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IIGCC updated position paper: EU Corporate Sustainability Due Diligence Directive

IIGCC welcomes the proposals for a Corporate Sustainability Due Diligence Directive (CSDD). CSDD presents a vital opportunity to embed environmentally responsible business practices within companies' business models and strategies, accelerating the behavioural changes needed to achieve the goals of the European Green Deal. Requirements for companies to identify, monitor and mitigate the adverse impacts of their activities, and those of their value chains, will enable institutional investors and asset managers to better understand how their holdings are managing sustainability risks and impacts. This in turn can support capital allocation decisions in line with net zero and enhance engagement with investees. Together with the requirement to adopt transition plans that align with a 1.5°C world, the CSDD proposals have the potential to underpin the reporting investors and companies must complete under the EU's sustainability disclosure framework with robust mechanisms needed for action.

Nonetheless, a number of critical issues remain outstanding, which could impede the legal clarity and effectiveness of the Directive. These issues need to be urgently resolved to ensure that CSDD is fit-for-purpose and coherent with the EU's wider framework on sustainable finance.

Following the agreement of the Council's General Approach (GA), we call on the Parliament to reflect the following points in its final position, and for co-legislators to account for these points during their subsequent trilogue negotiations. We acknowledge the progress made with the recent vote in the ECON Committee, and wish to outline our support for these compromises being the baseline for addressing the aforementioned critical issues throughout the rest of the Parliamentary process. Our support is contingent on the following considerations being reflected in the proposals:

- **Maintain a tailored approach for investor due diligence that recognises the nuances between how investors carry out due diligence, and how due diligence is carried out by companies operating in the real economy.** This includes acknowledgement of the levers investors have at their disposal, such as stewardship and engagement, and the constraints on their capacity to influence holdings, in line with the OECD Guidelines for Multinational Enterprises (OECD Guidelines) and sector-specific guidance for institutional investors;
- **Ensure that CSDD is coherent with the EU's wider framework for sustainable finance:**
    - Specifically, we recommend aligning the scope of entities captured by CSDD with that of the Corporate Sustainability Reporting Directive (CSRD), provided the application of the proposals to institutional investors and asset managers more broadly is workable in practice; and
    - **Avoiding duplication with existing regulatory requirements investors are subject to** by maintaining consistency with the disclosure requirements established by CSRD and the Sustainable Finance Disclosure Regulation (SFDR), as well as engagement and voting requirements established under the Shareholder Rights Directive II (SRD II). This includes in relation to definitions, terminology, concepts and obligations across these files;
- **Explicitly incorporate provisions for climate due diligence requirements,** alongside proposals for broader environmental and human rights due diligence; and
- **Strengthen existing requirements to adopt climate transition plans,** expanding these requirements to all in-scope companies.

<u>IIGCC's detailed recommendations</u>

Differentiating between due diligence for investors and other financial and non-financial corporates

IIGCC welcomes the amendments set out in the ECON Committee vote on 24 January, which provide for a tailored and proportionate due diligence regime for investors. The latest proposals capture the nuances within the investor/investee relationship and better recognise the tools investors have at their disposal to carry out due diligence and address adverse impacts.

Carrying out due diligence, both pre- and post-investment, enables investors to better identify and manage their own exposures to sustainability-related risks. This in turn supports capital allocation decisions and engagement with investees, creating a 'virtuous cycle' where companies are more likely to address adverse climate impacts they cause or are linked to and take action to align their business model and strategy with net zero as a result of investor pressure.

More broadly, we note that the optional expansion of downstream due diligence requirements to financial institutions under the Council's General Approach risks undermining the overall ambition of CSDD. IIGCC supports the removal of this provision from the final text, as this would ensure CSDD is implemented on a consistent basis, creating a more level playing field for sustainability due diligence across the EU.

Overall, IIGCC is supportive of an extension of the CSDD's due diligence provisions to institutional investors and asset managers, on the basis that the mechanisms for doing this are proportionate, workable, and clearly differentiate between how investors and other financial and non-financial corporates carry out due diligence in practice. This includes closer alignment with international standards and best practice, greater recognition of the nature of the investor/investee relationship, and more emphasis on requiring investors to use the tools at their disposal to address adverse impacts. We propose the following obligations are maintained, amended or introduced to achieve this:

- **Maintain the removal of the 'established business relationship' concept in favour of a risk-based approach that prioritises the most material adverse impacts**. Many of IIGCC's members have sizeable portfolios, which can include thousands of holdings, and large corporations will typically have extensive relationships across their value chains. Ongoing monitoring of all companies that in-scope firms have 'established relationships' with would not only be highly resource-intensive, but would also create a risk that companies will neglect adverse impacts arising further down the value chain. IIGCC is strongly supportive of a risk-based approach, which upholds consistency with established international practice (such as the OECD Guidelines), and allows companies to prioritise adverse impacts across the value chain based on their severity, rather than proximity. IIGCC also supports proposals that allow companies to prioritise adverse impacts based on their severity and likelihood if they cannot address all identified adverse impacts at once. However, it will be essential to clarify the extent to which the adequacy of companies' risk prioritisation could lead to liability, and who is responsible for determining whether companies prioritised the correct adverse impacts.

- **Maintain the investor exemption from the proposed civil liability regime.** While IIGCC supports the scoping-in to CSDD of investors, the final Directive must fully recognise the qualitative differences between the investor-investee relationship, and the 'client-supplier' relationship between companies operating in the real economy. Investors have no direct operational or contractual links with their investee companies. They hold investments in thousands of companies, many of which will be minority shareholdings, and across a range of asset classes and instruments, offering varying levels of control, influence, and access to data. As such, investors do not have the same degree of leverage to address adverse impacts as companies with contractual relationships with their value chains. Instead, they are usually *linked* to these impacts as a result of their ownership stake in companies, or their role in financing debt, rather than directly causing, or contributing to, adverse impacts. As noted in the OECD Guidelines, it remains the primary responsibility of investee companies to prevent or mitigate the adverse impacts *they cause or contribute to*. Therefore, the responsibility should not shift from the entity causing or contributing to these impacts to shareholders. We believe that the proposed civil liability regimes should be limited to the firms directly causing and contributing adverse impacts, with investors that are 'linked' to these impacts using the levers at their disposal (such as engagement with their holdings) to address them to the extent possible.

- **Maintain the investor exemption from divestment obligations.** IIGCC supports the provisions that investors would not be required to automatically terminate (or 'divest') their relationships with investees when adverse impacts cannot be easily or readily addressed. While divestment is one tool at investors' disposal, it is not the only one and should only be used as a last resort. In some cases, divestment may not be automatically possible (for example in the context of passive funds). Moreover, investors work within the mandates provided by their clients (e.g. asset owners), and may be required to invest in and hold companies in line with client instructions, irrespective of whether these companies are causing or linked to adverse impacts. To achieve real world emissions reductions at the scale necessary to reach net zero, it will be vital for investors to invest in and engage with companies that may presently be high-emitters, or operate in high-risk sectors, and hold them to account for the actions they are taking to transition. Many of these companies will be causing or contributing to significant adverse impacts, such as greenhouse gas emissions, and supporting them on their transition to net zero will be necessary to meet EU and international climate targets. Investor pressure is essential to positively influence their investees' management and mitigation of these impacts, and without this the channels for triggering the behavioural change necessary to shift their business practices would be severely limited. It is ultimately up to investors to determine whether their investees are taking sufficient action to address these impacts and divestment should be considered an option only where other channels to encourage progress have been exhausted.

- **Full recognition in the Directive of the levers investors have to engage with and induce investee companies to bring adverse impacts to an end, in line with the proposed Article 8(a) as voted by the ECON Committee.** While investors may not be able to directly address the adverse impacts caused or contributed to by their investees, they should seek to influence their investees to prevent or mitigate adverse impacts in a proportionate manner that reflects the degree of access and influence an investor has with their holdings. This includes, but is not limited to, ongoing engagement with their holdings and the exercising of voting rights. In line with the risk-based approach, such engagement must be proportionate and prioritised according to the severity and materiality of the adverse impacts, the activities of the holding and the sector it operates in, and the size of, and access to, the investment, amongst other factors.

- **Removal of Undertakings for Collective Investment in Transferable Securities (UCITs) and Alternative Investment Funds (AIFs) from the scope of CSDD**, given that due diligence is typically conducted by investors at the entity, rather than fund-level. Such an approach would also be consistent with the scope of CSRD.

Coherency of the EU's sustainable finance regulatory framework

We urge the co-legislators to ensure that CSDD is coherent with, and supports the functioning of, the EU's wider framework for sustainable finance. CSDD has the potential to serve as a useful counterpart to CSRD, which as noted in the Commission's proposals, 'will cover the last step of the due diligence duty, namely the reporting stage'. It can also support investors in scope of SFDR with their work to address principal adverse impacts (PAIs) stemming from their investment activities. However, alignment between the disclosure regimes established by CSRD and SFDR in particular, could be strengthened by:

- **Aligning the scope of companies captured by CSDD, both financial and non-financial, with CSRD, irrespective of whether they operate in a high-risk sector.** This will ensure consistency between the EU's requirements for companies to implement frameworks to undertake due diligence and then disclose on these frameworks (noting that reporting is the last stage of the due diligence process). Our support for a consistent scope between the files, which would bring a wider range of investors in scope, is contingent upon the implementation of our recommendations outlined above in relation to the application of CSDD to investors. We also emphasise the need to ensure that CSDD does not impose undue burdens on SMEs. Any obligations that are imposed on SMEs must be proportionate to their size and capabilities, in line with OECD guidelines.

- **Clarifying how CSDD will both underpin and complement requirements under SFDR**. CSDD should act as the 'action and behavioural mechanism' that supports the due diligence-related disclosures and reporting that investors and other financial institutions will make under SFDR. For example, under SFDR, investors are required to disclose their sustainability due diligence policies, and to report on the actions taken to address the PAIs of their investment decisions. However, this requirement does not directly mandate action on sustainability due diligence. We note that under UCITS and AIFMD, where PAIs are considered in line with SFDR, then they should be incorporated into due diligence requirements under these regulations. Care should therefore be taken to ensure that the requirements proposed under CSDD in this regard are consistent with these existing requirements. IIGCC also notes that under SFDR, these actions are undertaken on an ongoing basis, not just the pre-contractual stage. This is consistent with international standards such as the OECD Guidelines, which state that post-investment due diligence should be undertaken to identify, mitigate and prevent investees' adverse impacts. Coherency between the two files should be prioritised to prevent any duplicative or conflicting due diligence and reporting requirements, with the focus centring on the role of proportionate, risk-based engagement as the key lever investors have to influence the PAIs of their investment decisions.

- **Maintaining links to SRD II in relation to investor engagement and voting activities.** As set out in Article 8(a), where investors are engaging with their holdings to address and mitigate adverse impacts, these activities should be undertaken in line with their existing obligations under SRD II.

- **Harmonising concepts and terminology across CSDD and other key sustainable finance files**. This includes ensuring consistency between 'adverse impacts' under CSDD, 'PAIs' under SFDR, and 'material negative impacts' under the draft European Sustainability Reporting Standards (ESRS). IIGCC notes that under SFDR, there are no 'thresholds' for determining a PAI, which are always deemed to be material (particularly in the context of the mandatory indicators). Co-legislators should consider this in the context of the need to prioritise adverse impacts under CSDD, and ensure that the approaches for addressing these impacts are consistent between the two files.

Enhancing CSDD's climate provisions

IIGCC emphasises the importance of incorporating climate change factors into the due diligence requirements, and strengthening the climate-related provisions that have already been proposed. Specifically, IIGCC calls for:

- **The explicit integration of adverse climate impacts within CSDD**. In-scope companies should be required to identify, prevent and mitigate the actual and potential adverse impacts of their activities on climate change, alongside wider human rights and environmental factors. **IIGCC would support the inclusion of climate change in the list of environmental harms for which companies will need to conduct environmental due diligence, as set out in Annex II**. This would help to further ensure CSDD can act as an 'action and behavioural mechanism' to underpin SFDR, which includes greenhouse gas emissions in the list of mandatory PAIs that investors are required to identify, manage, and mitigate.
    - IIGCC acknowledges that questions have been raised as to how treaties such as the Paris Agreement (which target state actors) could be applied to companies. However, these concerns around the application of international conventions to companies would also apply to the other conventions listed in the Annex.
    - The Paris Agreement is widely recognised as an international standard for business action, with a considerable and growing number of companies globally committing to reducing emissions and building climate resilience in line with its provisions. Initiatives like the Glasgow Financial Alliance for Net Zero, the Paris Aligned Investment Initiative, and Climate Action 100+ are all examples of coalitions whose members have committed to aligning with net zero by 2050. The existence of corporate and investor-focused coalitions like these demonstrate that the Paris Agreement can provide a suitable framework for businesses to build on when pursuing their own climate goals.

- **Strengthened requirements on the adoption of transition plans.** IIGCC proposes that all companies in scope of CSDD should be required to adopt transition plans. This should include companies operating in high-risk sectors, whose transition to net zero would have the greatest impact on real-world emissions reductions.
    - Specifically, the list of high-risk sectors captured under CSDD should be extended to include carbon-intensive sectors. As noted above, the financial sector, while linked to adverse impacts, is rarely responsible for directly causing or contributing to them, and in our view should therefore be excluded from the scope of high-risk sectors.

- IIGCC welcomes the latest proposed amendments to Article 15, which would align transition plan requirements under CSDD more closely with CSRD. We emphasise the need to ensure that these plans are consistent with the more granular disclosure requirements that will be set out under the European Sustainability Reporting Standards (ESRS) E1 (once finalised). This should include implementing actions for capital expenditure, and alignment of companies' business model and strategy with net zero by 2050. More broadly, the plans should explicitly reference the EU's own climate objectives (e.g. 2030 and 2050 emissions reduction objectives) alongside the goals of the Paris Agreement.
- Companies adopting transition plans should be required to set robust, science-based emissions reduction targets. Under the current proposals, companies would only need to set emissions reduction objectives where climate change has been determined as a principal risk for, or impact of, its operations. However, no guidance is provided as to how a 'principal' risk or impact should be determined in practice which undermines the value of this requirement. Climate-related targets set the ambition for, and trajectory of, corporate transition plans. IIGCC therefore emphasises that they should form a mandatory part of transition plan disclosures, not be left to individual company discretion.
- There is a lack of detail as to how such emissions reduction objectives should be implemented. CSDD should explicitly state that these objectives should include short-, medium- and long-term targets, covering all scopes of emissions and aligned with the goal of limiting global temperature rises to 1.5°C. This will uphold the credibility of these objectives, and enable consistency with the transition plan disclosure requirements established under the draft ESRS E1.
- IIGCC notes that under CSRD, when companies have not yet set climate-related targets or transition plans, they can report why this is not the case on a 'comply or explain' basis. Given the urgent need for mandatory transition plan disclosures, accompanied by robust targets, we urge that co-legislators review the interactions between the application of transition plan requirements under CSDD and CSRD respectively, to ensure coherence and provide investors with the mandatory information they need to assess their holdings' alignment potential.

About IIGCC

The Institutional Investors Group on Climate Change (IIGCC) is the leading European membership body for investor collaboration on climate change and the voice of investors taking action for a prosperous, low carbon future. Our 375+ members, representing over €60 trillion in assets under management across 24 countries, are in a position to catalyse real-world change through their capital allocation decisions, engagement with companies and policy advocacy. Through our work as a network partner in Climate Action 100+, the largest global investor engagement initiative on climate change, we also engage with the world's biggest corporate emitters to improve their climate performance and ensure transparent disclosures of emissions and transition plans.

***Disclaimer**: This position paper was developed in collaboration with a number of IIGCC members but does not necessarily represent the views of the entire membership, either individually or collectively.*