

ERCST Reflection Note

Corporate Sustainability Due Diligence Directive: How to make it work?

Summary

This reflection note intends to take stock of the EU legislative developments in the corporate sustainability framework with focus on the Corporate Sustainability Due Diligence Directive.

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ERCST's reflection note

1. The context: interlinkages in the corporate sustainability framework

The Corporate Sustainability Due Diligence Directive is a part of the unfolding EU corporate sustainability landscape which aims not only at increased transparency but also at integrating sustainability to strategies and everyday activity of large corporations. The core elements of this interlinked framework consist of the Sustainable Finance Disclosure Regulation, the EU Taxonomy, the Corporate Sustainable Reporting Directive and, yet to be adopted, the CSDDD.

While the proposal emanates from the Commission, one of the main advocates for the European corporate sustainability agenda, including disclosure but also regulation, is the financial sector. The Paris Agreement sets the obligation to limit increase in global average temperature to well below 2.0°C and pursuing efforts to limit to 1.5°C. The signatories also commit to making all finance flows consistent with a pathway towards low-emissions and climate-resiliency, even if the interpretation of this provision is highly disputed in UNFCCC negotiations.

The Sustainable Finance Disclosure Regulation (SFDR) entered into force in 2021. Its objective is to set the transparency requirements for “sustainable” financial products, and it is addressed to financial market participants (banks, investment funds, asset managers, financial advisors).

The EU Taxonomy is presented as a flagship of the EU sustainable finance policy. It was introduced in 2020 by the EU institutions as a classification system which gives guidance to investors with respect to economic activities that contribute significantly to a sustainable economy and society. The Taxonomy Regulation also entails obligatory reporting by non-financial undertakings and financial market participants based on the Taxonomy criteria, including a plan to align the company with those criteria in maximum 10 years.

To align with the Taxonomy, an undertaking must, among other things, respect the Minimum Social Safeguards. Those refer to the international standards related to protection of human rights set by the OECD and the UN guidelines, as well as the principles set out in the international labour and human rights conventions.

The Corporate Sustainable Reporting Directive (CSRD) was adopted in 2022 and introduces detailed reporting obligations about impact of the company and risks to the company related to environment, human rights, social standards, governance. Based on the CSRD, the companies must disclose company's strategy, business model, targets, and governance, including role of the board and management, in relation to those factors. Reporting includes transition plans to align with the Paris Agreement objectives – if undertakings have ones - and an explanation of the role of and the plans for future Taxonomy alignment. The scope of reporting is very wide as it covers all potentially affected stakeholders, in the upstream and downstream value chain of business relationship, over the short-, mid-, to long term. The information collected under the CSRD is meant to correspond with the requirements of SFDR and the needs of financial sector to label its financial products as sustainable.

It must be noted that these pieces of legislation together, well intentioned as they may be, represent a significant foray of the regulator and public authorities into the market economy. This impacts not only economic efficiency, but also the overall society balance between the role of public institutions and market economy, something that we always must reflect on when new legislation is introduced or existing one is updated.

2. The Corporate Sustainability Due Diligence Directive: main features of the Commission proposal

A proposal for the Corporate Sustainability Due Diligence Directive (CSDDD) focuses on the adverse impacts of businesses on environmental and human rights, along their value chain, upstream and downstream. The CSDDD expands obligations of companies in this regard when compared to the Taxonomy (as present in the Minimum Social Safeguards) and the CSRD.

In contrast to other elements of the sustainability framework, the CSDDD goes beyond disclosure requirements and introduces the obligation for companies to actively manage these issues: identify, prevent, end, mitigate and publicly inform about them. Many of the requirements defined in the CSDDD are broadly based on international standards and conventions, including those of OECD, UNGP, international labour and human rights conventions. This represents a significant and a quantum leap in terms of passing state responsibilities onto private sector companies and privatizing some functions of the state.

The CSDDD passes on to companies some duties that were conceived as public obligations, national or global in some cases, and obliges them to integrate them in company strategy, policies, and procedures, in some instances through interventions in what are the responsibility of management, boards and shareholders, including provisions such as:

- Director's duty to set up, implement and oversee due diligence, including the complaints procedure
- Director's remuneration linked to the fulfilment of the corporate climate plan
- Responsibility for breach of director's duties regarding due diligence
- Civil liability of the company for failure to comply in case of causing an adverse impact
- Possibility to sue the undertaking for compensation for damages, also for operations of subsidiaries and of established business partners
- Administrative orders and fines for failure to comply – implemented at Member States level
- Transition plans to align with the Paris Agreement objectives

In addition, not as a matter of principle but one of practicality, all the elements of the corporate sustainability framework presented above require understanding, navigating, implementing, and supervising this framework by the public authorities will require significant resources: human, financial and in terms of time.

Also, as a matter of practicality, putting responsibility for very broad national level concepts on companies for a whole value chain is something that at a minimum can be labeled as impractical.

3. The CSDDD in the legislative process

The complex and sensitive nature of this piece of legislation is reflected by the fact that the draft proposal has been rejected twice by the Regulatory Scrutiny Board, which is the Commission's internal guardian of quality in the law-making process. The draft CSDDD never got an approval of the RSB as the Commission ultimately decided to send the proposal to the co-legislators without the RSB positive opinion.

The EU Council has adopted its general approach in the autumn of 2022. The compromise is very fragile, and the Council's position can be summarized as having the intention to limit the impact of the CSDDD, which is reflected in the following features:

- Inclusion of financial sector will depend on the decision of a Member State

- The scope of application leaves out the use of the company's products or provision of services
- Limiting the application of CSDDD by increasing the threshold of 1000 employees and EUR 300 mn turnover (instead of 500 employees and EUR 150 mn revenue)
- Limiting the companies' liability to adverse impacts which they or their business partners directly (and jointly) cause
- Prioritisation of adverse impacts based on the risk assessment
- Transition plans: connecting the CSDDD with the CSRD and adding reporting on exposure to coal-, oil- and gas-related activities
- Deleted the director's duty to care and the link between their remuneration and corporate climate plans.

The European Parliament is the political driving force behind this file and the mere number of committees willing to give their views – eight - shows it is very high on the political agenda. The draft report of the rapporteur in the leading committee on legal affairs indicates the possible direction of the EP's position:

- Expanding the scope of the CSDDD application to companies of 250 employees and EUR 40 mn turnover
- Enlarging the list of high-impact sectors
- Expanding the notion of adverse impacts to “good governance”, i.e. on the proper functioning of public administration, the rule of law, electoral systems
- Coverage of full value chain (expanding to marketing and advertising)
- Prioritisation of adverse impacts based on the risk assessment
- Expansion and detailing the requirements concerning the transition plans

Opposite views of co-legislators and their positions adopted with tight majority will make the trilog a very challenging process. Perhaps a motivating factor will be a deadline for negotiations which lapses in March 2024 when the EU institutions will start preparing for the European elections.

Transition plans

One example where clarity and guidance are most wanted is Article 15 of the CSDDD. It requires the Member States to ensure that large companies adopt a plan to ensure that the business model and strategy of the company are compatible with the transition to a sustainable economy and with the 1.5°C target in line with the Paris Agreement. The CSRD introduces merely an obligation to publish such plans if the company claims to have them. The CSDD makes a significant leap forward in this regard and introduces the obligation to adopt such a plan.

First, the legally binding target of the Paris Agreement is limiting global warming to 2°C and pursuing efforts towards 1.5°C.

Second, the Paris Agreement objectives are not intended for corporates. These are the commitments of the state actors acting globally in a collective pursuit of a common goal. Article 15 of the CSDDD effectively imposes the obligation of a result on individual companies. Currently the signatories of the Paris Agreement are collectively out of the trajectory to the 1.5 target. It is neither logical nor practical that the co-legislators impose it on the individual companies. The share of businesses in contributing to this target should be fair and clear.

Some practical issues that need to be considered could include:

- Revise the language on obligation for the companies to align with the Paris Agreement targets, since it was never intended.

- Accepting the existing market standards to prepare and measure the corporate transition plans
- Transition plans should be allowed at a capital group level; forcing each subsidiary to have a transition plan is not practical
- Making clear that the variety of transition plans referred to in the EU legislation regard the same concept and there is compatibility between them, for example those referred to in the CSDD and the CSRD, a plan to align with the Taxonomy or those referred to in the reviewed ETS Directive¹.

4. Takeaways

As a preamble there is no doubt that there is broad agreement that all segments of society and the economy must make a fair contribution to addressing climate change. Business has the same obligations as everyone else, not less, but it needs to be discharged in a way that also respects the responsibility and accountability of management and shareholders.

The Commission's rationale behind the CSDDD proposal is to force business to align with what it sees as broader societal goals. However, this contradicts the case that is made for the sustainable disclosure framework as a way of providing information to investors to nudge companies in the right direction. If this is not sufficient, then the extensive disclosure regulatory framework loses its *raison d'être*.

Alternatively, it can be seen as devolving to business targets and obligations that were to be implemented at the national or global level. The clearest example is the net zero objective under the Paris Agreement, which was conceived as global net zero goal, and not one that was meant or could be devolved to the individual, or individual enterprise level.

It is also argued that disclosure requirements are important for investors but not necessarily sufficient to trigger the behavioral change of business. In that sense the public sector through laws it passes takes away the responsibility and accountability that exists through corporate governance, which represents a significant enlargement of the reach of the public authorities, with wider societal implications, which may not be apparent now yet.

The argument is also made that since many companies follow the existing market and voluntary due diligence schemes, compliance with the CSDDD should not cause an excessive burden. What is not considered, is the difference between a code of conduct, agreed through corporate governance, and that which is imposed by public authority, with the coverage of managing economy from the private to the public sector.

The expected impact of this directive makes it a maybe one of *the* most important pieces of the EU legislation in the field of sustainability. It expresses a deep sense of lack of trust in shareholders and management ability to manage the affairs of the enterprise and sees the need for a public centralization of the management of the economy.

In face of existing or upcoming national due diligence schemes in Europe (notably Germany, France, Netherlands, Norway) businesses generally have preference for a harmonised system which helps to avoid the fragmentation of the market.

¹ According to Article 10a of the reviewed ETS Directive, from 2026 onwards, the free allocation of emission allowances to the 20% installations with the highest emission intensities should also be conditional on the set-up and implementation of climate neutrality plans

If the regulation is to be employed the right balance must be maintained. The basic principle of law-making is that regulating should be limited only to what is necessary and it should be done with the highest possible clarity. This will ensure that laws are properly implemented and internalized by stakeholders.

One significant element that is not hypothetical anymore is the fact that this opens the door to green litigation, essentially allowing, as currently seen in real cases, organizations in any jurisdiction to litigate any entity that is perceived with an ability to pay.

Business should be kept to the highest standards that are reasonable and implementable, while allowing the owners to exercise their management's their rights and obligations. The Commission proposal is highly demanding – at moments beyond what can be practically manageable by the company – and the European Parliament's ideas increase this level of ambition.