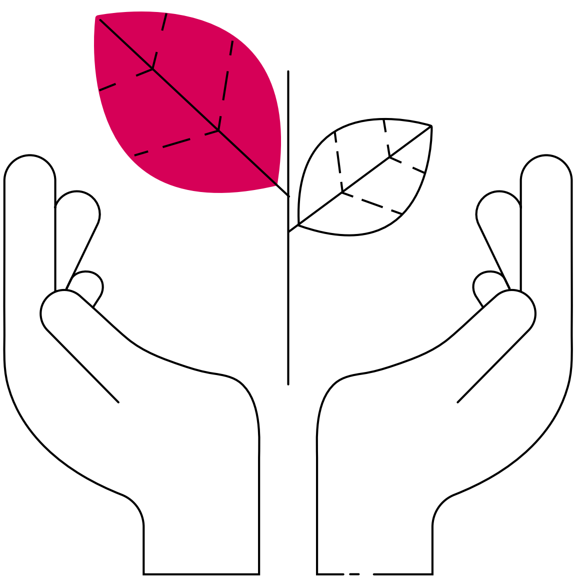
The EU Corporate Sustainability Due Diligence Directive

What you need to know

Once implemented, the EU's proposed **Corporate Sustainability Due Diligence Directive** (CS3D), will impose an unparalleled and extensive corporate governance duty on many companies based in and outside the EU. Unlike most other ESG obligations currently in force, this will not be a "comply-explain" obligation, but a "comply or be liable" obligation. It will require action beyond mere reporting, and it comes with regulatory, civil enforcement and compensation mechanisms.

Through the trilogue, the European Commission, the Council and Parliament are currently negotiating CS3D proposals with a view to agreeing the final text by the end of 2023 or early 2024. CS3D aims to foster sustainable and responsible corporate behaviour by establishing due diligence requirements on both human rights and the environment. More specifically, its requirements relate to identifying, managing, preventing, mitigating and eliminating adverse impacts of activities on human rights and the environment throughout global corporate value chains.



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Will this apply to your company?

At present, there are four proposed groups of companies under scope. These will help to create a critical mass of the business market to affect the desired behavioural changes in support of a just and sustainable economy.

Group 1

The European Parliament have widened the original threshold for Group 1 (i.e. those companies based in the EU with more than 500 employees and a net worldwide turnover of €150m+ in the last financial year for which annual financial statements have been prepared). The Parliament proposes a new Group 1 threshold, i.e. for those companies with over 250 employees on average which also generate a net worldwide turnover of more than €40m in the EU. The previous references to high-risks sectors has also been removed thereby expanding its reach even further.

Group 2

Group 2 catches a company falling outside Group 1 if their ultimate parent company of the group had 500 employees and a net worldwide turnover in excess of €150m in the last financial year for which annual financial statements have been prepared. A further important feature of CS3D is its extra-territorial nature in that companies established outside the EU may fall within scope.

Group 3

Group 3 covers companies with a net worldwide turnover of greater than €150m so long as at least €40m of this turnover was generated in the EU (e.g. by way of turnover generated from vertical agreements with EU third parties and/or subsidiaries in return for royalties).

Group 4

Companies not meeting the Group 3 thresholds may fall within Group 4, if the ultimate parent company of the group had 500+ employees and a net worldwide turnover of €150m of which €40m or more was generated in the EU. This Group 4 category includes turnover generated from vertical agreements with EU third parties and/or subsidiaries in return for royalties.

What is the impact of this scope?

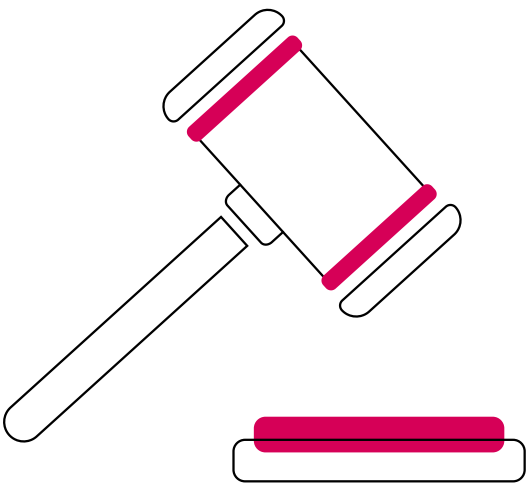
Whilst this Directive is primarily targeted at large companies its impact will be felt by those companies, including small and medium-sized enterprises (SMEs), in its value chain with whom it has a business relationship. The CS3D targets companies in the real economy but also includes the financial sector (a point currently under debate).

The key requirements for your company

The Directive requires companies to look at the adverse impacts of their own activities, their subsidiaries and across their value chain on both the environment (including climate) and human rights. This is in keeping with the emerging trend of a more holistic and integrated approach to sustainable business in the context of viewing human rights and environmental due diligence together.

In addition to identifying, preventing, minimising, mitigating and ceasing adverse impacts (and potential adverse impacts), companies must also:

- integrate environmental and human rights due diligence in all corporate policies;
- develop and maintain a grievance mechanism;
- monitor, review, assess and verify the effectiveness and implementation of their due diligence policy and measures; and
- disclose and report.



A further key provision is the requirement to develop and implement a detailed transition plan which ensures that the company's business model and strategy are aligned with the transition to sustainable economy and the 1.5°C Paris Agreement temperature goal. This includes requiring the company to set time-bound climate-related targets for scope 1, 2 and, where relevant, scope 3 emissions and to describe their progress against these.

The Parliament proposes companies with over 1000 employees on average have a relevant and effective AGM-approved policy in place. This is to ensure that part of any variable remuneration for directors is linked to the transition plan.

What are the implications of non-compliance?

Not adhering to the CS3D requirements will come at a cost to companies with potential consequences including:

- maximum fines of up to 5% net global turnover;
- exclusion from EU public procurement;
- removal of goods from the market;
- impacts on Directors' bonuses; and
- potential civil liability claims/ class actions arising from a failure to comply with the due diligence process.

C3SD also introduces a new network of supervisors within EU Member States to ensure compliance with each national authority able to call for remedial actions and impose sanctions.

What's next?

Once the trilogue is completed and the final text agreed, CS3D enters into force 20 days after publication in the Official Journal of the European Union. Each Member State then has two years for transposition into national law. Notwithstanding, a growing number of Member States have or are in the process of putting in place mandatory human rights due diligence requirements.

These, and the Directive itself, build on and cement the existing practices by businesses through adherence to voluntary frameworks (e.g. the UN Guiding Principles on Business and Human Rights, the OECD Guidelines for Multinational Enterprises, and the OECD Due Diligence Guidance for Responsible Business Conduct).

The time to start preparing is now, not later

Whilst the precise final wording of the Directive remains to be agreed, there are six practical steps you can take now to accelerate your readiness for CS3D:

1. Create a task force of your key internal stakeholders to determine whether the impact of the CS3D will directly apply (based on criteria such as employee numbers, market sector and accounting policies), or indirectly, due to your role in another company's value chain.
2. Map your value chain and business relationships. Collate the data.
3. Highlight the human and social value impact of the requirements across your value chain including the risk of human trafficking, living wage, working conditions and employee health and well-being.
4. Identify what you are already doing e.g. procurement questionnaires and identify gaps in your current processes.
5. Undertake materiality assessments to identify relevant human rights and environmental impacts across your value chain and prioritise material issues in your action plan.
6. Design and align your climate transition plan ready for implementation.

Starting with the above six actions positions your company part way on the journey to implementation of the Directive's requirements. Understanding what the actual and potential areas of impact across your global value chain on human rights and the environment is a critical foundation for ensuring a targeted and effective approach to implementation. The old adage 'don't let the perfect be the enemy of the good' applies here.

It is better to make progress on some areas than to wait and do nothing. Unlike other legislation, the CS3D firmly moves companies out of the sphere of merely reporting your plans or your intentions to implementing them. Undertaking these practical steps now will accelerate adoption and enable greater resilience of the company.

> **Now is the time to demonstrate your commitment to sustainable and responsible corporate behaviour.**

Contact

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