentioned Italian 'social cooperatives' (see also Section 8 below) with employee, volunteer, customer, and investor members. Another example is an agri-food cooperative with producer, investor, processor, wholesale, retail, sponsor, and consumer members. The most important MSC is, however, the cooperative bank.[198] Consumer activism has long history in consumers' cooperatives. The problem for them is, however, conflicting interests with producers' cooperatives, both driven by their members' private interest. In a MSC, producers' and consumers' interests must be mitigated to secure long-term sustainable value creation.

[193] F. Boons and F. Lüdeke-Freund, 'Business models for sustainable innovation: state-of-the-art and steps towards a research agenda' (2013) 45 *Journal of Cleaner Production* 9-19.
[194] T. J. Dean and J. S. McMullen, 'Toward a theory of sustainable entrepreneurship: Reducing environmental degradation through entrepreneurial action' (2007) 22 *Journal of Business Venturing* 50–76.
[195] de Lange, 'Start-up sustainability'.
[196] C. Leviten-Reid and B. Fairbairn, 'Multi-stakeholder Governance in Cooperative Organizations: Toward a New Framework for Research?' (2011) 2 (2) *Canadian Journal of Nonprofit and Social Economy Research – Revue canadienne de recherche sur les OBSL et l'économie sociale* 25-36; V. Papadimitropoulos, 'Reflections'.
[197] E. Ostrom, 'Reformulating the Commons' (2000) 6 (1) *Swiss Political Science Review* 29-52.
[198] European Association of Co-operative Banks, Annual Report 2017 (2018).

10 Social entrepreneurship[199]

10.1 What are social enterprises?

Several European countries have adopted specific legislation for 'social enterprises', resulting in variations in Europe in the understanding of what a social enterprise means.[200] Originally, the concept of social enterprise had deep ties to the cooperative ownership model, especially to workers' cooperatives. The first of these laws was the 1991 Italian legislation on 'social cooperatives', which are dominated by employee members.

In 2011, the European Commission launched its 'Social Business Initiative' to strengthen and rejuvenate Member States' policy work supporting the growth of social entrepreneurship.[201] In 2017 the European Parliament launched a study for a Directive to provide for a 'European Social Enterprise' legal certification.[202] At the same time private actors (especially 'B Lab') lobby

[199] There is a lively discussion on 'social enterprises in Europe'. In this section we have used especially the recent works A. Argyrou, 'Providing Social Enterprises with Better Access to Public Procurement: The Development of Supportive Legal Frameworks'(2017) 12(3) *European Procurement & Public Private Partnership Law Review*, 310—324; A. Argyrou, '*Social enterprises in the EU: Law promoting stakeholder participation in social enterprises'* (Deventer: Wolters Kluwer, 2018), A. Argyrou, R. Diepeveen and T. Lambooy, 'Social Entrepreneurship: (The Challenge for) Women as Economic Actors: The Role and Position of Women in Dutch Social Enterprises' in B. Sjåfjell and I. Fannon (eds) *Creating Corporate Sustainability: Gender as an Agent for Change* (Cambridge University Press 2018) 164-186; A. Fici, 'A European statute for social and solidarity-based enterprise: A Study for the JURI Committee, European Parliament, Directorate-General for Internal Policies, Policy Department C: Citizens' (2017) *Rights and Constitutional Affairs*, http://www.europarl.europa.eu/RegData/etudes/STUD/2017/583123/IPOL_STU(2017)583123_EN.pdf and C. Liao, 'Social enterprise law: friend or foe to corporate sustainability?' in B. Sjåfjell and C. Bruner (eds) *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge University Press, forthcoming 2019). Especially Fici's study provides a comprehensive foundation for mapping European social enterprises, as it reviews many of EU wide and Member State specific legal definitions and governance aspects of Europe's social enterprises.

[200] See European Commission, A map of social enterprises and their ecosystems in Europe, http://ec.europa.eu/social/main.jsp?langId=en&catId=89&newsId=2149, including Executive Summary (December 2014), Synthesis Report (2015) and country reports, http://ec.europa.eu/social/keyDocuments.jsp?advSearchKey=socentcntryrepts&mode=advancedSubmit&langId=en&policyArea=&type=0&country=0&year=0&orderBy=docOrder; Argyrou, *Social enterprises in the EU*; Liao, 'Social enterprise law'.

[201] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Social Business Initiative: Creating a favourable climate for social enterprises, key stakeholders in the social economy and innovation, COM(2011) 682 final, p. 5, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52011DC0682.

[202] Fici, 'A European statute'.

governments to enact new separate corporate legal forms for businesses producing public benefits.

Without a common legal framework, so far, for defining social enterprises, it is unclear how sustainable they generally are as businesses, and how they could contribute to Europe's implementation of the SDGs.[203]

ASSESSING SOCIAL ENTERPRISES

- Social entrepreneurship is in the limelight in Europe
- Concept of social enterprise lacks common definition
- Social enterprise movement may inadvertently reinforce misconception that mainstream companies are required to maximise returns for investors

'Social enterprises' are based on 'ad hoc' or 'tailor-made' legislation, based on a varying array of features concerning either the purpose pursued, the activity conducted to pursue this purpose, or the structure of internal governance.[204] In the Member States, there are laws according to which a social enterprise is a legal form of incorporation (either a particular type of cooperative or a particular type of company), but also laws according to which a social enterprise is a legal qualification (or status), organized as a cooperative or company. Some jurisdictions (such as Lithuania and Spain) recognise functionally only 'work integration social enterprises' (WISE) as social

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[203] There are many scholarly definitions that academics have embraced from time to time (see Argyrou, '*Social enterprises in the EU'*) without using the Commission's definition as a common ground. See Argyrou, 'Providing Social Enterprises'. There is a lot of literature on how sustainability could be connected with social entrepreneurship; see for instance K. Schaefer, P.D. Corner and K. Kearins, 'Social, Environmental and Sustainable Entrepreneurship Research: What Is Needed for Sustainability-as-Flourishing?' (2015) 28 *Organization and Environment* 4, 394-413; N. Thompson, K. Kiefer and J.G. York, 'Distinctions not Dichotomies: Exploring Social, Sustainable, and Environmental Entrepreneurship' in G.T. Lumpkin and J. A. Katz (eds) *Social and Sustainable Entrepreneurship* (Emerald Group Pub, 2011) 201-229; S. Schaltegger and M. Wagner, 'Sustainable entrepreneurship and sustainability innovation: Categories and interactions' [2011] *Business 20 Strategy and the Environment* 4, 222-237; Shepherd and Patzelt 2011; Hall, Daneke, and Lenox, 'Sustainable development and entrepreneurship'; N. Thompson, K. Kiefer and J.G. York, 'Distinctions not Dichotomies: Exploring Social, Sustainable, and Environmental Entrepreneurship' in G.T. Lumpkin and J. A. Katz (eds) *Social and Sustainable Entrepreneurship* (Emerald Group Pub, 2011) 201-229; D.F. Pacheco, T.J. Dean and D.S. Payne, 'Escaping the green prison: Entrepreneurship and the creation of opportunities for sustainable development' [2010] 25 *Journal of Business Venturing* 5, 464-480 at 471.
[204] See in detail Argyrou, *Social enterprises in the EU*.

enterprises (organised legally usually as cooperatives), and some have laws according to which the social enterprise is identified by the performance of several activities of social utility, including, but not limited to, work integration of particular disadvantaged persons or workers (as the Finnish law, organised legally usually as companies). Other jurisdictions require benefits to health, education, culture, work integration, or social inclusion (Spain). On the other hand, the Italian example of first and foremost understanding social enterprises as a specific corporate form, a 'social cooperative', has been followed at least by France, Greece, Poland, Portugal and Spain. Unlike 'ordinary' cooperatives whose purpose is to generate economic benefits for the members,[205] social cooperatives require a social purpose in generally or a particular purpose such as the promotion and integration of disadvantaged people, employment of people with disabilities, and/or benefiting health, education, culture, work integration, or social inclusion. Often a majority of the profits are required to be reinvested back into the social purpose.[206] To complicate the taxonomy even further, there is a specific European SME called 'social start-up' referred to in the 2016 European Commission Communication on the Start-up and Scale-up Initiative (start-ups that produce a desired societal impact), sharing many of the possibilities and obstacles of SMEs discussed in Section 9 above but having its own specific character that bring it closer to social enterprises.[207]

In its 2016 Communication, the Commission sees that there is an increasing global interest in 'social innovation' as a way to 'sustainable growth', e.g. fair trade, distance learning, mobile money transfer, integrating migrants, and zero-carbon housing.[208] These 'social start-ups' therefore have high potential for innovation and positive impact in the economy and society at

[205] See for instance A. Bartolacelli, 'The (Unsuccessful?) Quest for Sustainability in Italian Business Law' in B. Sjåfjell and C. Bruner (eds) *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (forthcoming).

[206] Liao, 'Social enterprise law'.

[207] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Europe's next leaders: the Start-up and Scale-up Initiative, COM(2016) 733 final, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52016DC0733.

[208] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Europe's next leaders: the Start-up and Scale-up Initiative, COM(2016) 733 final, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52016DC0733.

large. According to the Commission their business model (combining economic efficiency with societally centred objectives) has proven very resilient, and there are good prospects for them due to increasing demand for social innovation and the rise of new technologies and collaborative platforms. In addition, in the Commission's opinion, many social start-ups have potential for scaling proven business models which could be replicated in other territories.

10.2 Governing social enterprises

However, realising this Commission-recognized potential requires a much more robust and contextualised understanding of their governance and their social and environmental impacts. As the governance of a social enterprise is influenced by the applicable Member State legislation varying from state to state, there is a vast variation of governance models.[209] For cases in which the social enterprise is a particular type of company or a particular type of cooperative, its governance features are in general those of a company and of a cooperative, respectively. In contrast, for cases in which the social enterprise has a particular legal qualification or status, its governance features vary according to the legal form in which the organization has been established (association, foundation, company, cooperative).[210] Typically, there are, however, some kind of specific reporting requirements and some kind of duty to involve various 'stakeholders', especially workers, in the management of the enterprise.[211] Due to the variations in corporate forms and governance models of social enterprises, it is impossible to say anything definite and general about how their governance mechanisms incentivise or disincentivise sustainable business models.

It is equally difficult to generalise about the duties of the possible board and management. The social enterprise's purpose affects the boards' decisions and discretionary power.[212] For example, Italian Law no. 381/91 stipulates that 'social cooperatives aim to pursue the general

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[209] See in detail Argyrou, '*Social Enterprises in the EU law*'.
[210] See in detail by jurisdictions and by governance models Argyrou, ibid.
[211] Fici, 'A European statute'.
[212] See in detail Argyrou, '*Social Enterprises in the EU law*'.

interest of the community in the human promotion and social integration of citizens' (art. 1, par. 1). [213]

10.3 Are social enterprises sustainable?

All in all, the social enterprises landscape is quite chaotic, globally and in Europe.[214] However, Liao has been able to make three preliminary observations:[215]

- Most social enterprise laws in Europe tend to prioritize issues of social sustainability, and to a lesser extent economic sustainability, whereas environmental sustainability governance falls to the wayside all together.
- The majority of social enterprise laws throughout the world seem purposefully designed to address the needs of special and/or marginalized populations – either by hiring vulnerable citizens as employees, such as women[216] and people with disabilities and other disadvantaged groups, or benefiting health, education, social inclusion, etc. within local communities.
- The American B Lab's intensive international lobbying of states to adopt a 'B Corporation' certification and 'benefit corporation' legislation stands out in the landscape of law-based social enterprise constructions.

According to Liao, B Lab – financed by big business[217] – has actively pursued an international market for its brand, which puts it in stark contrast to government-led initiatives across jurisdictions that rarely emphasise the need for other nations to emulate them. In Europe however, only Italy has adopted (2017) a Delaware law and B Lab based legislation on *societá benefit*.[218]

[213] See in detail Argyrou, ibid.
[214] D. Young, E. Searing and C. Brewer (ed.), *The Social Enterprise Zoo: A Guide for Perplexed Scholars, Entrepreneurs, Philanthropists, Leaders, Investors and Policymakers* (Northampton: Edward Elgar Publishers, 2016); see Liao, 'Social enterprise law'.
[215] Liao, ibid.
[216] Argyrou, Diepeveen and Laamboy, 'Social Entrepreunership'.
[217] V. Baumfield, 'How Change Happens: The Benefit Corporation in the United States and Considerations for Australia' in Beate Sjåfjell and Irene Lynch Fannon (eds) *Creating Corporate Sustainability: Gender as an Agent for Change* (Cambridge University Press, 2018) 188-212.
[218] A. Bartolacelli, 'The (Unsuccessful?) Quest for Sustainability in Italian Business Law'; Liao, 'Social enterprise law'.

Clearly, the efforts of the B Lab have contributed to the discourse of how businesses should engage with society. However, the rise of benefit corporations has led to a growing chorus of concerns that these alternative laws may only strengthen normative 'e contrario' beliefs that the sole purpose of the mainstream corporation is to maximize profits – thus exacerbating the challenge of broad-scale change in business as usual. The impact of B Lab's international lobbying efforts is exacerbated by the fact that legal features of the benefit corporation are relatively weak compared to other corporate legal systems, especially with regard to what may loosely be denoted stakeholder protection. According to Liao,[219] it is fair to question the motives behind the B Lab's pursuit for global reach, particularly given the high risk of the cultural Americanization of what constitutes a good corporation, and what laws are needed to permit and/or require such good corporate behaviour.[220]

Any proposals for harmonising European social enterprise law on the EU level would require a thorough investigation of what social enterprises are, what the impact of regulating them would be on the broader business landscape, and what this would mean for the goal of achieving sustainable business.[221] While arguing for harmonization, Fici states that the concept of 'enterprise' does not coincide with the one of 'entities of the social economy' or 'social and solidarity-based enterprises' used in Member States' legislation (for instance France, Greece, Portugal, Spain) and by the European Commission (see above) and Parliament.[222] According to Fici, 'social enterprises' are types of entities of the social economy, but they are not the only ones.[223] For example, he sees cooperatives as corporate forms as entities of the social economy, albeit they are not necessarily counted as business models as social enterprises, because according to him entities that benefit their members cannot be social enterprises, only entities

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[219] Liao, ibid.
[220] 'Having the support of a handful of local advocates within a jurisdiction does not negate these risks, nor absolve B Lab from its ethical responsibilities to consider the implications to local and national laws, customs, and culture'; Liao, 'Social enterprise law'.
[221] See Argyrou, '*Social enterprises in the EU*'; Argyrou, 'Providing Social Enterprises'.
[222] See European Parliament resolution of 10 September 2015 on Social Entrepreneurship and Social Innovation in combating unemployment (2014/2236(INI)), OJ C 316, 22.9.2017, p. 224–232.
[223] Fici, 'A European statute'.

that serve the 'community'. However, Fici's classifications do not reflect legal reality, as in some European jurisdictions the definition of entities of the social economy embrace also non-business organizations, which both social enterprises and cooperatives as a starting point always are.

Keeping all this mind there is no autonomic connection between 'social enterprises' and sustainability. The various definitions of social entrepreneurship do not make any claim as to their nature as business models. There are not necessarily specific drivers for them to be sustainable in the various regulatory regimes, taking into consideration both planetary boundaries and the social foundation. On the other hand, an enterprise with a sustainable business model may find itself excluded from the social enterprise discussion if does has not a specific regulatory 'social' purpose. Sustainable businesses may find that they can at best claim to be 'socially responsible business organisations'.[224] If 'social enterprise' is seen only as a label that fit in reality also non-sustainable businesses and even exclude sustainable businesses, the label does not only limit their relevance for the sustainability discourse but may even be seen as an impediment to securing the contribution of business to sustainability.

That being said, undoubtedly there are a number of businesses that both identify as social enterprises and seek to contribute to sustainability.[225] The label of social enterprise may in some cases give them a perception of scope to do so and function as certification to attract sustainability-oriented investors, consumers and public procurers. Social enterprises can thereby both individually and as a group form a space for testing out innovative products, services, and processes, and in the same way as SMEs in general, appeal to sustainability-oriented customers, procurers, and business partners.

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[224] An example is the Italian 'benefit society', defined as a society (1) that performs an economic activity not only for profit distribution, but (also) for one or more common benefit purposes, and (2) that acts in a responsible, sustainable and transparent manner towards people, communities, territories and environment, cultural and social goods and activities, entities and associations and other stakeholders. A benefit society must be managed in a way that balances the interests of the members and the other stakeholders. Fici rejects straightforwardly the social enterprise nature of a benefit company: 'As one may easily observe [sic], the benefit society status has nothing to do with the S[ocial] E[nterprise] status, for reasons that are apparent. Rather, the benefit society may be ascribed to the category of "socially responsible business organizations".' Fici, 'A European statute'.
[225] See Argyrou, '*Social enterprises in the EU*'; Argyrou, 'Providing Social Enterprises'.

10.4 Social enterprises, finance and product markets

Much of what is said above about the relationships between finance, product markets and SMEs also applies to social enterprises, which often are (but do not have to be) small and medium-sized. However, the financial position of a social enterprise depends on its purpose and generally its business form. In the strictest form, a social enterprise cannot benefit anyone else than the subjects of its purpose. This excludes both companies and cooperatives out of the definition as the purpose of both is to generate economic welfare to their members. Different kinds of 'asset locks' prevent or strongly restrict using the profit generated to the benefit of founders, members, shareholders, directors, employees. It is difficult to get financing to an entity without any benefits to the investor at least if investors are not granted a correspondingly proportional power of control of the entity.[226]

At the end of the day it is questionable whether a social enterprise can survive on donations (as a some kind of foundation) or government aid (as a some kind of third sector hybrid) only, as the Italian 'social cooperatives' that are employee dominated but often heavily subsidized by the government. Social enterprises are typically dependent on a public main contractor, as the Italian social cooperatives in health and social sector, and the social enterprises in Scotland enjoying the Community Benefit Clause in public procurements.[227]

10.5 Is social entrepreneurship worth pursuing?

It is difficult to arrive at far-fetching conclusions about social enterprises as their effects on society, economy and the planet depends on what kind of social enterprise is in question. In some jurisdictions, it is suggested that businesses identifying as social enterprises generally outperform profit-driven SMEs on a number of indicators including job creation. Social

[226] Fici, 'A European statute'.
[227] See S. Sacchetti and E. Tortia, 'The extended governance of cooperative firms: inter-firm coordination and consistency of values' *Annals of Public and Cooperative Economics* 87(1) (2016) 93–116; Argyrou, '*Social enterprises in the EU'*; Argyrou, 'Providing Social Enterprises'.

enterprises can also become a major contributor to gross domestic product. [228] This might be explained by the fact that social enterprises include, according to some definitions, also multinational cooperatives. Also, in some jurisdictions, social enterprises reduce inequalities by providing stable employment to those typically excluded from the market, but do not have larger societal or environmental impact.[229] On the other hand, governmental policies and interventions supporting certain politically as social defined enterprises may lead to significant market distortions on the supply side that need to be accounted for when postulating on the effectiveness of ad hoc social enterprise laws to securing the social foundation. The impact and potential of social enterprises is negligible vis-à-vis the urgent need to place the business of mainstream enterprises within planetary boundaries and address their human rights conduct. As shown in section 6, this does not apply to multinationals only, as it is crucial to make all SMEs sustainable. The business model is crucial, and community-based cooperative-like SMEs might have also good social outcomes besides creating sustainable value.

Liao's conclusion is that lawmakers will need to proceed cautiously and question the motives behind the establishment of any new social enterprise laws, particularly if they are implants from other jurisdictions. If lasting change on a broader scale is expected for sustainability, then in addition to reforming corporate and regulatory rules, the risks and rewards of social enterprise law and other potential supporting pathways to reform need to be fully explored. [230] The social enterprise law phenomenon is gaining international attention and, whether a friend or foe, it seems unwise for this potential driver for change to be taken lightly. We agree with these conclusions. The Commission should critically review the European trajectory of several overlapping and narrowing, sometimes even contradictory, definitions of social enterprise. It should update the goals of its social enterprise policy and make clear what role 'social' purpose has – if any – in the general European drive to secure the contribution of all business to the implementation of the SDGs.

[228] See Liao, 'Social enterprise law'.
[229] See Argyrou, '*Social enterprises in the EU*'; Argyrou, 'Providing Social Enterprises'.
[230] Liao, 'Social enterprise law'.

11 High level policy support, but gaps and incoherencies

Moving from the in-depth assessment of selected market actors to the broader regulatory framework, SMART has identified a lack of policy coherence for sustainability and a difference in approach to and support for policy areas. We see this inter alia in the difference between the treatment of trade and investment, on the one hand, and human rights and environmental protection, on the other. Assumed value neutral economic areas, such as law and policy facilitating cross-border trade and investment, and regulating competition, have more support and a longer history, leaving more politically fraught issues such as most aspects of sustainability, including protection human rights and mitigation of climate change, starting at a disadvantage.

On the *international level*, there is high policy level support for sustainability but a lack of stringency, prioritization and coherency**.** This is illustrated notably in the SDGs themselves. The goal of continued economic growth for all countries, without any limitations, is symptomatic. Trade and investment regimes have a much stronger position in practice than the environment and human rights. We are seeing the first tentative inclusion of environment and human rights into the economic areas, but this is very reticent and on some prioritised issues only. The human rights and environmental policy arenas have made progress in developing norms for global commerce, but the trade and investment fields have been slow to adopt these.

A lack of transparency in the development of multi- and bilateral trade and investment treaties is a part of the problem. The EU has not been clear enough as to the relative hierarchy of certain international instruments (e.g. UN human rights and labour standards, and environmental conventions) over the economic entitlements of private market actors. Transparency is of considerable importance, but will not alone deliver accountability. More detailed requirements for state implementation are required. Accountability that will promote sustainability entails a holistic approach to the interaction of trade, investment, business and finance in light of the sustainability goals.

On the *EU level*, there is an even clearer basis in the Treaty to say that sustainability is an overarching goal for the European Union, internally as well as in its relationship with the global community. However, in practice there is a prioritisation of economic activities in a way that brings with it a primacy of economic growth over other goals. A notable example is the EU's laudable Sustainable Finance Initiative, where the EU Commission's Action Plan is entitled Action Plan: Financing Sustainable Growth,[231] elevating economic growth to the level of overarching aim. The report does not contain the words 'limits' or 'boundaries'. This also illustrates silo-thinking, as the EU's 7th Environmental Framework Programme explicitly sets out (as its title indicates), that we indeed must find out how to live well within the limits of our planet.[232]

Over the last decade, the EU has made several significant initiatives that contain the potential for facilitating market actors that promote sustainable and development-friendly business and finance. This includes paradigm shift in the definition of Corporate Social Responsibility in 2011,[233] the follow-up of this through the adoption of the so-called Non-Financial Reporting Directive,[234] the reform of the Public Procurement Directives in 2014,[235] and most recently, the Sustainable Finance initiative,[236] as well as the Circular Economy initiative.[237]

[231] COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS Action Plan: Financing Sustainable Growth, COM/2018/097 final.
[232] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013D1386
[233] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52011DC0681
[234] https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en
[235] https://ec.europa.eu/growth/single-market/public-procurement/strategy_en
[236] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en
[237] http://ec.europa.eu/environment/circular-economy/index_en.htm

We have discussed these initiatives above, in terms of their contribution to and hindrance of sustainability. On a general note, we identify three main impediments to the EU's attempts to facilitate more sustainable market actors:

- Firstly, *a limited knowledge basis for the initiatives*, both on the theoretical and practical level. There is a lacking theoretical basis for reforms (a notable example is the reform of the Shareholder Rights Directive).[238] There is also a lacking practical understanding of how companies (and investors) are increasingly organising their transnational enterprises through global production networks and through financial engineering, which takes them out of the realm of legislation intended to influence their behaviour.
- Secondly, silo-thinking despite an aspirational tendency towards a more comprehensive approach to policy.[239] The EU, as well as its Member States, remains strongly influenced by the compartmentalized division of labour, where each DG can concentrate on promoting its own specific goals without being concerned about possibly counterproductive impacts on that which lies within the influence of other DGs. This is informed by the perception that it is sufficient for example to leave environmental protection to environmental law and policy and that company law can concentrate on regulating the relationship of the companies and their shareholders.
- Thirdly, compromise-driven initiatives. The combination of the Treaty-based subsidiarity principle and the political reality of attempting to achieve consensus in an increasingly politically turbulent Europe, often result in initiatives that are more open to interpretation by Member States, than ideally would have been the case.

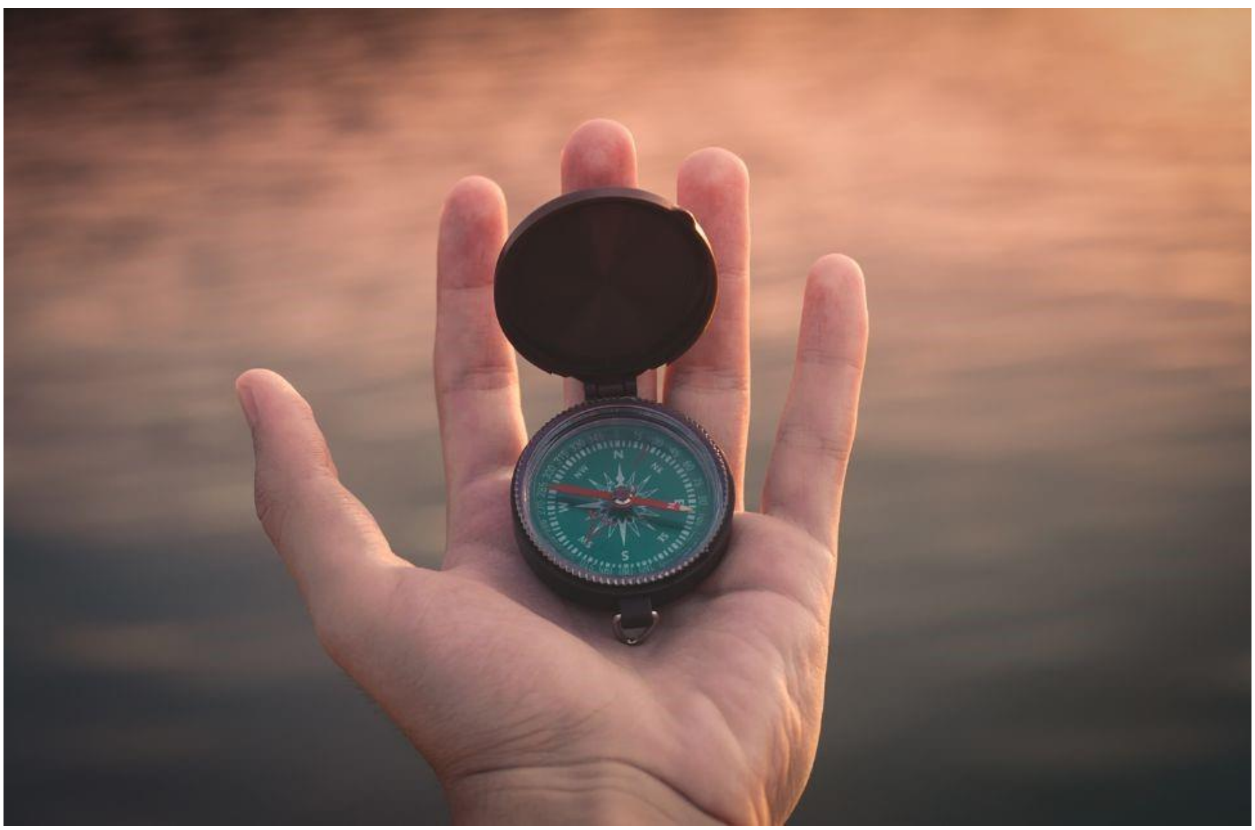
As a result, the *Member States* often are left with the task of implementing broadly formulated legislative initiatives from the EU. This typically leaves a lot of scope to transpose the EU secondary legislation in a more stringent way. However, Member States tend to opt for minimum implementation out of fear for regulatory competition, to an extent that is not always supported by EU law, and with lack of recognition of the basis in EU law for more proactive and mandatory approach to regulation.

[238] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (Text with EEA relevance), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017L0828

[239] The Sustainable Finance Initiative is a laudable example of an attempt to break down the silos.

On the Member State level we also see that myths concerning assumed value neutral economic rules act as barriers. Member States are hesitant to take initiatives that promote sustainability amongst market actors, concerned that these might violate competition law rules and state aid rules, often without a proper foundation for doing so. Indirectly, this reflects an attitude of the value neutrality and thereby, it seems, the primacy of rules intended to promote economic development, over initiatives aimed at facilitating social justice or environmental protection.

This connects to larger issues, which concerns also the EU, where a misleading dichotomy between economics, on the one hand, and all other issues, including social development and environmental protection, which are lumped together as 'ethical' issues. The dichotomy is misleading because it ignores the inextricably interconnectedness of the economy with society and with the environment that provides the basis for all life on this planet.



12. Towards Sustainability Agenda for Business

12.1 Policy incoherence for sustainability

In this report, we have observed the lack of a comprehensive and consistent approach, with conflicting policies on the international and EU level, and discussed our three case studies of European businesses: large parent company of transnational corporate group, SMEs, and the chaotic picture of social enterprises. Summarising our analysis, we see a number of significant gaps, incoherencies and barriers, but also hope.

The lack of a comprehensive and consistent approach, the tendency to silo thinking, and the path-dependent dominance of dated economic together poses a systemic barrier. Yet, the impetus that the adoption of the SDGs has given policymakers, including notably the EU, may overcome this, together with unprecedented collaboration between public authorities, business, finance, civil society and academia.

In this phase, the EU needs to move beyond the attitude that companies, investors and public procurers only can be encouraged to be sustainable, and expecting reflexive processes to lead to sustainable finance, sustainable business and sustainable governance of global value chains. The EU can speak more clearly about what these market actors are doing – and the transition that they need to be a part of.

We strongly encourage the EU to continue on the path it has tentatively opened up for, setting out sustainability requirements for investors as well as for the intermediaries and facilitators in the investment chains, and for businesses and specifically their boards.

We see an international and European norm-development with the increasing recognition of the responsibility of business and finance, not just for its individual legal entity but for the global value chain upon which it bases its businesses. Member States are starting to pick up on the recognition of due diligence as the accepted mechanism for understanding the sustainability impacts across global value chains.

We now need further action, also on the EU level, to implement the overarching aim of sustainability in a way that solves the policy incoherence problems and resolves the contradictions in law and policy.

A major barrier to sustainable business is still the strong, short-term pressure for maximising returns to investors. This pressure, which we denote the shareholder primacy drive although it is detrimental also to any shareholder with more than a short-term perspective on her investment, has taken over the space company law gives corporate boards and top management to shift over to more sustainable business models. This further strengthens our SMART call for a reform of corporate law, to take back the power of defining corporate purpose and the role and duties of the board is. This could be key to a broader set of reforms, which may be necessary to mitigate the systemic unsustainability of business and finance today.

While there are positive tendencies amongst consumers, civil society and workers, especially the younger generation, the crux remains of businesses based on selling increasing quantities of consumer products, namely their business model is one based on overconsumption. A much more consistent and comprehensive approach to achieving a sustainable circular economy is necessary if the EU is to realise the potential of this particular initiative.

We have seen that there is a tendency for well-intended initiatives to be watered down or not enforced. We hope that the growing recognition of the seriousness of the convergence of crises that the world's societies face will encourage more powerful policy and legislative action. The unresolved tension between sustainability and growth may undermine good initiatives if it is not acknowledged and confronted.

On a general note, there is a lack of knowledge and understanding of the complexity of what sustainability entails. This is evident from high-level policymakers down to individual municipalities, consumers, decision-makers in large and small businesses, fund managers and other intermediaries. There is also a lack of systems that can deal with this complexity. We posit that only by working together in unprecedented ways through new alliances, will it be possible to deal with this complexity.

This emphasises the need for closer collaboration between academia and policy-makers and the necessity of ensuring that platforms, such as the Multi-Stakeholder Platform on the Implementation of the Sustainable Development Goals, have the required mix of expertise and competence in earth sciences and in social sciences (which it does not have today).

12.2 Towards a Policy Framework for Sustainable Business

What then does sustainability require of business? A starting point may be to state that contributing to sustainability, to the implementation of the SDGs, requires that businesses, in aggregate, create sustainable value.

Sustainable value can be defined as economic value that contributes to a safe and just space for humanity, or securing the social foundation for people everywhere now and in the future, while staying within planetary boundaries. Following on the definition of sustainability in Section 2 above, sustainable value creation is an economic foundation for stable and resilient societies. It is value creation which contributes to the economic foundation for human welfare and which respects human rights in the value creation processes themselves. Sustainable value creation does this in a way that ensures the long-term stability and resilience of the ecosystems that support human life on planet earth.

One way to express this in a more digestible form for business is to suggest that businesses adopt sustainable business models. Schaltegger et al define a business model for sustainability as a model that:

> helps describing, analyzing, managing, and communicating (i) a company's sustainable value proposition to its customers, and all other stakeholders, (ii) how it creates and delivers this value, (iii) and how it captures economic value while maintaining or

> regenerating natural, social, and economic capital beyond its organizational boundaries.[240]

Business models for sustainability will be specific to their sector and line of business. However, drawing on the definition of sustainable value creation above, we may say that a sustainable business model entails certain basic commitments by a company. Under a sustainable business model, a business commits to:

a) Creating sustainable value that contributes to realizing a safe and just space for humanity.
b) Respecting the ecological boundaries of our planet and the fundamental human rights that form the basis for human welfare throughout its value chain activities globally;
c) Continually assessing the sustainability of its impacts of its activities, including the impacts of its products, services and processes, throughout its value chain globally;
d) Taking prompt and concrete action to stop activities which have negative impacts on sustainability and ensuring a continuous improvement processes to meet its the commitment to create sustainable value within planetary boundaries; and
e) Communicating these efforts in a verifiable manner internally in the business and externally to society.

To what extent the business can have overview of and influence its contractual parties, and where relevant, the global value chains of its products, services and processes, will naturally vary with the size and position of the business.[241]

Developing sustainable business models can be done from the beginning, for start-ups, or through a transformation of existing business models. The other market actors – in the financial markets, the investors and the intermediaries, and in the end-product markets, the consumers and the public procurers – will, in a sustainable economy, engage with companies with a sustainable business model in a way that facilitates, promotes and supports the sustainability of their business. Businesses with non-sustainable business models should then either be

[240] S. Schaltegger et al., 'Business Models for Sustainability: Origins, Present Research, and Future Avenues', (2016) 29(1), *Organization & Environment.* 3-10, DOI: 10.1177/1086026615599806
2016, Vol. 29(1) 3–10, DOI: 10.1177/1086026615599806
[241] We discussed archetypes of such influence in Section 4 above.

encouraged or mandated to change their business models or they should be avoided by the other market actors.

A policy framework for sustainable business models encourages and ensures that sustainable business models thrive. A policy framework that promotes and strengthens sustainable business models is open to reconsideration of hegemonic approaches, such as that of businesses' responsibility towards society being something that should only be 'company led' and that the role of regulation should only be complementary and supportive.[242] It does not take path-dependent choices, but rather reconsiders afresh what is required based on the principle of 'Think Sustainability First'.[243]

A policy framework for sustainability engages with the governance of global value chains, ensuring that this governance, in aggregate, contributes to supporting the social foundation for people in lower and lowest-income countries while at the same time being a part of the necessary transition away from linear and unsustainable business models to circular and sustainable ways of organizing business.

The transnational nature of global value chains entails that if this aspect of the implementation of the SDGs is not sufficiently dealt with, (other) national and regional attempts at implementing the SDGs will be undermined.

Policy coherence for sustainable development thereby requires taking the goal of sustainability as a framework. Within this framework, it needs to be analysed whether existing regulation (broadly understood, including law, social norms, market influences and also the effect of the physical world) of the market actors facilitates and, where necessary, mandates, decisions that

[242] COMMISSION STAFF WORKING DOCUMENT, SWD(2016) 390 final, Key European action supporting the 2030 Agenda and the Sustainable Development Goals. Accompanying the Commission Communication COM(2016) 739 final.

[243] As proposed by the High Level Expert Group on Sustainable Finance, in their final report of 31 Jan. 2018, and followed up in 'Implementing the Sustainable Development Goals through the next Multi-Annual Financial Framework of the European Union', Advisory report to the European Commission by the Multi-Stakeholder Platform on the Implementation of the Sustainable Development Goals in the EU, March 2018.

contribute to a safe and just operating space for all humanity. In such a safe and just operating space, human rights and other fundamental social rights are promoted and protected within planetary boundaries. To achieve sustainability, it is crucial to create forces or incentives that transcend the silo-thinking and categorisation that prevents the necessary holistic and integrated approach.

12.3 SMART work towards 2020

The SMART Project now moves into the phase where we will concentrate on developing reform proposals. We therefore share at the end of this report some tentative reflections on the areas that we will focus on towards 2020.

Our ***reform proposals*** will consist, where we believe this is necessary, of proposals to adopt or reform existing legislative instruments. We will also develop proposals aimed at the actors themselves, and we anticipate doing this work in the following areas:

- Company law and corporate governance codes and recommendations
- Sustainable corporate governance
- Sustainable global value chains governance
- Sustainability assessment tools
- Sustainability reporting systems and rules
- Sustainable finance, including financial and securities market law
- Sustainable public procurement
- Consumer to business relationship
- Product regulation
- Impact assessment for policy coherence for sustainability

General goals for our work in the forthcoming phase will be to achieve policy coherence between various initiatives, laws and policies, both horizontally and vertically. We will also focus on strengthening the international and transdisciplinary collaboration, consciousness-raising – and broader industry engagement.

We look forward to receiving feedback to our results and our tentative reflections on how to move forward. We strongly believe that unprecedented collaboration across fields is necessary to achieve sustainability, and we welcome possibilities to engage with other actors.

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