New EU mandatory ESG due diligence requirements

New EU rules seek to set mandatory human rights and environmental due diligence requirements for any businesses operating in the Single Market.

The European Commission published in February a proposal for a Directive on Corporate Sustainability Due Diligence. The proposed rules address the regulatory fragmentation on environmental and human rights due diligence and foster responsible and sustainable corporate behaviour across value chains.

With this proposal, the Commission recognises the transformative role businesses can play in enhancing sustainable practices and in building a robust, socially responsible, and sustainable economy.

The proposed directive builds on the OECD framework and UN Guiding Principles on business and human rights, intending to set a global golden standard on due diligence.

Does this apply to your business?

The suggested scope of application would extend to all companies operating in the EU, and would specifically apply to UK-based companies as follows:

- **Group 1:** companies with 500 or more employees and with an EU-generated turnover of above EUR150 million.
- **Group 2**. **:** between 250-500 employees and an EU-generated turnover of above EUR40 million, where at least 50% of the specified turnover was generated in high impact sectors

High-impact sectors have been defined in line with OECD guidelines to include textiles, agriculture, food and drinks manufacturing, mineral resources (including oil, gas, and metals).

Whilst the financial sector is also included within the scope, the Commission noted that their due diligence would not be applicable to their whole value chain, and would exclude SMEs receiving loans, credit, financing, insurance, or reinsurance.

What would the requirements be?

The proposal introduces requirements that extend to subsidiaries and direct and indirect 'established business relationships', transcending Tier 1 suppliers and including the whole value chain. Obligations would include:

- **Implementation of formal policy and risk management procedures:** develop and integrate due diligence into all corporate policies
- **Risk identification:** identify actual and potential adverse human rights and environmental impacts in the company's operations, subsidiaries and value chains
- **Risk prevention, mitigation and monitoring:** businesses would need to minimise and end adverse impacts where possible. To do so, the Commission proposed several appropriate measures, from the adoption of action plans to contractual assurances from business partners
- **Public disclosure**: relevant due diligence policies must be communicated publicly
- **Combatting climate change:** Group 1 companies would be required to adopt a plan showcasing the compatibility of their business strategy with limiting the environmental impact in line with the 1.5°C Paris Agreement target and include emission reduction objectives in their plan if climate change was identified as a principal risk. These obligations

would have to be considered when setting a director's variable renumeration, if it is linked to the director's contribution to the company's business strategy.

What about non-compliance?

The Commission proposed three levels of enforcement:

- **Company level:** companies would be required to establish a complaints mechanism.
- **Administrative supervision:** Member States would be required to designate an authority with a minimum set of enforcement and investigation powers. At European level, the Commission would establish a European Network of Supervisory Authorities.
- **Civil Liability:** the draft proposal would enable victims of violations across a company's own operations and its subsidiaries and established business relationships to obtain compensation for damage at national courts.

What would this mean at an international level?

The proposal is extra-territorial by design, illustrating the EU's wider efforts to set global standards on how companies engage with value chains. The UK is also seeing a wider trend towards enhanced ESG due diligence laws and increasing accountability for ESG non-compliance in supply chains. The 2021 Environment Act tackles this issue of ensuring that large businesses in the UK are not contributing to illegal deforestation via their use of certain imported "forest risk" products.

What's the impact for UK business?

As the rules apply to all businesses operating across the EU, UK businesses would be faced with increased costs and enhanced administrative burdens. Businesses would benefit from enhanced transparency on sustainability and socially responsible matters, *vis-a-vis* investors (meeting increasingly ESG-dominated requirements, and thus so avoiding facing exclusion from investor portfolios), and *vis-a-vis* the consumer base**.** Additionally, the directive would consolidate an EU-wide harmonised system for due diligence requirements, which are currently upheld by a fragmented and disparate approach across Member States.

However, large companies are expected to pass on demands to their suppliers. Despite the exclusion of SMEs, they face the risk of being affected through business relationships with companies in scope. But the proposal outlines certain obligations, both on Member States and on the companies included within the direct scope, to support indirectly affected companies overcome the financial and practical implementation challenges.

The proposed requirements would make companies responsible for factors beyond their control and hard to comply with. It would also imply an additional administrative burden and business cost, as well as potentially undermining certain companies' ability to remain competitive worldwide. This added compliance cost would come at a time when the disruption of Ukrainian and Russian supply of raw materials will result in higher prices as well as surging energy prices. A strict mandatory due diligence could therefore place an additional strain on value chains and enhance existing cost pressures for firms in certain industries.

What happens next?

The file has progressed to the European Parliament and the Council for legislative scrutiny. The several delays for its adoption and rare two-time rejection from the Regulatory Scrutiny Board reflect the contentious nature of this proposal, which is not foreseen to cease in upcoming negotiations. Subsequently, we expect significant amendments to the most contentious elements.

Once adopted, the proposal establishes a two-year transposition period for ‘Group 1’ companies, and of four years for ‘Group 2’ companies.

What are we doing?

The CBI supports close international alignment and a balanced approach to ESG requirements, involving workable requirements that truly enable a long-lasting transformation to a green and socially responsible economy and do not deter businesses from international investments needed to stimulate growth.

We will continue to work with BusinessEurope to ensure close EU-UK cooperation on ESG matters (find the BusinessEurope position here). We will push for the interoperability of reporting requirements to minimise the administrative burden on UK businesses.

If you would like to discuss the proposal in more detail and get involved, get in touch with our Brussels team.