

TRANSCENDENT GROUP INSIGHT

Corporate Sustainability and Due Diligence

Over the past couple of years, European companies and financial institutions have been keeping a close eye on a wave of sustainability related legislation coming out of the EU. While financial institutions have already begun adopting to legislation resulting from the sustainable finance action plan, non-financial companies are likely to be preparing for taxonomy reporting, and the implications of the Corporate Sustainability Reporting Directive (CSRD).

A major step towards fostering sustainable and responsible corporate behavior is EU's **Proposal for a Directive on corporate sustainability Due Diligence**¹ (The Directive), which the Commission adopted on 23 February, 2022.

Soon, certain companies will also be required to include sustainability in due diligence process and supply chain management. The aim of the Directive is to tackle human rights and environmental impacts across global supply chains, and to *"foster sustainable and responsible corporate behavior and to anchor human rights and environmental considerations in companies' operations and corporate governance."*²

If the EU adopts this directive in its entirety, companies will need to address their adverse impacts on human rights and the environment, including in their value chains both inside and outside of Europe.

In this iteration of GRC insights, our colleagues Nezik Keshto and Fredrik Fogde will give a brief introduction to the new regulatory requirements and how understand and manage these requirements.

Background and Purpose of Corporate Sustainability Due Diligence

General concepts and theories such as Environmental, Social and Governance (ESG) and Corporate Social Responsibility (CSR) are increasingly being regulated by legislation from the EU, broadly across both the financial sector but also other companies that are covered by, among other things, transparency demands to combat greenwashing. The legal requirements are becoming increasingly precise and specific, in order to make the transition to a sustainable business and companies in alignment with the Paris Agreement and the UN's Sustainable Development Goals (SDG).

According to the EU, the Proposal for a Directive on Corporate Sustainability Due Diligence has broad support from both companies and representatives of civil society. 70% of the

¹ https://ec.europa.eu/info/sites/default/files/1_1_183885_prop_dir_susta_en.pdf

² https://ec.europa.eu/info/business-economy-euro/doing-business-eu/corporate-sustainability-due-diligence_en

companies surveyed say that a regulatory framework for corporate sustainability due diligence is needed.³

What is Corporate Sustainability Due Diligence?

Companies play an important role in contributing to sustainable development. Until recently, the work towards corporate sustainability has been scattered and not uniform. The Directive is based on a [study published in 2020](#), which highlighted the limited uptake of voluntary due diligence among companies in Europe. In line with other sustainability related regulations, the Directive aims to create a standardized and obligatory framework for addressing these issues.

The proposed Directive contains articles for how human rights and environmental impact are to be valued in business decisions and strategy, by including these factors in the value chain, the corporate governance, and in management systems. The purpose is to minimize negative impacts on human rights and the environment, by obligating companies to perform due diligence process in order to have insight in how their business effect human rights and the environment.

Proposal for a Directive on Corporate Sustainability Due Diligence

The directive sets out a process of the due diligence that encompasses the following:

(1) Integrating due diligence into policies and management systems

This target pushes companies to include due diligence in all company policies, and that a due diligence policy must be created and kept up to date. These governance requirements will require companies to establish and maintain due diligence procedures. There will be a transition cost affected by this change.

(2) Identifying and assessing adverse human rights and environmental impacts

Companies will be required to identify and assess adverse human rights and environmental impacts (both within own operations, in subsidiaries, in their products and in the value chain) throughout the life-cycle of its products. The Directive specifically mentions the impact on human rights and environment linked to raw material sourcing, manufacturing, or at the level of product or waste disposal.

(3) Preventing, ceasing, or minimizing actual and potential adverse human rights, and environmental impacts

This step includes establishing a clear structure and strategy for how to prevent and mitigate potential adverse impacts, which should be clearly distinguished in the internal governance structure. For cases where potential adverse impacts on human rights and environment cannot be addressed by the measures upheld by the company, the Directive explains the obligation for companies to refrain from entering new relations and if possible, according to the law governing their relation – to temporarily suspend the commercial relationship. The temporary suspension should be upheld if it is reasonable to expect prevention and minimization efforts to succeed in the short-term.

If the potential adverse impact is too severe in respect to the activities concerned, a termination of the business relationship is expected.

³ https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance/public-consultation_en

(4) Assessing the effectiveness of measures

This step requires a monitoring practice and compliance measures that will serve to enhance and strengthen companies' sustainability due diligence, which is to be reflected in the due diligence policy.

This also entails establishing and maintaining a complaints procedure in cases of legitimate concerns regarding the potential or actual adverse impacts, which includes the companies own value chain.

Companies are also obliged to grant the possibility of a complaint from affected external parties – such as trade unions or civil society organizations in the region that the adverse impact has occurred.

(5) Communicating

In line with other sustainability-focused regulation from the EU, transparency and communication will be a key aspect of the Directive as well. The provisions lay out obligations for the companies in the scope of the Directive to publicly communicate on their due diligence, by the latest the 30th of April each year. This public message is to be put up on the website.

(6) Providing remediation

Potential civil liability of companies for the damages arising from a company's own operation, at the level of its subsidiaries and at the level of direct and indirect business relations in the value chain is proposed as something the Directive will provide.

All these targets are clearly defined in the articles of the proposed Directive.

Obligations of the company and director duties

Besides the targets and structure of the work relating to how to implement and conduct a due diligence, companies are also required to account for their impact and utilize the due diligence in business decisions. This will strengthen the company's resilience in the long-term, but will entail governance, risk and compliance procedures that need to be integrated in the rest of the business. Resources need to be allocated to risk management and adaptability, as the Directive will uncover the companies' negative environmental and human rights impact.

The Directive also puts forward the introduction of director duties. The directors of EU companies that are in scope for the Directive, have duties to take into account the impact on human rights, environment and climate change when making business decisions and when considering what is in the best interest of the company. To achieve this, the Directive also put the duties of creating and implementing the appropriate due diligence processes the director, and including this in the overall corporate strategy. The rules regarding the duties of the directors are enforced through existing law in the Member States and will not be included in the enforcement mechanisms by the Directive.

Scope of affected companies

According to the proposal, the following two groups of companies will be affected by the directive.

Group 1: Around 9,400 companies - 500+ employees and net EUR 150 million+ turnover worldwide.

Group 2: Around 3,400 companies in high-impact sectors. - 250+ employees and net EUR 40+ million turnover worldwide and operating in defined high impact sectors.

High impact sectors that is referred to in group two are for the purpose of the Directive the following sectors – manufactures and traders of textiles, leather and footwear, agriculture, manufacturers of food and beverages, extractors and traders of mineral resources (crude petroleum, natural gas, metals with more). This list is not exhaustive, and for the companies in group 2, the rules in the Directive will start to apply two years later than for group 1.

Besides the approximately 13 000 EU companies that are within the scope of the Directive, an addition of around 4000 third country companies active in the EU will be affected. SME:s and micro companies are not within the scope of the proposed rules, but will however be indirectly affected considering the supporting measures provided in the proposal.

Enforcement from the EU and next steps

The EU notes that they need to foster sustainable corporate behavior since the progression is slow and uneven. National rules are not enough to digest the complexity of companies and their value chain, especially in cases where this is global. They are also slowing down the overall sustainability agenda due to difference in obligation from a member state to another.

Member states will execute the administrative supervision through national authorities, that will supervise and impose sanctions, fines, and compliance orders.

At this stage, the Proposal need to be approved and adopted by the Council and European Parliament. When this step is fulfilled, the Member States will have 2 years to implement the Directive into national law and start their obligations towards the Directive and the Commission.

Summary

The Directive has the potential to have far-reaching positive impact. The current version is however a first attempt from the EU to harmonize and implement a standardized sustainability due diligence framework across various sectors, and indirectly across various regions across the world The Directive will undoubtedly have a long-term effect on strategic and corporate decisions, that will stem from the thorough sustainability due diligence that is now implicated. Moreover, the short-term effect of implementing a regulatory framework with so much potential will set the bar for how efficiently the market absorbs regulatory requirements for sustainability work.

As in all sustainability matters, effective integration requires a holistic point of view, with an approach that includes governance, risk and compliance strategies as well as other business-critical areas.

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