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EU ESG: European Commission's Proposal for Corporate Sustainability Due Diligence

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TO: ICI Members

ICI Global Members

ESG Task Force

EU ESG Disclosure Regulation Working Group SUBJECTS: ESG

International/Global RE: EU ESG: European Commission's Proposal for Corporate Sustainability Due Diligence

On 23 February 2022, the European Commission published a proposal,[\[1\]](#) in a form of Directive, on corporate sustainability due diligence. The proposed Directive would introduce new obligations for large companies to carry out due diligence in relation to adverse environmental and human rights impacts across their own operations, the operation of their subsidiaries, and the value chain operations carried out by entities with whom companies have established business relationships. On 28 March 2022, the European Commission opened a consultation on the Directive under the Better Regulation process, with the comments due 23 May 2022.[\[2\]](#)

The proposed Directive would require in-scope companies to identify, prevent, mitigate, and remediate the adverse impacts of their activities on human rights and the environment. The due diligence obligations will also apply to companies based outside the EU, provided that they meet applicable thresholds for turnover generated within the EU. The proposed Directive also introduces duties for the directors of the EU companies on setting up and overseeing the implementation of the due diligence processes and adapting the corporate strategy to due diligence.

Notably, the proposed Directive scopes in "regulated financial undertakings" in the "company" definition, which would include asset managers and investment funds, among others. In our response[\[3\]](#) to the Commission's consultation on this legislative initiative (which was previously referred to as Sustainable Corporate Governance Initiative) in February 2021, we cautioned that the application of additional due diligence requirements not tailored for fund management context could severely disrupt the investment process, harming investors saving for retirement, education, and other important financial goals.

The proposed Directive will now go through a legislative process, including debates and negotiations by co-legislators, the European Parliament, and the Council.

Background: Interactions with Sustainability Initiatives in the EU

The proposed Directive is closely interrelated with the proposed Corporate Sustainability Reporting Directive (CSRD).^[4] The CSRD, which will revise the Non-Financial Reporting Directive (NFRD),^[5] would mandate and standardize sustainability reporting by certain companies. The two initiatives are closely interrelated in that, theoretically, the CSRD reporting would be based using due diligence processes set up under the Due Diligence Directive (although the due diligence obligations, as proposed, cover more companies than the CSRD does, see memo section 4(F), below).

The proposed Directive is also viewed as complementary to other EU sustainability initiatives, including the EU Taxonomy Regulation^[6] and the Sustainable Finance Disclosure Regulation (SFDR).^[7] For example, the SFDR requires large financial market participants to publish a statement on due diligence policies with respect to principal adverse impacts of investment decisions on sustainability factors (others must comply on a "comply or explain basis"). Such disclosure requirement must be supported by appropriate due diligence, which the Directive aims to create.

Scope of Entities Covered

The proposed Directive would apply to the following EU and non-EU companies:

- "Very Large Companies":
 - EU-based companies with more than 500 employees on average and a worldwide net turnover^[8] exceeding EUR 150 million in the last financial year; or
 - Non-EU-based companies with a net turnover of more than EUR 150 million generated in the EU in the last financial year.
- "Large Companies":
 - EU-based companies with more than 250 employees on average and a worldwide net turnover of more than EUR 40 million in the last financial year, of which at least 50% was generated in one or more of the high-impact sectors;^[9] or
 - Non-EU-based companies with a net turnover of more than EUR 40 million but not more than EUR 150 million generated in the EU in the last financial year, of which at least 50% was generated in one or more than one of the high-impact sectors.

Application to Asset Managers and Investment Funds. The proposed Directive defines "companies" broadly, encompassing most types of legal entities. It specifically includes, regardless of legal form, a long list of regulated financial undertakings.^[10] Among other financial undertakings, the following asset managers and funds are captured in the proposed Directive:

- Investment firms under Markets in Financial Instruments Directive (MiFID II);^[11]
- Alternative investment fund managers (AIFMs);
- UCITS management companies;
- Alternative investment funds (AIFs) managed by AIFMs; and
- UCITS.

Small and Medium Enterprises (SMEs). Considering the financial and administrative burden stemming from the due diligence obligations, SMEs, including micro companies, are

excluded from the proposed Directive. The due diligence requirements for Large Companies will apply two years after the proposed Directive starts applying in order to provide a longer adaptation period. Further, non-EU-based companies falling within the scope of the proposed Directive are required to designate an authorized representative established or domiciled in one of the EU Member States where it operates.

Due Diligence Obligations (Including with Respect to Value Chains)

The due diligence obligations under the proposed Directive will apply to the operations of in-scope companies, operations of their subsidiaries, and the value chain operations carried out by entities with whom the companies have "established business relationships."

Value Chain. The term "value chain" covers activities related to the production of goods or provision of services, including product development, use and disposal of products, as well as related activities of upstream and downstream established business relationships.

Value Chain of Financial Undertakings. The "value chain" of financial undertakings is limited to the activities of their clients who received loans, credit, and other financial services, as well as other companies in the client's group whose activities are linked to the contract in question. Clients that are households and natural persons not acting in a professional or business capacity, as well as SMEs, should not be considered to be part of the value chain.

Established Business Relationships. "Established business relationships" capture direct and indirect business relationships that are (i) expected to be lasting, and (ii) do not represent a negligible or merely ancillary part of a value chain. These relationships should be reassessed periodically, and at least every 12 months.

Requirements on Environmental and Human Rights Due Diligence

The proposed Directive sets out the following requirements that in-scope companies should comply with when conducting environmental and human rights due diligence.

Integrate Due Diligence into Companies' Policies

Companies are required to integrate due diligence into all their corporate policies and have in place a due diligence policy, which should at least contain (i) a description of the due diligence approach, (ii) a code of conduct for employees and subsidiaries, and (iii) a description of the processes put in place to implement the due diligence policy in practice. The due diligence policy should be updated annually.

Identify Potential and Actual Adverse Environmental and Human Rights Impacts

The proposed Directive requires companies to take appropriate measures to identify actual and potential adverse environmental and human rights impacts arising from their own operations, their subsidiaries, and their established business relationships within their value chains.

Adverse environmental and human rights impacts are defined as violations of the international environmental and human rights conventions as listed in the Annex to the proposed Directive.^[12] These include, among others, child labor, exploitation of workers, discrimination, infringement of communities' land rights, pollution, and biodiversity loss. While the Paris Agreement is not included in the list of international conventions, the proposed Directive sets out a separate requirement for Very Large Companies on considering climate change in their business models and strategies (see Section 5 for

further details). Large Companies are only required to identify actual and potential severe adverse impacts on the environment and human rights relevant to their respective high-impact sectors.

For financial undertakings providing credit, loans or other financial services, the identification of potential and actual adverse impacts should be carried out only before providing these financial services.

Prevent, Mitigate, and End Identified Potential and Actual Adverse Impacts

Companies are required to take appropriate measures to prevent or, where prevention is not possible, mitigate potential adverse environmental and human rights impacts that have been identified. They should also take appropriate measures to bring to an end the actual adverse impacts identified, or where these impacts cannot be brought to an end, minimize the extent of their impacts.

Among other measures, a company may seek contractual assurances that ensure compliance with its code of conduct and prevention/corrective action plan from its direct business partners. Such contractual assurance should be accompanied by appropriate compliance verification measures, such as through independent third-party verification. Companies may also make necessary investments to prevent, cease, or minimize the potential and actual adverse impacts. The proposed Directive notes that companies should prioritize engagement with business relationships in the value chain, instead of terminating the business relationship, as a last-resort action after attempting prevention, bringing to an end, or minimizing potential and actual adverse impacts without success.

If prevention or mitigation of a potential adverse impact is unsuccessful, or an actual adverse impact could not be ended or minimized, companies are refrained from extending or entering into new relationships with business partners connected to such impact. If the impact is severe, companies should terminate the existing relationships with the relevant business partners, provided that it is legally possible. Nevertheless, financial undertakings providing credit, loans, or other financial services are not required to terminate their financial service contract when this can be reasonably expected to cause substantial prejudice to the entity to whom that service is being provided.

Establish and Maintain a Complaints Procedure

Companies should establish complaints procedures for affected persons, trade unions, and civil society organizations, in order to address legitimate concerns regarding potential or actual adverse environmental and human rights impacts with respect to their own operations, the operations of their subsidiaries, and their established business relationships in the value chains. Complainants should be entitled to appropriate follow-up from the company and a meeting with the company's representatives at an appropriate level.

Monitor the Effectiveness of Due Diligence Policies and Measures

Companies should conduct periodic assessments, at least annually, of their own operations, those of their subsidiaries, and those of their established business relationships in the value chains, to monitor the effectiveness of their due diligence measures. Such assessments should verify that adverse impacts are properly identified, due diligence measures are implemented, and adverse impacts have been prevented or brought to an end.

Publicly Communicating on Due Diligence

In order to avoid duplicating reporting obligations, the proposed Directive does not introduce any new reporting obligations in addition to those under the NFRD, which will be revised by the CSRD. For companies that are within the scope of the proposed Directive and do not fall into the scope of NFRD (and the scope of CSRD once finalized), they should publish on their websites an annual statement communicating relevant information on due diligence policies, processes, and activities conducted to identify and address actual or potential adverse impacts. Such statement should be published by 30 April of each year.

Obligation to Adopt Climate Change Plan

In addition to the above environmental and human rights due diligence requirements, the proposed Directive requires Very Large Companies (both EU-based and non-EU based) to adopt corporate plans to ensure that their business models and strategies are compatible with the transition to a sustainable economy and the Paris Agreement's goal of limiting global warming to 1.5°C. These plans should identify the extent to which climate change is a risk for, or an impact of, the company's operations. Where climate change is or should have been identified as a principal risk or impact, the company is required to include an emission reduction objective in its plan.

Companies should also duly take into account their climate change plans when setting variable director and executive remuneration, if such remuneration is already linked to the company's business strategy and long-term interests and sustainability.

Directors' Duties of Care (For In-Scope EU Companies Only)

The proposed Directive states that, when fulfilling their existing duty to act in the best interest of the company, directors[\[13\]](#) of EU companies should take into account the human rights, climate change, and environmental consequences of their decisions, including in the short-, medium- and long-term horizons. Directors of EU companies are also responsible for putting in place and overseeing the required due diligence actions (as discussed in Section 3), with due consideration to the input of stakeholders and civil society organizations.

Sanctions and Civil Liability

The proposed Directive provides for a combination of sanctions and civil liability. In the case of non-compliance, the national supervisory authorities should impose dissuasive, proportionate, and effective sanctions, including fines and compliance orders. The Commission will establish a European Network of Supervisory Authorities to ensure a coordinated approach to supervision among the Member States.

Further, the proposed Directive requires the Member States to ensure companies are liable for civil damages in circumstances where they fail to comply with their obligations to prevent and mitigate potential adverse impacts, as well as to minimize or bring the actual adverse impacts to an end. Nevertheless, a company will not be liable for damages caused by an adverse impact arising as a result of activities of an indirect business partner, provided that the company obtained contractual assurances from its direct business partner.

endnotes

[1] See Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, available at https://ec.europa.eu/info/sites/default/files/1_1_183885_prop_dir_susta_en.pdf.

[2] See https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance_en.

[3] See ICI Memorandum [33099], dated 8 February 2021, available at <https://www.ici.org/memo33099>.

[4] Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting COM/2021/189 final, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0189>.

[5] 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, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095>.

[6] REGULATION (EU) 2020/852 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32020R0852&from=EN#d1e40-13-1>.

[7] REGULATION (EU) 2019/2088 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 27 November 2019 on sustainability-related disclosures in the financial services sector, available at <https://eur-lex.europa.eu/eli/reg/2019/2088/oj>. The SFDR mandates website disclosure of "principal adverse impacts of investment decisions on sustainability factors" for financial market participants with more than 500 employees. See SFDR, Article 4.

[8] "Net turnover" refers to the amounts derived from the sale of products and the provision of services after deducting sales rebates and value-added tax and other taxes directly linked to turnover. See DIRECTIVE 2013/34/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013 on the annual financial statements, consolidated financial statements, and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC at Article 2(5), available at <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32013L0034>.

For a company that applies international accounting standards or is established outside the EU, net turnover refers to the revenue as defined by or within the meaning of the financial reporting framework on the basis of which the financial statements of the company are prepared. See proposed Directive, *supra* note 1, at Article 3, point (m).

[9] The selection of high-impact sectors is based on existing sectoral OECD due diligence guidance. Despite the fact that financial sector is covered in the sectoral OECD guidance, it is not included in the high-impact sectors for the purpose of the proposed Directive due to

its specificities. High-impact sectors include, amongst others, textiles and clothing, extraction of and trading in mineral resources (including oil and gas, metals and other non-metallic minerals, and quarry products), agriculture and forestry, fisheries and food manufacture, and wholesale trade in raw materials, animals, wood, food, and beverages. See proposed Directive, *supra* note 1, Recital (22) and Article 2, point (1)(b). Also See sectoral OECD due diligence guidance at <http://mneguidelines.oecd.org/sectors/>.

[10] See proposed Directive, *supra* note 1, at Article 3, point (a)(iv).

[11] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU Text with EEA relevance, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0065>.

[12] See ANNEX to the proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, available at https://ec.europa.eu/info/sites/default/files/1_2_183888_annex_dir_susta_en.pdf.

[13] Directors, for the purpose of the proposed Directive, refer to any member of the administrative, management, or supervisory bodies of a company, or the chief executive officer if there is no such management or supervisory body. See proposed Directive, *supra* note 1, at Article 3, point (o).