Understanding the governance of corporate social and environmental impacts

If you are running a global business, the rise in regulations related to products, supply chains, and non-financial reporting can seem overwhelming. This brief aims to place these demands in a longer historical context, explaining why there is currently an acceleration of these kinds of governance devices, why the EU is a key driver of this approach, and how these requirements are becoming part of the new 'normal' for doing business. Importantly, these approaches are likely to make sustainable development more rather than less likely. In the context of SeaBOS, the commitments and prior work undertaken to address them have provided member companies with a head start in understanding supply chains, enhancing raw material traceability, addressing modern slavery, and developing experience in corporate reporting.

1. The longer view

Before the 1950s, corporations usually operated within a limited geographic area, most often in the country where they were incorporated or headquartered. This allowed governments to regulate corporate activities to ensure wider social goals were met, such as reducing local pollution (which impacted public health) and ensuring fair treatment of workers (by regulating working hours and safety conditions). This situation changed when globalisation took effect and led to two problems that more 'modern' forms of corporate regulation seek to address. First, corporations headquartered in one country may cause adverse effects in other countries. This can create tensions between nations and raise concerns that goods manufactured abroad may have negative effects that are outlawed in the importing country. Second, the activities of corporations operating within a country may not be fully within government control, especially if the country has fewer regulations or a limited ability to enforce existing ones. In both cases, these governance gaps result in harms that existing legal frameworks do not adequately address. Sustainability-focused corporate regulation is designed to address this situation.[1]

Over the past 50 years, corporate regulation for sustainability has gone through three distinct phases, with a fourth phase (arguably a revolution) now unfolding. The first phase of governance arose in the 1970s, exemplified by the OECD's Guidelines on Multinational Enterprises (most recently updated in 2023). These guidelines codified expectations for the behaviour of OECD headquartered companies and introduced a grievance mechanism for the resolution of disputes. At this time, consumer boycotts of products and corporations also became more prevalent as a means to demand more 'sustainable' products[2], while the regulations primarily addressed social issues, focusing on workers and consumers, with only a vague consideration of environmental impacts (which has since expanded).

The second phase began around 2000 and focused on guiding corporate behaviour by encouraging companies to disclose their impacts. The assumption was that if corporations were transparent about their impacts, they would be more likely to think about how to remedy negative effects. The United Nations Global Compact was launched around this time along with several voluntary reporting guidelines, such as the Global Reporting Initiative which was established in 1997 and remains the longest-standing framework for impact reporting. This phase also saw the emergence of 'ethical' investors and screened funds, which, like earlier consumer boycotts, brought economic considerations to the fore. These investors were seeking to limit their risk exposure to activities they believed would undermine long-term economic returns and did not align with their ethical values.

By the late 2010s, a third phase of governance emerged in response to some of the failures of the previous phase. In particular, voluntary reporting to inform stakeholders and financial actors had remained limited and 'greenwashing' concerns were rife. This led to the development of mandated corporate reporting requirements to ensure widespread reporting and improve its quality. Ongoing scientific and ethical concerns also resulted in new expectations for corporate behaviour. While there have always been mandatory disclosures related to health and product safety, new topics appeared linked to concerns about climate change, biodiversity loss, novel materials (such as plastics) in the environment, and the resurgence of modern slavery.

2. Current corporate regulation approaches

The fourth phase of regulation is now emerging, characterized by the interlocking of requirements in three ways:

Regulation of companies and investors

First, disclosure regulation now focuses on both corporations and capital market participants, seeking to align sustainability incentives across both. Importantly, rather than mandating a particular performance level (which is underpinned by direct regulation), this requires economic entities to disclose how, and to what extent, they have integrated environmental, social and governance (ESG) factors into their operations. Stock exchanges, which are themselves private entities, are part of this approach as they seek to understand, communicate and mitigate risks in their markets. This aspect of regulation is not novel but is intensifying as global environmental change accelerates. In addition, common approaches as to what constitutes 'sustainable' activities are applied equally to corporations and investors. For example, under the EU sustainable finance framework the EU Taxonomy seeks to provide clear guidance for companies affected by the European Union's Corporate Sustainability Reporting Directive and for investors affected by the Sustainable Finance Disclosure Regulation as to what is 'sustainable'.

Common global expectations

The second type of interlocking involves the evolution of common expectations across multiple countries. This is most evident within the EU, given the nature of the single market, but it also extends beyond the EU. For example, the approach of using a taxonomy to define 'sustainable' activities is gaining traction globally, with the second version of the Association of Southeast Asian Nations (ASEAN) taxonomy becoming effective in February 2024 (with around 24 Taxonomies in development or in existence presently). This means of regulating is designed to evolve in response to new scientific developments and is linked to global agreements on climate change – and likely on biodiversity too in the future. Another example is the 2023 ESG reporting requirements for corporations listed on major Chinese stock exchanges. Driven by investors' needs to assess global opportunities and risks, stock market listing requirements have been crucial for spreading regulatory expectations from developed economies to the rest of the world. Countries that wish to attract foreign investors also seek to provide a 'level playing field' in terms of corporate governance requirements.

Regulating products and market access

The third element entails controlling corporate access to markets through a focus on raw materials and products. Here the rationale is that consumers want to consume goods made with the same level of safety and probity as those produced domestically. This is evident in the EU's ban on imports of goods made with slave labour (mirroring the State of California's longstanding approach in this area). Another example is the prohibition of commodities and products associated with deforestation. Ensuring the desired quality of commodities and goods requires sound due diligence of supply chains as well. Consumer protection, including advertising standards, is also becoming a powerful aspect of regulation, with regulations across the globe focusing on if 'green claims' can be verified. This legislation is also prompted by the perception of high levels of dishonesty in advertising claims.

3. Essential elements of governance

All of the trends identified in this section have earlier precedents, but together, they are reshaping the corporate governance context for transnational corporations.

Corporate governance has transnational effects

A single corporation will be affected by regulatory expectations both in the country where it operates and in the country where it is headquartered. With transnational regulation becoming the 'norm', companies will have to comply with multiple sets of requirements. Initially, there will likely be different approaches to regulation in different countries, increasing the cost and complexity of compliance. Over time, however, the harmonization of regulations onto a more common basis will likely emerge. For example, the various due diligence requirements introduced by individual EU member states over the past five years have recently been consolidated into the EU-wide Corporate Sustainability Due Diligence Directive. When the Directive is implemented all corporations in the common market become subject to the law, albeit that some of the detailed legislation will vary between countries.

Corporate responsibilities extend beyond direct activities

The EU's Corporate Sustainability Due Diligence Directive illustrates another characteristic of modern

Why is the EU leading in transnational regulation?

The EU has long been a source of innovation in corporate governance terms, in part because it has the views and experiences of its member states to draw from. The size of the EU market also means that any innovations it adopts will have wider effects than a single country governance experiment.

In addition, and critically, the EU has incorporated environmental concerns as a central part of its policy making.[3] In part, this reflected political preferences of European population (such as the Green Party electoral success, which started in Germany in 1983) as well as the poor state of the environment of several European countries due to their earlier move to industrial economies. This also a strategic decision by the EU to take the lead on sustainability matters.

The EU drives policy making through economic plans with the most recent one – the Green Deal – having a central focus on environmental matters. This means that the economic policy of the EU block has environmental concerns at its heart. Given that corporate activities drive the shape of economies, regulating corporate behaviour directly (through import bans) or indirectly (through due diligence reporting requirements) is essential to achieve broader economic objectives. This also means that governments view financial markets as a way to steer their economic interests.

The EU's approach are also in line with global agreements to address climate change and biodiversity loss, as well as with the UN Guiding Principles on Business and Human Rights, with a protect, respect and remedy focus.

Finally, the structure of the EU itself promotes regulatory innovation and reach. This happens in two ways: (1) the EU (as a supranational body) can regulate activities in all members states (as they have for accounting standards) or (2) create Directives (in its inter-governmental role) that require Member States to adopt new regulatory approaches or achieve particular outcomes. This means that different Members in the EU may adopt different approaches to regulating (that suit their needs) and makes it complicated to work in the block.

Note: A supranational body is one that governs a country, to the extent that it has been given powers to the body to regulate it. An inter-governmental body fosters agreement on principles/outcomes, which each member country will implement within their borders. The international climate change and biodiversity panels are inter-governmental bodies.

governance: the extension of responsibilities beyond direct activities. Under this directive, companies are expected to take responsibility for their value chain behaviours, where they have some degree of influence over the outcomes. Such an approach encourages a more relational and less transactional relationship with suppliers and customers. However, there is anecdotal evidence that due diligence requirements are resulting in transnational corporations reducing their number of suppliers with consequences for smaller suppliers who may be losing livelihoods. Similarly, the focus on addressing 'scope 3' emissions is a further example of increasing expectations that corporations manage impact beyond their direct control. Although this can be difficult, it is becoming the new norm for areas where system wide negative aspects exist.

Corporate governance reflects ecological principles

Ecological principles are being integrated into corporate governance in two ways. First, the topics on which disclosure is sought reflect those parts of the bio- and atmosphere that are most out of balance, such as climate change and biological resources. Institutions charged with ensuring the stability of the global financial system (e.g., central banks and intergovernmental bodies such as the World Bank) are concerned that climate change and biodiversity loss pose an existential threat to economies and markets. Second, the kind of information being required reflects this concern. For example, companies are increasingly asked to provide details on their transition plans to assure markets that their commitments are backed by plans for a 'just' transition. This focus not only aligns with global inter-governmental agreements but also addresses the broader concern that rising inequality could destabilize economies and societies. Likewise, requiring information on dependencies (i.e. how companies rely on well-functioning ecosystems) also reflects ecological principles and constitutes an extension of the more traditional focus on impacts. For instance, initiatives like the Taskforces on Climate- and Nature-related Financial Disclosures emphasise the financial risks associated with these dependencies.

The need for robust information to underpin ecologically focused reporting is substantial. For example, understanding a company's actions, impacts and dependencies requires traceability not only of its direct activities but also throughout its value chain. In the case of biodiversity impacts, the spatial location of the activities is also required. Translating physical actions into ecological categories, such as 'sustainably harvested', demands integrating scientific knowledge into business mapping processes. Voluntary governance mechanisms such as the Science Based Targets Initiative (for climate change) and the Science Based Targets

Network (for biodiversity) can help translate global policy goals into actionable steps at the organizational level.

Figure 1 demonstrates (for key aspects of the EU requirements) the inter-locking nature of elements of corporate focused regulation.

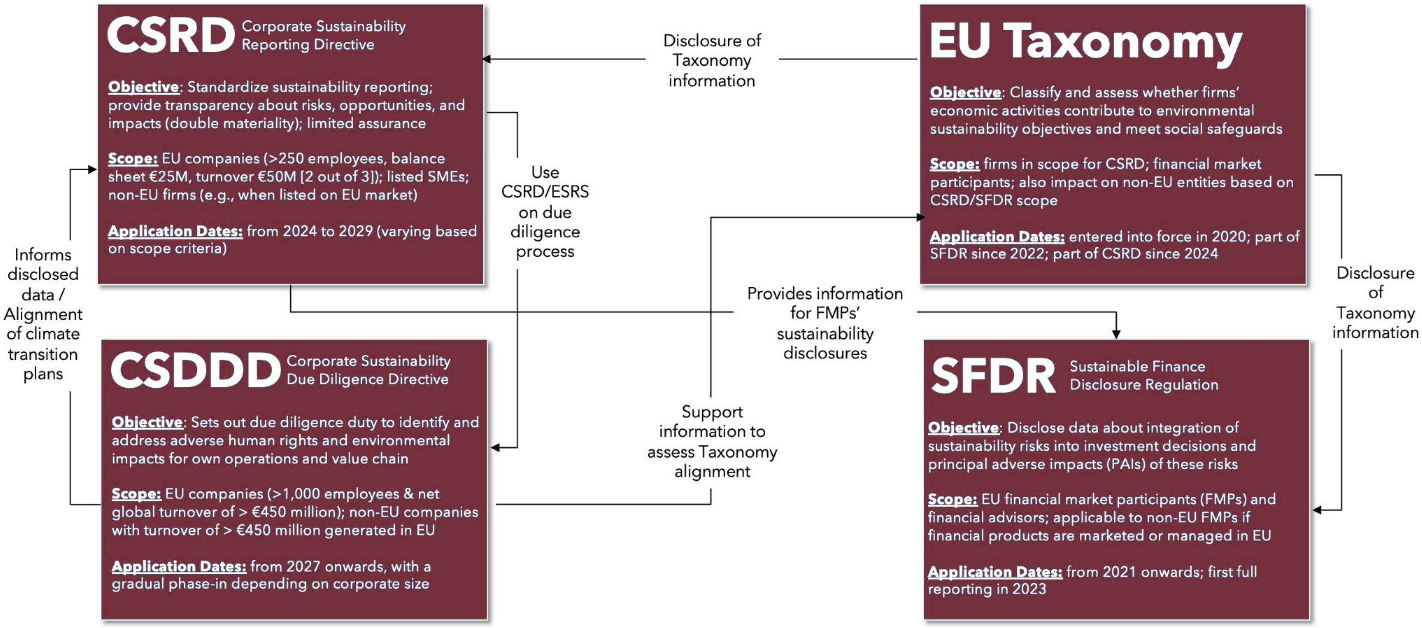

Figure 1. Interlocking EU regulations. (Source: Andreas Rache, Copenhagen Business School and reproduced with his permission)

References

1. Österblom, H., Bebbington, J., Blasiak, R., Sobkowiak, M. and Folke C. (2022). Transnational Corporations, Biosphere Stewardship, and Sustainable Futures. *Annual Review of Environment and Resources*, 47(1). 609-635.
2. The first consumer boycott that we know of happened during the 1700s and by 1791 around half a million United Kingdom consumers were boycotting slave-produced sugar. This movement sought to reduce demand for slave-produced sugar so that there would be an economic as well as a moral drive for eliminating chattel slavery.
3. Bebbington, J. (1993) The European Community Fifth Action Plan; Towards Sustainability. *Social and Environmental Accountability Journal*, 13(1) 9-11.

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