Launch Event

Evaluation of the Corporate Sustainability Due Diligence Directive (CS3D)

ERCST, December 9, 2024

Andrei Marcu, Michael Mehling & Ana Ruiz

ERCST
Roundtable on Climate Change and Sustainable Transition

1) Context of the work

Against the backdrop of the recently published EU CS3D – and **its entry into force on July 25, 2024:**

- ERCST has conducted an evaluation of the final text of the CS3D, building on its previous work resulting in the report "*The EU Corporate Sustainability Due Diligence Directive and its Extraterritorial Effect: Promise and Pitfalls*"
- This analysis considers, namely: (i) the two previous negative opinions from the European Commission's Regulatory Scrutiny Board; (ii) the Commission Staff Working Document; and (iii) the Commission's initial proposal.
- Focus is given to the directive's key provisions and elements, as well as unresolved issues, such as inconsistencies with other directives (like CSRD), company concerns about due diligence, extraterritoriality, liability risks, administrative burdens and impacts on non-EU businesses.

2) CS3D background and rationale

Roundtable on Climate Change and Sustainable Transition

Advancement of Human Rights and Environmental Standards:

- Driven by international **soft law frameworks**: (i) *UN Guiding Principles on Business and Human Rights;* and (ii) *OECD Guidelines for Multinational Enterprises on Responsible Business Conduct.*
- Strengthened by **mandatory human rights and environmental due diligence (mHREDD) laws** in EU Member States: (i) UK's *Modern Slavery Act* (2015); (ii) France's *Duty of Vigilance Act* (2017); (iii) Netherlands' *Child Labour Due Diligence Law* (2019); (iv) Germany's *Supply Chain Due Diligence Act* (2021); (v) Norway's *Transparency Act* (2021).
- **EU's** Primary law mandates advancing **human rights** and **sustainable development** internationally. CS3D aims to:
  - Establish a **harmonized framework** for sustainability due diligence.
  - Avoid legal fragmentation and ensure a **level playing field** within the EU single market.

2) Legislative process

- EC initiated a preparatory phase for a legislative procedure focused on **sustainable corporate governance** in summer 2020.
- Objective: Strengthen EU corporate governance to address **sustainability-related aspects** (i.e., human rights, climate change, and environmental concerns) within their operations and values chains.
- **Public consultation** on sustainable governance initiative: October 2020.
- Following this, EP adopted two resolutions:

  - **December 2020**: Non-legislative resolution on sustainable corporate governance.

  - **March 2021**: Recommendation for legislative action on corporate due diligence and accountability.
- **Council conclusions**: December 2020, called for EU legal framework on due diligence.

2) Legislative process (cont.)

Legislative Proposal and Challenges:

- EC's legislative proposal unveiled on **February 23, 2022** (delayed from 2021).

Prior to this, **Regulatory Scrutiny Board (RSB) Opinions**:

  - Preliminary and revised impact assessment received **two negative opinions** (April & November 2021).
  - Final proposal accompanied by revised impact assessment and staff working document with additional explanations.

Inter-institutional negotiations:

- Trilogues between ECn, EP, and Council began February 2023.
- **Provisional agreement** reached December 14, 2023, but failed approval by the Coreper in February 2024 due to Member State opposition (e.g., Germany, Italy, Austria, and Finland, France).

2) Legislative process (cont.)

Revised Compromises:

- Belgian Presidency successfully renegotiated and revised key sections of the text **personal scope**, **civil liability**, and **chain of activities** definitions.
- Secured **qualified majority** – albeit by a narrow margin – approval on March 15, 2024.

Final Adoption Timeline:

- EP plenary adoption: **April 24, 2024**.
- Council adoption: **May 24, 2024**.
- Directive published: **July 5, 2024**; entered into force **July 25, 2024**.

<u>Overall, a process that lasted 4 years.</u>

2.2. ERCST's 1st Project

ERCST participated in discussions on **extraterritorial effects** of the CS3D:

- Highlighted concerns about regulatory overreach, international trade conflicts, and sovereignty challenges.
- Debate over whether CS3D represents genuine extraterritorial regulation or a **territorial extension** of EU policymaking.
- EU's approach reflects the **"Brussels Effect"**, influencing global laws but raising questions on:
  - Alignment with **national sovereignty** under the UN Charter.
  - Potential conflict with **CBDR-RC principles** in the UNFCCC and Paris Agreement.
- **Potential Challenges**:
- Risk of shifting **collective national obligations** under international treaties to individual corporate responsibilities.
- Concerns about undermining the **cooperative essence** of multilateral commitments like the Paris Agreement.

2.2. ERCST's 1st Project: Key Recommendations

1. **Harmonized EU-wide Standards**: Prevent legal fragmentation, reducing compliance costs and improving legal certainty. Focus on SMEs' ability to navigate regulatory requirements.
2. **Global Impact Assessment**: Consider effects on **developing countries** to avoid creating trade barriers or exacerbating inequalities.
3. **Proportionate Enforcement**: Define clear enforcement methods to minimize litigation and legal uncertainty. Ensure civil society's role is effective but not overly burdensome for businesses.
4. **Economic Balance**: Avoid excessive compliance costs that could lead to **offshoring** or reduced EU investments.
5. **Stakeholder Engagement**: Foster collaboration with diverse stakeholders inside and outside the EU. Balance **environmental and social goals** with economic competitiveness.

- **Goal**: Optimize the Directive's implementation while addressing global and economic challenges.

3) EC Regulatory Scrutiny Board (RSB): Overview

- The EC RSB, composed by nine members, is an independent body within the Commission that advises the College of Commissioners.
- The Board’s role is to provide quality assurance of Commission impact assessments, ‘fitness checks’ of multiple policies and laws, and major evaluation reports to the political level of the Commission.
- These are an assessment of <u>the quality of the impact assessment and **not** an assessment of the related legislative proposal</u>.
- Under the Working Methods of the EC, any initiative requiring an impact assessment must secure a positive opinion from the EC RSB before proceeding to Inter-Service Consultation.
- <u>The Vice President for Inter-Institutional Relations and Foresight may authorize the continuation of preparations for an initiative that has received a second negative opinion from the EC RSB</u>.

3.1. The Case of the CS3D

With the agreement of Vice-President for Inter-Institutional Relations and Foresight, Maroš Šefčovič, the **EC has deemed it appropriate to proceed with the CS3D initiative not only because it was included in the 2022 Joint Political Priorities by the EP, the Council, and the EC, but also for the following stated reasons**:

(i) *Political importance*: The initiative aligned with the EC's priority of "*An economy that works for people,*" supporting the Sustainable Finance package and the European Green Deal.

(ii) *Urgency of action*: Prompt action was required in the field of supply chain due diligence to facilitate the sustainability transition, **mitigate the risk of Single Market fragmentation**, and address growing demands for legislative clarity.

(iii) *Addressed shortcomings*: Additional clarifications and evidence was provided to address the EC RSB's concerns – by the accompanying Staff Working Document – and these were considered incorporated into the revised legal proposal.

3.2. EC RSB Negative Opinions

Roundtable on Climate Change and Sustainable Transition

1) Vague problem definition

- The impact assessment report lacked specific evidence on the scale and evolution of environmental and sustainability issues linked to the insufficient use of corporate sustainability management practices by EU companies, including SME's.
- While it highlighted the benefits of adopting these practices, failed to adequately identify and provide evidence for the barriers preventing companies from pursuing sustainable management.
- Needed to more convincingly demonstrate why market dynamics and corporate strategies are insufficient.
- Better substantiate the link between sustainability tools and their impact on addressing these problems.

3.2. EC RSB Negative Opinions (cont.)

ERCST
Roundtable on Climate Change and Sustainable Transition

2) Limited Analysis of Policy Options

a. Directors' Duties vs. Due Diligence:

- Lacked clarity on why regulating directors' duties was necessary in addition to due diligence.
- Needed to explain its added value.
- Lacked the justification for why stand-alone options (directors' duties or due diligence) were not considered.

b. Enforcement and liability:

- Dismissed due diligence without civil liability without proving ineffectiveness.
- Did not compare all enforcement options, including a stand-alone administrative supervision option.
- Needed more details on sanctions for non-compliant third-country companies and potential legal consequences.

3.2. EC RSB Negative Opinions (cont.)

2) Limited Analysis Policy Options (cont.)

c. Medium-Sized Companies:

- Justification needed for including medium-sized companies in high-impact sectors.
- Clarify phase-in process and safeguards to prevent large companies from imposing undue compliance burdens on SMEs.

d. Coherence with other initiatives:

- Personal scope should have been be better aligned with CSRD and consider the relevance of international environmental conventions in due diligence obligations.
- Needed to clarify rules for foreign companies, turnover thresholds, and the scope of operations (EU-linked or global).

3.2. EC RSB Negative Opinions (cont.)

ERCST
Roundtable on Climate Change and Sustainable Transition

2) <u>Limited Analysis Policy Options (cont.)</u>

e. Mandatory Science-Based Targets:

- Lacked clarification and substantiation for the need of mandatory science-based climate targets.
- Needed to explain why climate targets were tied to company size, not emissions.
- Needed to justified why science-based targets are part of directors' duties, not due diligence.

f. Public Authorities' Role:

- Needed to clarify how authorities will monitor compliance and coordinate enforcement, especially with non-EU companies.

3.2. EC RSB Negative Opinions (cont.)

ERCST
Roundtable on Climate Change and Sustainable Transition

3) Imbalanced impact assessment

- Lacked a balanced and neutral view on impacts related to competition, innovation, agility, and litigation risks.
- The impact on competition, supplier diversification, and supply chain resilience should have been thoroughly assessed.
- Needed to assess risks in developing countries, such as "sustainability leakage" – i.e., if EU companies will ultimately have to withdraw from certain suppliers due to sustainability issues, non-EU companies (out of the scope) may take over suppliers without improving human rights or environmental standards.
- Lacked the evaluation of how these measures affect EU companies (on the global playing field and competitiveness), particularly SMEs, in comparison to third-country competitors not subject to the same thresholds or obligations.

3.2. EC RSB Negative Opinions (cont.)

ERCST
Roundtable on Climate Change and Sustainable Transition

4) Insufficient Proportionality Assessment

- Did not sufficiently demonstrate the proportionality of the preferred option.
- Did clarify the initiative's substantial costs BUT did not sufficiently address the uncertainty of whether the estimated benefits will outweigh these costs.
- Should have better compared options based on their effectiveness in achieving the specific objectives outlined, ensuring a clearer analysis of their expected impact.

5) Inadequate Stakeholder Views

- Did not effectively integrate stakeholder views, particularly criticisms from SMEs and other sectors. Needed to be a more balanced presentation of these perspectives.

3.3. Commission Staff Working Document

ERCST
Roundtable on Climate Change and Sustainable Transition

1) Problem description

- Sustainability performance improving globally, with **Europe leading**.
- **Gaps persist**:
  - Less than 35% of companies have **sustainable procurement policies**.
  - **Supply chain risk analysis** underutilized.
  - **Industry federations** lack concrete actions like target-setting.
- Clear **due diligence standards** required to:
  - Reduce **transaction costs**.
  - Create a **level playing field** for companies, investors, and consumers.
- **CS3D** complements regulations like: (i) **Conflict Minerals Regulation**; (ii) **Deforestation Proposal**; (iii) **Batteries Proposal**.
- **Broad Coverage of CS3D**: **Horizontal requirements** for wider sustainability issues.
- **Alignment with European Green Deal and Global Alignment.**

3.3. Commission Staff Working Document (cont.)

ERCST
Roundtable on Climate Change and Sustainable Transition

2) Policy Options

- **SMEs excluded**; focus on:
    - Companies with **>250 employees and €40M turnover** in high-impact sectors.
    - Companies with **>500 employees and €150M turnover** across all sectors.
- **High-impact sectors** defined based on **OECD guidance** and risk of adverse impacts.
- Non-EU companies with **direct EU market links** included under the same thresholds.
- **Midcap companies** in high-impact sectors have a **2-year transition** period.
- Due diligence for these companies limited to **severe impacts** in their sector.
- **Support for SMEs**: (i) accessible tools like **hotlines**, **training**, and a potential **observatory** for assistance; (ii) measures to **minimize indirect impacts** on SMEs in the value chain.
- **Material Scope**: retains a **cross-cutting framework** for human rights and environmental impacts, addressing issues comprehensively.

3.3. Commission Staff Working Document (cont.)

ERCST
Roundtable on Climate Change and Sustainable Transition

2) Policy Options (cont.)

- **Directors' Duties** – aligned with due diligence processes, including:
  - Setting and overseeing **corporate due diligence** measures.
  - Integrating **sustainability** into corporate strategies.
- Clarified **general duty of care** to include human rights, climate change, and environmental impacts over short-, medium-, and long-term horizons.
- **More extensive proposals** for directors' duties were omitted to ensure proportionality.
- **Civil Liability**: Established as a key enforcement tool, complementing **administrative supervision**.
- Reflects international standards (**UN Guiding Principles**) and mirrors EU practices (e.g., competition law).
- Provides **legal clarity** and remedies for victims (e.g., land restitution)Universally applicable, ensuring remedies across jurisdictions.
- Concerns about **litigation** mitigated by evidence from existing laws and unchanged **burden-of-proof** rules.

3.3. Commission Staff Working Document (cont.)

3) Assessment of impacts

Reduced procedural costs:

- €760M annually, €220M one-off (vs. €1.72B and €500M previously).
- Non-EU companies: €240M annually, €70M one-off.
- Administrative costs minimized due to overlap with existing **CSRD reporting requirements**.
- Supervisory costs: €5.55M annually, €130K one-time setup.

Proportionality:

- SMEs excluded; **midcap companies** face simplified obligations for severe impacts only.
- Support measures for SMEs include:
  - Financial aid, training, and observatories for supply chain transparency.
  - Model contracts and multi-stakeholder initiatives.

3.3. Commission Staff Working Document (cont.)

ERCST
Roundtable on Climate Change and Sustainable Transition

3) Assessment of impacts (cont.)

Third-Country Impact:

- Promotes global due diligence, aligning with **EU trade and development policies**.
- Risks mitigated by shared costs, local engagement, and sustainability investments.
- Collaboration with third-country governments to strengthen governance and practices.
- **Competition and Competitiveness**:

Anti-competition risks addressed with revised Horizontal Guidelines and merger controls.

- Vertical integration unlikely to increase significantly due to high costs and complexity.
- Initiative fosters **sustainable product innovation** and aligns with EU values.
- Benefits include enhanced risk management, reputation, and legal clarity.

3.3. Commission Staff Working Document (cont.)

ERCST
Roundtable on Climate Change and Sustainable Transition

4) Proportionality of the Preferred Option

Proportionality Enhancements:

- **SMEs excluded**: Protects SMEs from disproportionate demands by business partners.
- **Midcap companies in high-impact sectors**: Reduced scope with narrower sector definitions and streamlined obligations.
- **Third-country companies**: Scope aligned with EU companies for consistency.
- **Civil liability**: Specific conditions introduced for damages in indirect established business relationships.

Reduction in Affected Companies:

- Approximately **13,000 EU companies** and **4,000 non-EU companies** now covered.
- Non-EU company figures were not part of the initial impact assessment.

Key Outcome:

- Adjustments ensure proportionality while aligning with the initiative’s sustainability objectives.

4) Final Text *vis-à-vis* the Proposal of the European Commission

ERCST
Roundtable on Climate Change and Sustainable Transition

4.1. Subject Matter (Article 1), Personal Scope (Article 2) and Material Scope (Article 5)

- Mandates **human rights and environmental due diligence** across a company's operations, subsidiaries, and "business partners" within their **chain of activities**. **Terminology changed**: Replacement of "*established business relationships*" (EC Proposal) with "*business partners*" and "chain of activities."
- **"Chain of activities" (Article 3(1)(g)**) encompasses company's business partners (direct and indirect): (i) **upstream activities**: including design, sourcing, manufacturing, transport, and supply. (ii) **downstream activities**: limited to distribution, transport, and storage **performed for or on behalf of the company. Exclusions**: Disposal activities and downstream activities related to services of a company's business partners (Recitals 25 and 26).
- **Climate Transition Plan**: Beyond due diligence obligations, <u>companies required to adopt and implement plans for **climate change mitigation**</u>, now explicitly included as a **core pillar** of the Directive.
- **Thresholds for large companies** increased significantly:
    - **EU companies**: Now 1,000+ employees (previously 500) and €450 million+ turnover (previously €150 million).
    - **Non-EU companies**: €450 million+ turnover within the EU (previously €150 million).
- The **high-impact sector category** for midcap companies was **removed** entirely. SMEs remain excluded to prevent excessive burdens. **Acknowledged spillover effects**: SMEs engaged in supply chains of larger companies may still be indirectly impacted.
- Final Directive expected to cover **5,500 businesses** (60–70% fewer than prior drafts).
- **Risk-Based Approach**: Aligns with international human rights due diligence standards. Emphasis on **risk management**, **remediation**, **stakeholder engagement**, and **prioritization** of harms/risks.

4) Final Text *vis-à-vis* the Proposal of the European Commission

4.2. Material Scope – Combating climate change (Article 22)

- The provision requires companies to "*adopt and put into effect*" a transition plan for climate change mitigation ("TPCCM") **aiming to ensure, through *best efforts***, that the company's business model and strategy are **compatible with** the transition to a sustainable economy and a **goal of limiting global warming to 1.5°C** – referencing the Paris Agreement – and the objective of achieving climate neutrality as established by the EU Climate Law, including its intermediate and 2050 climate neutrality targets.
- While under CSRD the emphasis is, prima facie, on the disclosure/ report of the TPCCM, the formulation of the legal obligation in Article 22 of the CS3D is **explicitly twofold**:

(i) the duty "**to adopt**", which implies the existence of a formal internal approval of the plan; and

(ii) the duty "**to put into effect**", which adds to the adoption a duty directed towards implementation.

4) Final Text *vis-à-vis* the Proposal of the European Commission

ERCST
Roundtable on Climate Change and Sustainable Transition

4.2. Material Scope – Combating climate change (Article 22)

4.2.1. Obligation of conduct vs result

- The last part of the CS3D TPCCM obligation, i.e., the **duty to implement/put into effect**, is explicitly phrased (i.e., the wording "*through best efforts*") as an obligation of conduct or means (cf. also Recital 73)
- The "*best efforts*" refers to the goal, and the goal is ensuring 1.5°C compatibility – not that 1.5°C is the result of any individual company's actions.

4.2.2. Compatibility with limiting global warming to 1.5°C

- According to the application requirements (ESRS E1 AR2 and AR26) current approaches suggest that **companies should benchmark their efforts against the 1.5°C target**.
- This benchmark should be **based on a sectoral decarbonisation pathway**, if available for the company's sector, **or on an economy-wide scenario,** acknowledging its limitations.
- However, **without clear methodologies or sector-specific pathways established by public policies**, <u>companies, especially those operating across multiple sectors, may face significant challenges</u>.

4) Final Text *vis-à-vis* the Proposal of the European Commission

4.2. Material Scope – Combating climate change (Article 22)

- 4.2.3. Presumption of compliance in relation to CSRD

- According to Article 22(2), companies which are complying with the CSRD disclosure obligations and follow the ESRS E1 requirements on climate transition planning have complied with their duty to adopt such a plan under Article 22(1) of the CS3D.

- A *contrario sensu*, companies still have an additional obligation to put these plans into effect and update them annually describing their process according to Article 22(3) of the CS3D (cf. Recital 73).

- CS3D does not introduce any additional disclosure obligations for climate transition plans; these are fully covered by the CSRD and detailed in the ESRS.

- For the limited number of companies that fall under the CS3D but are not subject to the CSRD, the Commission is authorized, under Article 34 of the CS3D, to draft a Delegated Act to establish reporting requirements.

4) Final Text *vis-à-vis* the Proposal of the European Commission

ERCST
Roundtable on Climate Change and Sustainable Transition

4.3. Civil liability (Article 29)

- Article 29 of CS3D incorporated significant changes compared to the European Commission's original proposal, namely the emphasis on the "*right to full compensation*".

- Under this provision, a company may incur in civil liability if two conditions are met:

(a) the company negligently or intentionally failed to meet the obligations of Art. 10 and 11 CSDDD, "*when the right, prohibition or obligation listed in the Annex to this Directive is aimed at protecting the natural or legal person*", and

(b) as a result of said failure "*a damage to the natural or legal person's legal interest protected under national law was caused*".

- A notable addition from the Council is the clause stipulating that a company *"cannot be held liable if the damage was caused only by its business partners in its chain of activities"*.

- In principle, this introduces an exclusion of liability for damages caused solely by a company's direct or indirect business partners. In contrast: (i) the Commission's proposal foresaw a limitation of liability for damages caused by indirect business partners; (ii) the Parliament's mandate did not include any limitations on liability in this context.

4) Final Text *vis-à-vis* the Proposal of the European Commission

4.5. Other Provisions

- The European Commission's original proposal had two provisions related to corporate governance: Article 25 on directors' duty of care and Article 26 on "*setting up and overseeing due diligence*." Article 25 proposed that directors of in-scope companies would have a duty of care, requiring them to "*take into account [...] sustainability matters*" when acting in the best interests of the company.
- Together, these provisions would have established a framework for personal liability, potentially enabling directors to be sued individually for failing to fulfill this duty.
- However, these provisions were entirely removed from the final text, as Council strongly opposed their inclusion throughout the negotiations. This was also something that raised concerns to the EC RSB.

5) Takeways

CS3D file faced a number of institutional and political challenges:

- Among the criticisms voiced by the RSB and other stakeholders are vague problem definitions, imbalanced stakeholder engagement, and weak proportionality justifications.
- Legislative process was marked by delays and political deadlock among key Member States (e.g., Germany, Italy, France).

Trilogue process concluded with a sense of urgency:

- Final agreement reached under significant time constraint before the legislative window closed during the previous institutional cycle, which may have contributed to limited stakeholder engagement.
- Concerns remain about adequate consideration of stakeholder input and economic/geopolitical impacts.

Climate-related obligations have created significant compliance uncertainty:

- Requirement for 1.5°C-alignment introduces challenges for operationalization at corporate level.
- Lingering questions about practical application, metrics, and burden distribution across sectors and regions.

5) Takeways (cont.)

ERCST
Roundtable on Climate Change and Sustainable Transition

Economic implications may have been underestimated:

- Compliance costs remain substantial even after revisions; other initiatives suggest they may be higher in practice.
- Risks of regulatory arbitrage and trade tensions due to stringent disclosure requirements and extraterritorial reach.

Evolving economic and geopolitical context also affect CS3D file:

- EU adding further layer of regulation as major trading partners opt for deregulation and subsidy-driven support (e.g. the U.S. with the Inflation Reduction Act, or China with "Made in China 2025" and the 14^{th} FYP).
- Persistently high energy costs, fiscal pressures, and geopolitical rivalries heighten risks to EU stability (cf. Draghi Report), elevating competitiveness concerns in the new European Commission's agenda of political priorities.

Balancing Promise and Peril:

- CS3D seeks to embed sustainability into corporate governance and set a global regulatory standard, but its success will hinge on balancing sustainability goals with economic feasibility and attendant economic burdens.
- Effective implementation therefore requires careful navigation of competing imperatives and reassessment of compliance costs amidst evolving global challenges.

6) Recommendations

ERCST
Roundtable on
Climate Change and
Sustainable Transition

Overarching recommendation:

A pragmatic, iterative approach combining short-term measures with longer-term reevaluation and reform efforts in light of a dynamically evolving context and changing political priorities.

Immediate measures:

- **Conduct a comprehensive review**: Assess competitiveness implications and sector-specific impacts in light of geopolitical and economic developments, ensuring robust stakeholder engagement inside/outside the EU.
- **Improve regulatory clarity**: Issue detailed guidance on chain of activities' obligations and scope of liability to reduce litigation risks, with clear criteria for interpreting references to climate neutrality/1.5°C.
- **Accelerate capacity building efforts**: Invest in administrative resources, training programs, and digital tools to support consistent enforcement and ease compliance.
- **Enhanced global collaboration**: Engage with international stakeholders to align sustainability standards and minimize regulatory arbitrage.

6) Recommendations (cont.)

Longer-term considerations that can guide future regulatory reform:

- **Regulatory streamlining and simplification:** Consolidate overlapping obligations across different reporting regimes (e.g., CS3D, CSRD, Energy Efficiency Directive etc.) to reduce compliance burden (cf. recently announced **"Omnibus Regulation"** on a unified ESG reporting framework).
- **More tailored implementation**: Differentiate requirements based on company size, sector, and geography to ease burdens on SMEs & high-risk sectors; prioritize actions based on materiality of risks and company-specific contexts.
- **Balance ambition with feasibility**: Ensure that implementation aligns with the EU's economic resilience goals while preserving the CS3D's sustainability objectives to secure broad, long-term stakeholder and public support.

ERCST
Roundtable on
Climate Change and
Sustainable Transition

Thank you!