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COMMISSION STAFF WORKING DOCUMENT

IMPACT ASSESSMENT REPORT

Accompanying the document

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937

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Glossary

Term or acronym	Meaning or definition
Limited Liability Companies (LLCs)	Limited liability company means a company having legal personality, possessing separate assets which alone serve to cover its debts and that is subject, under the national law governing it, to conditions concerning guarantees for the protection of the interests of its owners and third parties (e.g. the types of companies listed under Annex II of the Company Law Directive (EU) 2017/1132, of 14 June 2017, relating to certain aspects of company law). The owners of limited liability companies are shareholders or members, depending on the legal form; the term "shareholders" is used in this report as (also) referring to members, where relevant.
Directors	Directors as defined by Article 3(i) of Directive 2007/36/EU, as amended by Directive (EU) 2017/828 (Shareholder Rights Directive) which encompasses directors of the various national limited liability company forms and the one and two-tier (dual) board systems: (i) any member of the administrative, management or supervisory bodies of a company; (ii) where they are not members of the administrative, management or supervisory bodies of a company, the chief executive officer and, if such function exists in a company, the deputy chief executive officer; (iii) where so determined by a Member State, other persons who perform functions similar to those performed under point (i) or (ii)." Where there is no board the person(s) entrusted with managing the affairs of the company should be considered director(s).
Supporting study on due diligence	Study on due diligence requirements through the supply chain, prepared for the European Commission by BIICL and LSE, final report with annexes (February 2020)
Supporting study on directors' duties	Study on directors' duties and sustainable corporate governance, prepared for the European Commission by EY, final report with annexes (July 2020)
Open public consultation (OPC)	The open public consultation conducted at the EU Survey "Have your say" portal of the European Commission between 26 October 2020 and 8 February 2021 to gather data and to collect the views of stakeholders with regard to a possible initiative on sustainable corporate governance.
ESG	Environmental, Social and Governance
UN SDG	United Nations' Sustainable Development Goals. The 17

	SDGs are at the heart of the 2030 Agenda for Sustainable Development, adopted by all United Nations Member States in 2015.
UNGPs	United Nations' "Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework. The UNGPs is an instrument consisting of 31 principles developed by the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises, and were endorsed by the Human Rights Council in its resolution 17/4 of 16 June 2011.
(Corporate) due diligence	Due diligence refers to the establishment and implementation of adequate measures by a company with a view to identifying, preventing and mitigating the actual and potential (i.e. risk of) adverse impacts on human rights (including labour rights)[1] and the environment (including the climate),[2] in the company's own operations, its supply or value chains and adverse impacts linked to the company's products and services. It is also called due diligence for responsible business conduct[3]; supply or value chain due diligence; corporate due diligence for human rights and environmental impacts; social, environmental and human rights due diligence; or sustainability due diligence[4].
Value chain	All activities, operations and business relationships of an undertaking, including entities with which the undertaking has a direct or indirect business relationship, upstream and downstream and which either: (a) supply products, parts of products or services that contribute to the undertaking's own products or services, or (b) receive products or services from the undertaking. For the purpose of this document, the notion of value chain is broader than the term "supply chain" or "upstream value chain" and encompasses it. Downstream value chain includes parts of the life-cycle of production which starts from the use phase and includes the product end of life activities, such as recycling, disposal of waste. Where sources cited in this

[1] As provided for in the UNGPSs, GP 12 and OECD Due Diligence Guidance for Responsible Business Conduct
[2] As in the OECD Due Diligence Guidance for Responsible Business Conduct
[3] See the OECD Guidance referred to above.
[4] See Supporting study on due diligence, p. 59 and p. 156.

	document use the term "supply chain", this document takes over this terminology.
Environmental impacts	Environmental impacts are those specified in selected international environmental conventions which contain duties that are implementable for companies. For a list of environmental harms covered in this initiative, please refer to the list of human rights and environmental agreements in **Annex 17**.
Human rights impacts	Human rights impacts are understood as the violation of human rights, contained in international conventions on human rights, including labour rights. For a list of human rights impacts, including labour rights, covered in this initiative, please refer to the list of human rights and environmental agreements in **Annex 17**.
Corporate science-based targets	While the EU has set public targets on energy efficiency and renewable energy for Member States, such targets apply within the EU only and are largely limited to public objectives. Translation of the EU's Paris commitment into corporate target setting as well would ensure its achievement by industry. Corporate science-based targets translate the 1.5°C goal into concrete corporate action.
Stakeholders of a company	Shareholders (members), employees, customers (consumers and other businesses), suppliers and other entities, people, groups, local communities, etc. affected by the operation of the company, including employees and others in its value chains, as well as the local and the global environment (including the climate).
Shareholder Rights Directive (SRD)	Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies (SRD I), as amended, among others, by Directive (EU) 2017/828 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (SRD II)
Non-Financial Reporting Directive (NFRD)	Directive 2014/95/EU amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups
Corporate Sustainability Reporting Directive (CSRD) or NFRD review	Commission Proposal for a Directive amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting
Accounting Directive	Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC and repealing Council Directives 78/660/EEC and 83/349/EEC

Capital Requirements Directive (CRD)	Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (CRD IV), as amended, among others, by Directive (EU) 2019/878 as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (CRD V)
Capital Requirements Regulation (CRR)	EU Regulation No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012
EFRAG	European Financial Reporting Advisory Group
EBA	European Banking Authority
CAPEX	Capital Expenditure
CFP	Corporate Financial Performance
GHG	Greenhouse gases (greenhouse gas emission)
OECD Guidelines for Multinational Enterprises	OECD MNE Guidelines are set of recommendations on responsible business conduct addressed by governments to multinational enterprises operating in or from the 49 adhering countries. They provide non-binding principles and standards for responsible business conduct in a global context that are consistent with applicable laws and internationally recognised standards. The implementation of the due diligence recommendations in the OECD Guidelines for Multinational Enterprises is supported by the OECD Due Diligence Guidance for Responsible Business Conduct and sector-specific due diligence guidance developed by the OECD.
Midcaps	There is no official or widely accepted definition of 'midcaps' at present. 'Midcaps' are deemed to be medium capitalisation enterprises comprising 250 to 3000 employees (in full-time equivalents). They are divided into 'small midcaps' of between 250 and 499 employees, and 'medium and large midcaps' of from 500 to 3000 employees. For the purposes of this report two different definitions are used to differentiate them from very large companies, also defined in various ways.

1. INTRODUCTION: POLITICAL AND LEGAL CONTEXT

1.1. How does this initiative contribute to the political priorities of the Commission and the EU?

The Union has set itself the objective of becoming **climate-neutral** by 2050[5] and to deliver on the **UN Sustainable Development Goals**.[6] Both these commitments require changing the way in which we produce and consume. In its Communications on the European Green Deal and on A Strong Social Europe for Just Transition, the Commission committed to tackling climate and other environment-related challenges and set the ambition to upgrade Europe's social market economy to achieve a just transition to sustainability.

As part of the European Green Deal, an initiative on sustainable corporate governance was listed among the deliverables of the Action Plan on a Circular Economy, the Biodiversity strategy, the Farm to Fork strategy and the Chemicals strategy and Updating the 2020 New Industrial Strategy: Building a stronger Single Market for Europe's recovery. This initiative would build on the analytical and consultative work carried out under Action 10 of the Commission's 2018 Action Plan on Financing Sustainable Growth[7], and contributes to the Strategy for Financing the Transition to a Sustainable Economy.

Furthermore, the COVID-19 pandemic revealed vulnerabilities of global supply chains for specific products and sectors which amplified adverse impacts on employment and social conditions in the EU and in other parts of the world.[8] Studies show that companies which integrate the interests of their employees, affected parties and the environment into corporate decisions performed better even during the pandemic.[9] The COVID crisis reinforced the emerging trend of calling for a paradigm shift towards a stronger focus on long-term sustainability and highlighted the need to foster a resilient economy and society.

The Communication "Europe's moment: Repair and Prepare for the Next Generation" mentions sustainable corporate governance as an integral part of the efforts to achieve a more resilient EU economy. It is against this background that the Commission's 2021 work programme foresees the adoption of a legislative proposal on sustainable corporate governance to foster long-term sustainable and responsible corporate behaviour.

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[5] "European Climate Law" (Regulation (EU) 2021/1119), together with a binding target to cut domestic net GHG emissions by at least 55 % compared to 1990 levels by 2030: Article 2 "European Climate Law".

[6] The EU is committed to implementing the global 2030 Agenda and the 17 SDGs (see "Delivering on the UN's Sustainable Development Goals – A comprehensive approach", SWD(2020) 400). Commission Reflection Paper "Towards sustainable Europe 2030, (January 2019)

[7] Following the 2018 recommendations of the High-Level Expert Group on Sustainable Finance.

[8] See **Annex 14** on specific related consequences of the Covid-19 crisis.

[9] See Cheema-Fox et al., 2020, Corporate Resilience and Response During COVID-19; OECD Centre for Responsible Business Conduct note "COVID 19 and Responsible Business Conduct"; European Capital Markets Institute's Commentary ESG resilience during the Covid crisis: Is green the new gold?, 67-2020.

Sustainability in corporate governance encompasses encouraging businesses to frame decisions in terms of their environmental, health, and human rights impact, as well as in terms of the company's good performance and resilience in the longer term.

This initiative would contribute to reinforcing the respect of the environment and human rights throughout value chains.[10] Being a horizontal instrument applying also to the value chain, it would complement other measures, existing or being prepared, which directly address some specific sustainability challenges, mostly within the EU.[11]

This initiative also responds to two European Parliament reports calling on the Commission to strengthen the dimension of sustainability in directors' duties and to propose EU rules for a comprehensive corporate due diligence obligation.[12]

1.2. What is the legal and policy context?

1.2.1. Companies, corporate governance and sustainability

The limited liability company – which this initiative focuses on – is the most used legal form for organising major business activities in the EU. While encouraging risk taking and innovation, creating a company as a legal entity separate from its founding owners (and future shareholders or members) has always presented governance-related issues.

Corporate governance, encompassing decision-making structures, management processes and the allocation of competences within the company, is important for providing proper accountability and incentives to ensure adequate representation of the interests of shareholders and other stakeholders in corporate decision-making. The debate on corporate governance and EU initiatives have traditionally centred on addressing the 'agency problem' due to the separation of ownership and control, to ensure that directors avoid decisions that serve their own interests instead of those of the owners of the company and the company itself. Internal accountability mechanisms (e.g. shareholder approval of certain decisions, strengthening shareholders' participation rights, shareholder say on directors' pay, etc.) have been developed to align the interests of shareholders and directors.[13] Following the financial crisis of 2007-8, short-termism of shareholders (including institutional investors) has been identified as contributing to excessive short-term focus in corporate decisions (and to poor investment decisions in

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[10] Objective identified in the Joint Communication of the Commission and the High Representative on the Global EU response to COVID-19. This initiative would also contribute to the EU's agenda to promote decent work worldwide, as referred to in the European Pillar of Social Rights Action Plan, the Council Conclusions on Human Rights and Decent Work in Global Supply Chains, and to the EU Action Plan on Human Rights and Democracy 2020-24. More specifically, the Trade Policy Review Communication makes clear that forced labour should not find a place in value chains of EU companies.

[11] See the list of such measures and a mapping of the added value of this initiative in **Annex 7**.

[12] See European Parliament resolution of 17 December 2020 on sustainable corporate governance (2020/2137(INI)) and European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL)) .

[13] See for example shareholder decisions in the context of takeovers in the Takeover Bids Directive, shareholders' voting rights and "say on pay" in the Shareholder Rights Directives (SRD I and II).

banks and other financial intermediaries); hence, the main aim of recent reform was to foster long-term oriented shareholder engagement and to strengthen long-term investment motives.[14]

The role of the company's board is to protect the interests of shareholders, creditors, employees and third parties by ensuring that the interests of the company are promoted through risk management, strategy, supervision of the management and ensuring compliance. The need for responsible business behaviour and for better considering the interests of "stakeholders" (employees, other affected people, the environment, etc.) in corporate strategies and decisions has gained importance, driven by an increased materiality of intangible assets and of sustainability risks for the performance of the company and by the need for the private sector's contribution to addressing today's sustainability challenges.

1.2.2. Interlinked initiatives and added value

At EU level, sustainable corporate governance has so far been mainly fostered indirectly by imposing **reporting requirements** on approx. 12 000 companies[15] around environmental, social and human rights related risks, impacts, measures (including due diligence) and policies in the Non-Financial Reporting Directive (NFRD).[16] The NFRD had some positive impact but, given its limited scope in terms of companies, has not resulted in mainstreaming a majority of companies taking stakeholder interests sufficiently into account or managing sustainability risks and impacts.[17] The recent Commission proposal for a Corporate Sustainability Reporting Directive (CSRD, revision of NFRD) extends the scope of the companies covered[18] and strengthens the standardisation of reported information. Similarly, the recent Taxonomy Regulation is a transparency tool that helps facilitate investment decisions and tackle greenwashing by providing a categorisation of environmentally sustainable economic activities with a minimum social safeguard.[19] Neither of these measures impose material duties on companies other than public reporting requirements, and investors can use such information when allocating capital to companies.

EU environmental law[20] introduces various environmental requirements for companies, Member States, or defines goals for the EU[21]. However, it generally does not apply to the

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[14] E.g. the revision of the Shareholders' Right Directive. More details in **Annex 6**.
[15] Large public-interest entities that have more than 500 employees (and the balance sheet total or net turnover of which exceeds the Accounting Directive's threshold for large enterprises, see Section 1.3), including listed companies, banks and insurance companies. Study on the NFRD.
[16] See also, as explained above, some very limited new rules of the SRD II.
[17] The Impact Assessment for the CSRD proposal and the study on the NFRD (section 2) found a limited change in corporate policies as a result of the NFRD, consistent with the perception of main stakeholders who could not identify a clear pattern of change in corporate behaviour driven by these reporting rules.
[18] Sustainability reporting obligation for all large companies as defined by the Directive and, as of 2026, to companies (including non-EU companies, excluding all micro enterprises) listed on EU regulated markets.
[19] In the future, the taxonomy may contain a categorization of socially sustainable activities, too.
[20] For further information please see **Annex 7**.

value chains outside the EU where up to 80-90% of the environmental harm may occur[22]. The most relevant interlinked initiative is the Environmental Liability Directive which requires the prevention of some environmental harm in case of immediate threat of damage and introduces the "polluter pays" principle. However, it has limited application[23] and does not cover the value chain. The Environmental Crime Directive 99/2008/EC which is currently under review[24] provides for a set of definitions of what constitutes environmental crime and obliges Member States to provide for effective, dissuasive and proportionate sanctions.

EU climate legislation, including the recently proposed "Fit for 55" Package and its key actions setting more ambitious energy efficiency and renewable energy targets for Member States by 2030, needs to be underpinned by a wider transformation of production (circularity, process efficiency, fuel-switching, etc.) and consumption processes to achieve climate neutrality by 2050 across the economy and throughout value chains. The "Fit for 55" Package will only indirectly apply to some non-EU value chains of EU companies through the Carbon Border Adjustment Mechanism (CBAM) which aims at preventing "carbon leakage"[25] by imposing a carbon adjustment price for imported products not subject to the carbon price deriving from the EU Emission Trading System. In addition, not all climate impact throughout the value chain of the imported product will be taken into account in the calculations under the CBAM.

Existing **EU health and safety, and human rights legislation** targets very specific adverse impacts (such as privacy, discrimination, specific health aspects related to dangerous substances, health and safety of workers, rights of the child, etc.) within the EU[26] but does not cover the entire plethora of human rights impacts and does not apply to the value chain.

Existing or planned **supply chain due diligence instruments at EU level** apply to a limited number of products: 4 minerals in the Conflict Minerals Regulation[27], timber and timber products under the EU Timber Regulation[28] (while new rules to minimise the risk

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[21] For example it introduces limitations on the release of some pollutants, defines EU goals (such as the European Climate Law) or sets targets for Member States (such as for energy efficiency), defines obligations for Member States (e.g. on protection of natural habitats), establishes minimum content in authorisation procedures for some economic activities (e.g. Environmental Impact Assessment), etc.
[22] See Starting at the source: Sustainability in supply chains (2016), Anne-Titia Bové and Steven Swartz.
[23] Harm to land, water or protected species; for land and water limited to some sectors (energy, metals, minerals, chemical, waste, large-scale pulp, paper, food production) and to large installations.
[24] A Commission proposal is planned for 14 December 2021.
[25] "Carbon leakage" resulting from the increased EU climate ambition could lead to increase total global emissions. The CBAM carbon adjustment price on selected types of imported products in the iron steel, aluminium, cement, electricity, fertilizers sectors would level the playing field between EU and imported products.
[26] Under EU law, every EU worker has certain minimum rights relating to protection against discrimination based on sex, race, religion, age, disability and sexual orientation, labour law (part-time work, fixed-term contracts, working hours, informing and consulting employees). See EUR-Lex for a summary.
[27] Regulation (EU) 2017/821.
[28] Regulation (EU) No 995/2010.

of deforestation and forest degradation would cover additional agricultural commodities)[29], and 4 minerals used for electric vehicle and industrial batteries in the Commission proposal for a new Batteries Regulation[30]. These rules ensure the avoidance of some clearly identified risks of adverse impacts in supply chains[31]. The Sustainable Products Initiative under development, aims to revise the current Ecodesign Directive and concerns the sustainability of products placed on the EU market more broadly. However, this initiative would only consider specific due diligence requirements with respect to specific products, should there be the need for such rules in addition to the present initiative.

The legislative framework for a Union sustainable food system under development aims to make the EU food system sustainable and to integrate sustainability into all food-related policies. Inclusion of sector specific due diligence requirements for food companies will be explored.

Thus, the EU's regulatory environment currently does not offer EU companies a transparent and predictable framework that helps them to asses and manage sustainability risks and impacts across all risk and impact areas and across their value chains as well.

For more detailed information about the mapping of interlinked existing and planned EU law and information on the added value of this initiative, please refer to **Annex 7**.

1.3. Market context

There are about **13.7 million limited liability companies (LLCs)**[32] in the EU. **76 000** limited liability companies are **large**[33]**.** Looking at **very large EU limited liability companies** more closely, and in view of the regulatory options analysed in this report, about **23 200** companies **have more than 500 employees or a turnover above EUR 350 million**, roughly **9 400** of LLCs have **more than 500 employees and a turnover above EUR 150 million**, and about **8 900** LLC companies have **more than 1000 employees.**[34] Furthermore, there are about **3 250** EU-based limited liability companies that have shares listed in the EU.

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[29] Initiative on Deforestation and Forest Degradation: Beef, palm oil, soya, coffee, cocoa and wood.
[30] Proposal for a Regulation concerning batteries and waste batteries (COM(2020) 798/3).
[31] For example armed conflict and related serious human rights abuses in the Conflict Minerals Regulation
[32] Due to the close links to the NFRD and its current revision (amending the Accounting Directive), we rely here on the approximations for the number of companies that are considered as LLCs for the purposes of the Accounting Directive. In particular, we rely on the data included in the 2020 Study on the NFRD, both for the overall number and on the number of large LLCs.
[33] According to the Accounting Directive, large undertakings are those that exceed at least two of the three criteria: EUR 20 million balance sheet total, EUR 40 million net turnover, 250 employees.
[34] These data are derived from the Orbis database and include all companies domiciled in the EU, classified as public or private limited liability company in Orbis. Data are based on the most recent information available for the filtering variables (number of employees, turnover, balance sheet total), which means that occasionally figures for some companies may have been taken from earlier years.

According to the Commission's proposal, the sustainability reporting obligations under the Corporate Sustainability Reporting Directive would cover approximately **49 000** corporate groups (including all large companies and all EU and non-EU non-micro companies that have securities listed in EU regulated markets).[35]

Given the limited data on the turnover of third-country companies, it is not possible to estimate the number of third-country companies falling in the scope of this initiative.

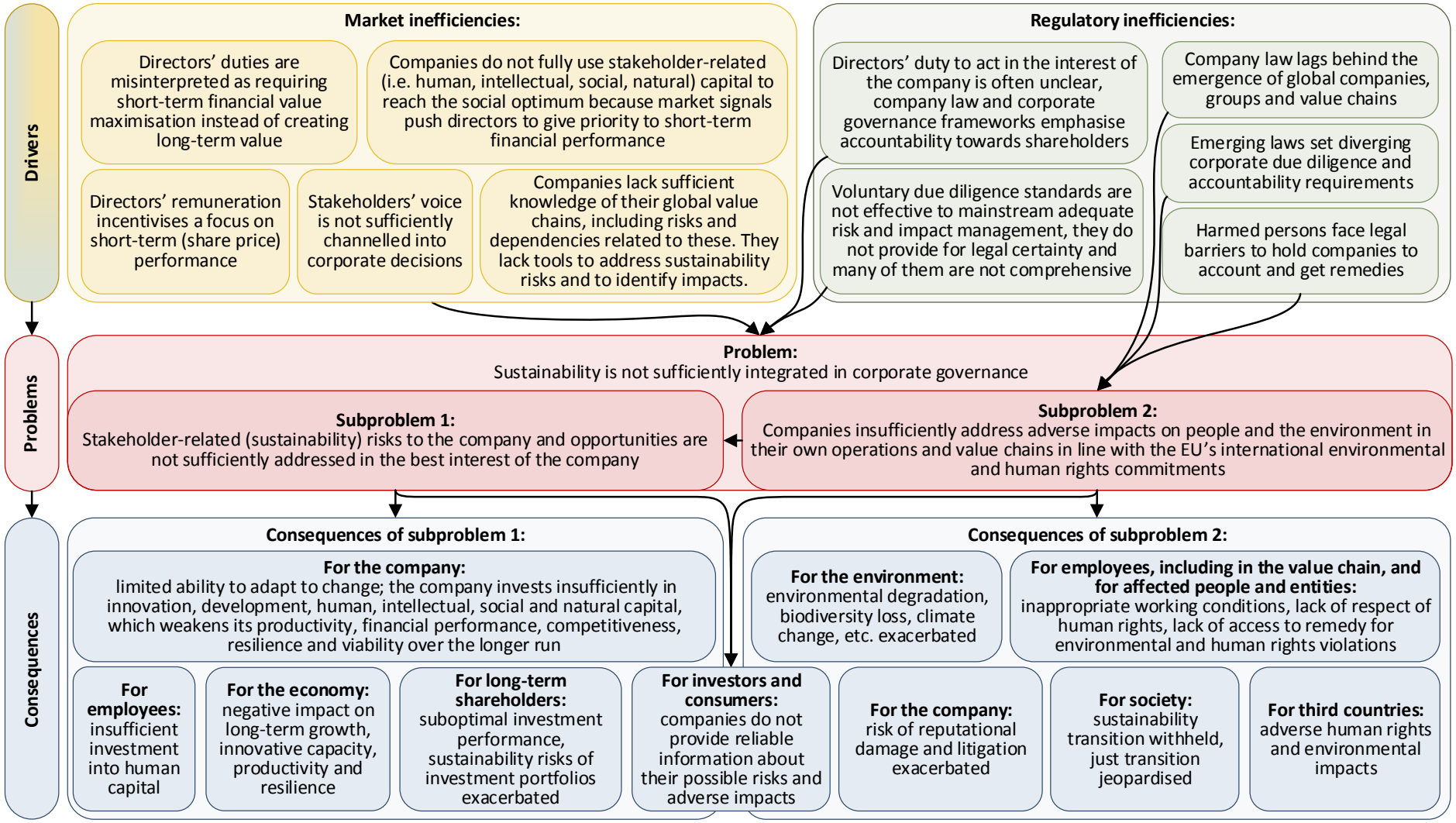
For further detail, please refer to **Annex 9**.

[35] See the NFRD study and the Commission's impact assessment accompanying the CSRD proposal. This figure takes into account the consolidated reporting requirement at group level. This represents approximately 65 000 individual large companies and 1 400 listed SMEs.

2. PROBLEM DEFINITION

2.1. What are the problems?

The following problem tree gives an overview of the identified problems, their underlying causes and their consequences for the various stakeholders.



2.1.1. Short explanation of the problem

This section explains the problems, as well as the drivers, with **Annex 10** providing additional evidence.

The main **problem** addressed by this initiative is the need to reinforce sustainability in corporate governance and management systems. There are (at least) two dimensions to this problem: first, stakeholder interests and stakeholder-related (sustainability) risks to the company which may materialize only in a longer time-frame are not sufficiently taken into account in corporate risk management systems and decisions (**sub-problem 1**). Intellectual, human, social and environmental capitals contribute in important ways to a company's long-term value, its resilience and external social and environmental impacts also increasingly affect the performance of the company. A failure to properly manage those dependencies and related risks (for example by protecting the quality of the soil on which the company depends, by training employees, or by adapting to climate change) may lead to suboptimal performance of the company, in particular, in the medium to longer term[36]. There may be similar consequences of neglecting stakeholder interests in management of the company, and consequently diminishing opportunities related to the sustainability transition[37]. Such opportunities arise for example from savings, resource efficiencies, better productivity linked to "nature positive" production processes, innovations leading to seizing sustainable product markets, investing into human capital, etc. This is the **internal dimension of sustainable corporate governance**, and it is primarily about the sustained performance of the company itself.

Secondly, companies do not sufficiently mitigate their adverse human rights and environmental impacts in line with the EU's international environmental and human rights commitments (**sub-problem 2**), and do not have adequate governance, management systems and measures to mitigate their harmful impacts. This is the **external dimension of sustainable corporate governance,** and it is primarily about adverse impacts on others and the planet (so called inside-out impacts of the company).

External impacts and internal risks and opportunities are strongly interlinked. External impacts, if unaddressed, can create reputational, litigation, operational or other risks, thereby affecting the performance of the company itself in the short, medium or long-term. Therefore, in practice, impact mitigation (due diligence) processes, where they are

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[36] The reasons why companies do not address these issues are explained further in this section.

[37] The World Economic Forum's Future of Nature and Business report identifies annual business opportunities linked to the sustainability transition worth $10 trillion in some sectors only that could create 395 million jobs by 2030.

in place, are often part of the company's risk management systems. In the same vein, addressing negative externalities may result in opportunities[38].

The **drivers** of these sub-problems are a **combination of market and regulatory failures**. As regards **market failures**, **competitive pressure** makes companies apply purchasing practices which prioritise short-term cost reductions. This may also lead to outsourcing parts of a company's production through global value chains located in third countries with often low human and labour rights or environmental standards, thus contributing indirectly to violations of human rights and to environmental degradation.[39]

Another well-documented pressure takes the form of **short-termism of investors**[40]. The best known example is the case of shareholders of companies listed on a public stock exchange but short-termism can also be found with bondholders and, to a lesser extent, shareholders in non-listed companies. Such pressures can also contribute to companies overlooking their external adverse impacts, disregarding longer-term sustainability risks and foregoing investments into the long-term sustainability and resilience of the company, including into new technologies, employees, and future-proof production processes. Partly as a response to such pressures, and often reinforced by the incentives built in their remuneration schemes, **corporate directors tend to interpret their duties vis-a-vis the company as requiring a focus on short-term financial performance**[41].

Also, companies may not manage their stakeholder-related risks because of a perceived lack of business case[42] or of awareness (due to the absence of market standards on risk management, or because risks arising in complex value chains are difficult and costly to identify, etc.).

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[38] The concept of "sustainability" is wider for the internal dimension than for the external dimension: while the external dimension captures human rights and environmental harm, risks to the company related to stakeholders may also arise, for instance, from insufficient human or natural capital development (e.g. failure to develop certain expertise of workers that would be key for the company).

[39] See Supporting study on due diligence, p. 214-217.

[40] For an analysis on short-termism of institutional investors and asset managers, see Kay review. For frequent portfolio turnover and short-term shareholding periods of "long-only" investors, see Mercer, IRRC Institute 2010, Do managers do what they say? For short-termism in banking, see EBA report on undue short-term pressure from the financial sector on corporations, 2019, finding that banks' average 3- to 5-year horizon for business planning and strategy-setting hampers longer term strategies and activities and does not allow long-term and sustainability challenges to be fully taken into account.

[41] See for example the SMART Research Reports - SMART (uio.no) financed by Horizon 2020:

[42]Supporting study on directors' duties. In addition to short termism, there are at least two other distinct mechanisms in economic literature that explain suboptimal outcomes in such context: 1) uncertainty about product quality (see Stiglitz 1979): in a model of costly search, depending mainly on the expected frequency of the (returning) customer, a firm finds it optimal to invest into transparency about the quality of its products or, alternatively, to increase the opacity. Product quality in the present context will include the firms' efforts to manage human rights and environmental risks; 2) poverty traps (see Capra et al 2009): a socially preferred outcome cannot be reached due to lack of (external) commitment mechanisms.

Finally, weak corporate governance amplifies agency problems within corporations[43]. Furthermore, as other stakeholders' voice is not sufficiently channelled into corporate governance[44], capitals (intellectual, human, social and environmental) linked to such stakeholders, may not be sufficiently protected or developed.

As regards regulatory failures, corporate regulation, corporate governance frameworks and accountability mechanisms focus on financial performance and emphasise accountability towards members/shareholders. The law is often unclear about whether and how broader stakeholder interests have to be taken into account in directors' decisions, i.e. when decisions are being made in the interest of the company. International policy frameworks and voluntary standards on mitigating adverse external impacts[45] exist[46] but they do not fully reflect the EU's human rights and environmental commitments and do not mainstream proper impact management. Furthermore, because of their non-mandatory nature and guidance-like language, they do not provide legal certainty for businesses[47] and cannot be expected to counter market pressure to reduce operating costs.

Sub-problem 2 is also caused by the fact that **company law is lagging behind the emergence of global value chains** where factual control can be exercised, similarly to **corporate ownership in groups**, but through contracts or financing. Through its purchasing decision, the company can control the quality of the product or service in terms of related externalities and through the contract itself it can attempt to impose certain human rights and environmental criteria, even beyond direct contractors. **Emerging EU and national laws on corporate due diligence diverge**[48], creating a risk of fragmentation and emergence of barriers for the EU single market, thus un-levelling the playing field and raising additional administrative burden and costs for companies based in different Member States. Finally, despite the grievance mechanisms established by countries adhering to the OECD Guidelines for Multinational Enterprises[49], victims do not have a legal instrument to **claim access to remedy** if an EU company is associated with harm in its value chain.

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[43] For instance directors' acting against the long-term value of the company, e.g. by exploiting their information advantage vis-à-vis shareholders about investment opportunities.
[44] See under section "What are the problem drivers?"
[45] Please see a list of examples of such standards on the International Trade Centre's (ITC) Standards Map.
[46] See e.g. International Trade Centre (ITC) The Standards Map project.
[47] Results of the public consultation show that while the majority of companies indicated that they have experience with voluntary measures (47.1%) or legal obligations (24.6%), only 1 in 4 considered the existing voluntary frameworks to be sufficient. Businesses complain about the voluntary nature of the regulatory framework contributing to legal uncertainties. A growing number of companies are being sued in court for causing harm, which may be the consequence of the lack of clear regulatory requirements. Emerging jurisprudence suggests companies' legal responsibility to mitigate harm in line with international agreements (such as the Paris agreement in Milieudefensie v. Shell of 26 May 2021).
[48] See section 2.2.2.4
[49] Requirement for governments to set up a National Contact Point contributing to the resolution of complaints against companies that may arise from the alleged non-observance of the guidelines in specific instances.

As regards consequences, **sub-problem 1** leads to insufficient ability of companies to adapt to change and to insufficient investment in development, innovation, human and natural capital, jeopardising the long-term productivity, competitiveness and resilience of the company, to a suboptimal return for members and shareholders[50]. Eventually, it will hamper the economy's innovative capacity, productivity, growth potential and resilience, including its long-term competitiveness. **Sub-problem 2** has negative impact on affected people, exacerbates biodiversity loss, environmental degradation and climate change. **Both sub-problems** result in companies not being able to disclose fully reliable information about their risks and impacts to shareholders and consumers as the underlying risk and impact management systems are not sufficiently developed. Both sub-problems slow down the sustainability transition[51] and jeopardise a fair transition.

2.1.2. Sub-problem 1: Stakeholder-related (sustainability) risks to the company and opportunities are not sufficiently addressed

A company's performance depends to a large extent on how it manages its stores of value, including financial capital, intellectual and human capital, social and relationship capital, and natural capital. These can be associated with some of the companies' stakeholders, such as employees, other affected people, or the environment[52]. All companies rely on all these stores of value to an extent[53], but dependencies may vary by sector or type of activity, location, in time, etc.

Companies' operations and assets may be affected by **external sustainability factors** as well[54]. Similarly, **repercussions from the cumulative adverse impacts** of economic activity and industrialisation on the environment and society also affect individual companies, deteriorating their operating environment and increasing their sustainability risks[55]. Risk to the company can also arise from **not addressing its own adverse**

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[50] Sub-problem 2 may also contribute to such consequence on the performance of the company.

[51] For instance, the restrained innovative capacity and insufficient contribution of companies to closing the investment gap hold up the accomplishment of the sustainability transition. According to McKinsey & Company, "How the European Union could achieve net-zero emissions at net-zero cost?" (December 2020), reaching the 2050 net-zero emission target alone would require a total capital expenditure of around EUR 1 trillion per year in the EU27 in the period 2021-2050.

[52] When asked about interests relevant for the company's long-term success and resilience, overall respondents to the public consultation highlighted: 1) interest of employees, 2) interest of customers, 3) interest of natural environment including climate change, 4) interests of people and communities affected by the company's operations, 5) shareholders' interest and 6) consequences of any decision in the long-term (beyond 3-5 years). See also **Annex 2**.

[53] For instance, intellectual capital became the most important asset in the knowledge based economy. The IBEPS Global Assessment Report on Biodiversity and Ecosystem Services (2019) shows that 50% of global GDP is strongly or moderately dependent on nature.

[54] For example, a company not preparing its workforce for the digital transformation, an SME supplier of a car manufacturer disregarding the buyer's transition towards electric cars, a company not taking steps to adapt to climate change and environmental degradation while these impact its operations.

[55] The individual contribution can be tangible. For instance, in Milieudefensie v. Shell, Shell's activities and products were found responsible for about 1% of global emissions every year.

impacts on others or the environment, including in the form of exposure to **litigation**[56] or **reputational** damage[57].

Companies **not properly managing such dependencies and risks** face challenges to their sustained performance and resilience. For instance[58], **climate change-related risks** comprise **physical risks** and **transition risks**. **Biodiversity loss** is associated with transition, liability, and physical risks, **other environmental risks, such as water-related risks** are also relevant.

Finally, if a company does not develop its **human capital** appropriately, it will face the risk of not being able to respond to the rapidly changing business environment, while human rights, labour and social issues (poor workplace safety, employment of forced or child labour, etc.) also create risks to the company.

Stakeholder-related risks, including employee-related and environmental risks can also arise for the company **from its value chains**. Sustainability-related **value chain disruptions** may affect the entire operation of a company. Exposure to sustainability risks through the value chain is significant as many value chains are geographically highly concentrated in areas where sustainability impacts are even more likely.[59]

As regards the magnitude of the problem, **sustainability risks have become more material** for the success of companies in the light of globalisation, climate change, increasing environmental degradation, the resulting scarcity of resources, and growing inequality.[60] Environmental risks are already rated among the ones with the highest likelihood and highest impact risks to businesses, with **human-made** environmental damage perceived as posing an **imminent threat**[61], and based on scientific forecasts, climate change presents increased risks already in the short run.[62] Reputational risks are also increasing as consumer preference continues to shift towards sustainable products.[63]

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[56] In Milieudefensie v. Shell, the company was ordered to cut the carbon emissions of its global value chains – including suppliers and products and services – in line with the Paris Agreement.
[57] For instance, in BP's Deepwater Horizon 2010 oil spill, the FT estimates that the clean-up costs alone may have amounted to USD 90 billion. The company suffered also from a reputational perspective.
[58] For more details on the different types of risks see **Annex 10**, point 1.
[59] For example, semiconductor chips and rare earths. For more details see **Annex 10**, point 1.
[60] The Bank of England shows that global economic losses from extreme weather events have been constantly increasing, see Climate change: why it matters to the Bank of England? and Climate change: what are the risks to financial stability? . See also Shining a light on climate risks: the ECB's economy-wide climate stress test (2021).
[61] See The Global Risk Report 2021 referred to above.
[62] The IPCC Special Report 2018 finds that every year's delay before initiating emission reductions decreases the available time to reach zero emissions on a pathway remaining below 1.5°C by approximately two years. The World Meteorological Organization's Global Annual to Decadal Climate Update forecasts increased temperatures until 2025 in almost all regions of the world, with more rain or tropical cyclones in certain regions. This increases physical risks to companies related to climate change.
[63] Wilson J., Consumer preferences continue to shift towards sustainability, market research shows. TriplePundit, November 2018. See also the study on EU market for sustainable products, the retail perspective on sourcing policies and consumer demand.

Supply chain disruptions had been widespread before the COVID-19 pandemic, but they have become even more pronounced since then and are expected to increase further[64]. The crisis revealed also strategic dependencies that affect EU companies.[65] Industry plays a key role – through its corporate policies and decisions – in improving resilience and reduce any dependencies that may lead to vulnerabilities, including through diversification of suppliers, increased use of secondary raw materials and substitution with other input materials.[66]

With increasing interest of investors in sustainable investment opportunities, disregarding sustainability considerations in corporate strategies can also **prevent** companies from **attracting investments**.[67]

Some risks affect some **sectors** more than others, and some **Member States** may be more exposed to some risks[68]. Other risks may affect all parts of Europe (SME subcontractors lagging behind the gradual transformation towards climate-friendly production of the buyer).

Companies show **different maturity** in the management of stakeholder-related risks, impacts and opportunities. In general, the risk management does not adequately address sustainability matters.[69]

Furthermore, there is little evidence that companies are managing sustainability risks when **valuing** assets, notably that they take risks resulting from decarbonisation or the physical impacts from climate change into account as they draw up their **financial statements**.[70] This is despite the fact that the stock of existing assets is at risk because of climate change is large.[71] Among EU companies which have to report to the public based on the NFRD[72] (including large listed companies), **only 20-25% of companies provide specific information related to** their environmental, climate and human risks and 11% explain the **opportunities** linked to sustainability challenges. Less than 6 % provide information related to **different time horizons** and around 11% provide information related to **supply chain risks**. Only 14% report that the **board has oversight** over environmental and human rights matters. The CSRD proposal aims to address these gaps,

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[64] The Business Costs of Supply Chain Disruption – GEP (economist.com)
[65] EU Strategic dependencies analysis accompanying the Commission's Communication "Updating the 2020 New Industrial Strategy: Building a stronger Single Market for Europe`s recovery", May 2021.
[66] OECD analysis has confirmed that global value chains maximize economic efficiency, and that resilient, supply chains are essential in times of crisis to absorb shocks, to offer options to adjust and to speed up recovery. Cf. Shocks, risks and global value chains: insights from the OECD METRO model, June 2020.
[67] See e.g. Global Sustainable Fund Flows – 4 2020, January 2021 Morningstar
[68] For examples of more affected sectors and Member States see **Annex 10**, point 1.
[69] See World Business Council for Sustainable Development on "Sustainability and enterprise risk management" (2017) according to which 80% of risk management and sustainability practitioners say risk management does not adequately address sustainability risks.
[70] See Institutional Investors Group on Climate Change Investor Expectations for Paris-aligned Accounts (2020).
[71] See Commission SWD "Closing the climate protection gap - scoping policy and data gaps", May 2021
[72] See The Alliance for Corporate Transparency Research Report 2019 on 1000 companies across sectors.

but they also point to underlying weaknesses in company management of sustainability risks and impacts.

As regards specifically the actual and potential impacts of **climate-related risks and opportunities** on the company's businesses, strategy, and financial planning, large companies' disclosure remains below 50%[73]. While several large companies are frontrunners, most corporate **strategies** are rarely elaborated with **sustainability objectives** based on **proper measurement.**[74,75] 30% of the companies reviewed report that they **integrate climate change risks into their risk management processes**. The market is even less advanced on **other environmental risks**[76].

There are some differences in the corporate sustainability reporting practices across European **regions**[77]**, sizes of companies**[78,79] **and sectors**.[80]

2.1.3. Sub-problem 2. Companies insufficiently address adverse impacts on people and the environment in their own operations and value chains in line with the EU's human rights and environmental commitments

Corporate due diligence is a management tool to identify and mitigate the company's actual and potential adverse impacts and related risks in their own operations and value chains in terms of human rights violations (including labour rights) and environmental harm. The concept of due diligence for human rights impacts was developed in the **United Nations Guiding Principles on Business and Human Rights** ("the UNGPs") and in the OECD Guidelines for Multinational Enterprises, related Guidance on Responsible Business Conduct and sectoral guidance and further embedded in the recommendations of ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy.[81] The OECD framework extended the application of due diligence to cover environmental harm. In the last decades, **voluntary standards** have

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[73] See TCFD's 2020 Status Report examining 1700 large companies' disclosures. For more details see **Annex 10**, point 2.
[74] See the TCFD's 2020 Status Report, referred to above, for more details refer to **Annex 10**, point 2.
[75] 86% of respondents to the public consultation believe sustainability risks, impacts and opportunities should be integrated into a company's strategy, decisions and oversight. Individual companies and business associations expressed support with 70.6% and NGOs with 92.4%.
[76] See 2019 Research Report of the Alliance for Corporate Transparency, referred to above.
[77] See the 2020 Research Report of the Alliance for Corporate Transparency for regional differences, for more details see **Annex 10**, point 2.
[78] See the TCFD's 2020 Status Report, referred to above, for details see **Annex 10**, point 2.
[79] In the Global Reporting Initiative's Sustainability Disclosure Database only between 10-15% of all sustainability reports in 2017-18 came from SMEs. Literature shows that most SMEs have been slow to adopt environment-related improvements in the EU. See the report on SMEs and the Environment in the European Union (Calogirou et al. 2010). For more details see **Annex 10**, point 2.
[80] See 2019 Research Report of the Alliance for Corporate Transparency, for details see **Annex 10**, point 2.
[81] See ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy

been developed on supply chain due diligence and progress has been made by voluntary business action[82].

Some companies have integrated sustainability into their decisions as this can provide them with a competitive advantage.[83] This also responds to the increasing consumer pressure.[84] However, **more companies could implement comprehensive human rights and environmental impact mitigation processes through their entire supply or value chains**, taking into account the relevance of most of these matters across a large number of sectors:[85]

- Among larger EU companies, **around 33% claim that they undertake voluntary** due diligence which takes into account all human rights and environmental impacts, and **16% cover the entire value chain**. SMEs perform due diligence to an even lesser extent, as most of them source locally, their general awareness on human rights is low, and their human and financial resources they can dedicate to due diligence are also more limited.[86] For more details on uptake of due diligence by EU companies see annex 10.

- From among those companies that do, **many do not practice due diligence in a sufficiently comprehensive way**[87], voluntarily reflecting the EU's human rights and environmental commitments and international standards.[88] While 36 % of large companies report on climate targets, 14% of them adopt **science-based targets** when it comes to climate change and the goal of the Paris agreement to limit it to 1.5°C.[89] 35 % of these **meet their emission reduction targets**[90]**.**

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[82] Examples include the Accord on Fire and Building Safety in Bangladesh (see P. M. Barrett, D. Baumann-Pauly and A. Gu (2018): Five Years After Rana Plaza-The Way Forward) and the 2016 initiative to improve labour rights in Myanmar. For more, see International Trade Centre (ITC): The Standards Map project and the Supporting study on due diligence (Table 8.8, p. 336).

[83] E.g. EU Code of Conduct on Responsible Food Business and Marketing Practices under the F2F Strategy that entered into force on 5 July 2021. For more initiatives see the Supporting study on due diligence.

[84] See e.g. M. White (2018), The conscious consumer; K. Haller, J. Lee, J. Cheung (2020), "Meet the 2020 consumers driving change"; or Deloitte's 2021 survey among UK consumers "Shifting sands: Are consumers still embracing sustainability?".

[85] See materiality matrix in The Alliance for Corporate Transparency Research Report 2019.

[86] "Uptake of CSR by European SMEs and start-ups". (EASME/2020/OP/0004) - Draft final report

[87] Research has shown that corporations that adopt internal carbon footprint policies often pay less attention to human rights risk management. See D. S Olawayi, The Human Rights-Based Approach to Carbon Finance (2016); C. Macchi, The Climate Change Dimension of Business and Human Rights: The Gradual Consolidation of a Concept of "Climate Due Diligence",(2020).

[88] Multiple sources confirm this. For example Corporate Human Rights Benchmark (2020): Measuring 230 global companies on their human rights performance; Alliance for Corporate Transparency (2019): Research Report on companies' sustainability disclosures; European Parliament (2020): Corporate due diligence and corporate accountability - European added value assessment; OECD (2021), Costs and Value of Due Diligence in Mineral Supply Chains.

[89] See The Alliance for Corporate Transparency Research Report 2019. Data from EcoVadis' rating responses (over 65 000 companies) reveal that about 3.5% of large companies issued SBTs in their 2019 assessments. See Ecovadis: Corporate Action on Greenhouse Gas Emissions (September 2020).

[90] See The Science Based Targets Initiative Annual Progress Report 2020. In 2019-2020, among those primarily large listed EU companies in high carbon sectors which have set targets, 35% achieved emissions

Corporate climate targets are often aspirational and rarely accompanied with proper asset allocation and investment[91].

- Only a few companies seem to reflect **quality criteria** for due diligence[92] and **report on the outcomes** of their environmental and human rights policies[93].

Certain EU companies have been associated with adverse human rights and environmental impacts, including in their value chains[94] and voluntary action does not appear to have resulted in improvements in some sectors[95]. Adverse impacts include in particular human rights issues such as forced labour, child labour, inadequate workplace health and safety, exploitation of workers, and environmental impacts such as GHG emissions, pollution, biodiversity loss. Examples of EU companies' association with adverse human rights and environmental impacts are included in **Annex 10**.

2.2. What are the problem drivers?

2.2.1. Market Inefficiencies

2.2.1.1. Companies do not fully use stakeholder-related (human, intellectual, social, natural) capital to reach the social optimum because market signals push directors to give priority to short-term financial performance

According to the theory of the firm[96], where incomplete markets create profit opportunities[97], companies aggravate the negative consequences of missing markets via their normal business operations.

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reductions in line with the target, suggesting that targets were either very recent, ineffective to drive emissions reductions or ignored by the company. Out of 1726 companies 6% has a climate science-based target. For biodiversity or water, target setting is even more limited than for climate change.

[91] None of the EU companies assessed by the investor organisation Climate Action 100+ has appropriate capital allocation aligned with the objective of limiting global warming to 1.5°C See 2020 Progress Report.

[92] For instance, only 3.6% companies report any information on the effectiveness of the policies adopted to address their identified human rights risk. Corporate Human Rights Benchmark (2020): Measuring 230 global companies on their human rights performance; Alliance for Corporate Transparency (2019): Research Report on companies' sustainability disclosures. R. McCorquodale, L. Smit, R. Brooks and S. Neely "Human Rights Due Diligence in Law and Practice: Good Practices and Challenges for Business Enterprises" (2017) found that nearly 80% of companies that used dedicated due diligence processes do identify adverse impacts, whereas 80 % of companies using non-specific due diligence do not.

[93] 28% of 1000 EU companies report on the outcomes of their climate policies, 3% of their biodiversity policies and 6% of human rights policies. The Alliance for Corporate Transparency Research Report 2019

[94] Study on due diligence (2021), p. 221 indicates no change in corporate risk assessment processes which focus on the materiality of the risks to the company, despite international guidance (UNGP, OECD) which clarifies that the relevant risks must extend beyond the risks of the company to those who are affected (the rights-holders). Negative corporate impacts as a consequence of globalisation and failure to undertake due diligence, ranging from environmental disasters and land grabbing to serious violations of labour and human rights, are well documented.

[95] Evidence clearly shows that a voluntary approach did not suffice to mainstream companies' implementation of comprehensive human rights and environmental impact mitigation processes, see **Annex 10** and section on problem drivers.

[96] R .H. Coase in the "The Theory of the firm", 1937.

At the same time, companies are severely impacted by the incompleteness of markets in their daily operations and their investment decisions, for example because of lack of information. In a competitive market environment, most entrepreneurs will know realized prices for goods and services sold, and entrepreneurs will know their own costs of production. The only certain way to improve financial performance consists in reducing those costs. This is the competitive pressure most firms are facing on a daily basis.

In addition, a firm will try to gain at least temporary pricing power and increase its profit opportunities by developing innovative products[98] and services or upgrading its production processes with the right investment decisions. For this, most companies put aside some of their earnings (retained earnings). If retained earnings are not sufficient, other sources are used (bank loans, corporate bonds or new share issuance).

For both challenges, the daily competitive pressure and the choice of the best project investment, companies struggle to manage the increasing risks related to the environment and the protection of social and humanitarian achievements. Markets for trading those risks typically do not exist, or are in an embryonic state of development.[99] Investments into more sustainable production processes may go against short-term liquidity constraints and their outcome may be regarded as uncertain even though they have a potential to significantly enhance long-term value and improve profitability. In the absence of legally binding requirements, firms have difficulty to argue in favour of better funded internal risk management processes as well as longer-term investments.

Market prices not adequately reflecting negative externalities also demonstrates this market failure. As regards environmental externalities for example, between 1992 and 2014 the value of produced capital (such as machines and buildings) roughly doubled and that of human capital (workers and their skills) rose by 13%, while the estimated value of natural capital declined by nearly 40%[100]. The demands that the economy currently places on nature are roughly equivalent to the sustainable output of 1.6 Earths and is

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[97] E.g. because the use of ecosystem services is not properly accounted for, or because the use of some limited resources at the expense of future generations is possible because there is no market where future generations could express their willingness to pay for those resources, etc.

[98] In their analysis of the varieties of capitalism, Hall and Soskice 2001 noted the structural differences between Western capitalist economies. Different degrees of regulation and differences in contract law could explain different corporate strategies. The theoretical literature on economic search suggests that high quality strategies go together with a preference for high levels of transparency and information about the firm's efforts to ensure this quality; more and more, quality encompasses aspects of impact on communities (decent labour, quality of the environment, etc.) or the biosphere (carbon footprint, impact on biodiversity, etc.).

[99] Insurance products, including those tradable on exchanges, will become available over time, but we are certainly very far from a satisfactory situation from the point of view of an average EU based medium size company. See for example European Commission, SWD Closing the Climate Protection Gap, 2021.

[100] Rasgupta review on the Economics of Biodiversity.

projected to increase substantially[101]. This pressure is not reflected in market prices, making it invisible to market participants. [102,103]

Furthermore, as regards companies listed on stock exchanges and their value chain partners, **pressure exerted by shareholders also contributes to corporate decision-makers' short-termism.** In this context, the demand by investors for more disclosure on sustainability impact is certainly positive, but does not appear sufficient to correct the incentives in place.

Addressing the problem of short-termism has been on the regulatory agenda since the financial crisis.[104] The 2018 Final report of the High-Level Expert Group on Sustainable Finance argues that sustainability is axiomatically linked to the long term: investment in infrastructure, renewable energy, climate change mitigation, etc. require a long-term horizon, often over several years if not decades.

There is **evidence of short-termism in the behaviour of EU listed companies**. Between 1992 and 2018 the ratio of total shareholder pay-outs – i.e. dividend payments and share buybacks – to corporate net income increased from 20% to 60% in listed European companies with a non-negative income. Simultaneously, business investment – in terms of the ratio of capital expenditure (CAPEX) and research and development (R&D) spending to net income – has declined by 45% and 38% respectively[105]. While the study has been criticised by a number of contributors, in particular as regards methodology[106], it can be stated that it builds on a broad set of data sources, including information obtained from economic databases, from literature and regulatory review, complemented by the results of the contractor's own survey. Also, other studies confirm the trend

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[101] https://www.economist.com/finance-and-economics/2021/02/06/how-should-economists-think-about-biodiversity.

[102] See detailed analysis in the third progress report of the Institute of European Environmental Policy: Mapping objectives in the field of environmental taxation and budgetary reform: internalisation of environmental external costs, December 2020. See also Rasgupta review on the Economics of Biodiversity

[103] As regards carbon for example, the Economist estimates that the economic loss to humanity from emissions ranges from around $30 to $400 a tonne.

[104] The Kay Review, 2012, demonstrated how short-termism, which largely stems from short-term incentives in the institutional investment chain, results in short-term pressure on investee companies and how companies respond to such pressures. The report argued that short-termism in business is a tendency to under-invest, whether in physical assets or in intangibles such as product development, capacity for innovation, employee skills, reputation.

[105] See Supporting study on directors' duties. The economic analysis in this study is based on the available financial information from 1992 to 2018 of 4,719 listed companies in 16 countries (15 MS plus the UK). The sample of positive net income companies included 4,154 companies. Net income is calculated by subtracting some of the costs associated with certain future-oriented activities, but adding those costs does not significantly change the overall trend. In the period under analysis the ratio of total pay-outs to net income increased also on the entire sample by 17 percentage points. Also, the share of companies that allocate more than 75% of their net income to pay-outs increased substantially: from 4% of the revenues in 1992 to 37% in 2018. Over the last two decades the indicators that proxy short-termism seem to have stabilised around high levels of payments to shareholders and low investment intensity.

[106] See further in **Annex 2**, Feedback to the IIA and position papers under the open public consultation.

identified[107]. Recent research as regards corporate revenue from taxonomy aligned green activities confirm the low level of sustainable corporate investments too, showing that the share of "sustainability investment" within corporate investment is also low[108].

While increased investment into intangibles may explain the relative decline in CAPEX investment over the last years, research estimates that this factor contributes only to a small extent to reduced investments.[109] Some contributors[110] argue that the funds distributed to shareholders can be re-deployed into venture capital or other listed companies with cutting-edge research and sustainable investment projects. However, venture capital investment in green start-ups for example accounts for about a tenth of all venture capital investment and firms which sell goods or services that cut emissions made up just five of the top 100 firms globally in 2020's public-listings. Also, resources distributed to shareholders are more often reinvested on secondary markets which results in less resources available for investment into real productive assets at the company level.

As regards shareholder short-term pressure on listed companies to deliver quarterly results, **shortening of shareholding periods** in general (on average 8 months on stock exchanges) and that of long-term investment strategies' average holding period for shares have been used as indicators[111]. Short-termism was attributed to the fact that the biggest part of assets of pension funds and insurance companies (institutional investors with long-term liabilities and hence with interests in the long-term performance of companies) are managed by asset managers the performance of which is ranked and evaluated on a quarterly basis or in shorter time-frame, creating **incentives in the asset management market for short-term performance**. The **average holding period of shares** in active, ***long-term*** **investment strategies** (excluding hedge funds and other short-term strategies) is **1.7 years** showing that the average "long-term" investment horizon is less than 2 years. Less than 10% of asset managers had a three year investment horizon.[112,113]

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[107] See, for example, "Share Repurchases in Europe: A Value Extraction Analysis", Sakinç (2017). The study finds significant increase in dividend payments, increase in share-buybacks, significant decrease in CAPEX investment and largely stagnating R&D expenses during 2000-2015 in largest 297 European companies. A study from the US finds similar evidence for short-termism contributing to low investment levels: G. Gutiérrez, T. Philippon, "Investment-less Growth: an Empirical Investigation", 2016.

[108] The research looks at 75 companies listed on three main European indices: EURO STOXX 50, DAX and CAC 40 operating in taxonomy relevant sectors. It shows that 77% of analysed companies have an alignment level equal to or lower than 1%, while 13% of analysed companies have an alignment level equal to or above 5%. https://www.sustainablefinancesurvey.de/survey

[109] G. Gutiérrez, T. Philippon, "Investment-less Growth: an Empirical Investigation", as referred to above.

[110] See for example the contribution of Styrelse Akademien Sverige or the Danish Committee on Corporate Governance to the inception impact assessment.

[111] Short-term buying and selling of shares may indicate that the shareholder focuses on quarterly (or more frequent) gains as opposed to benefiting from long-term performance improvements.

[112] Mercer, IRRC Institute 2010, Do managers do what they say?

[113] Evidence shows that so called "insider ownership" (i.e. large stake owned by families) of large listed financial firms did not lead to lower risk taking and did not reduce short-term focus in the run up to the

Also, **long-term performance metrics**, including environmental and social factors are still **insufficiently integrated into investment strategies**[114] despite EU action as a follow-up to the sustainable finance strategy.[115]

Too strong focus on short-term financial performance reduces companies' ability to integrate long-term sustainability considerations adequately into business strategies and prompt companies to sacrifice investments necessary for the longer-term viability of the company. This has two aspects: first, **companies may not properly identify and address long-term sustainability factors, such as environmental, including climate change, social, health and human rights** (including labour rights, child labour, etc.) **risks and impacts** in their operations and value chains. Secondly, companies may **fail to integrate potential new opportunities either for investment or for building resilience.**[116]

2.2.1.2. Directors' remuneration incentivises improving short-term (share price) performance (for listed companies)

Studies show that **directors' compensation places too high value on short-term value creation**, disregarding long-term value for the company, including for its stakeholders[117]. Remuneration **focuses too much on financial performance**[118]. Among the 8 targets an average CEO in 2017 had to meet, only 1 was a target for sustainability performance, the others for financial performance. Remuneration schemes are also **too short-term oriented**.[119]

On average, half of executive compensation in Europe is stock-based[120], which reinforces pressures to manage corporate resources in a way aimed to increase share price in the

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financial crisis: Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide (fdic.gov).

[114] For example, investment strategies integrating ESG matters (i.e. by far the most popular responsible investment strategy) amounted to a mere EUR 4 trillion of assets under management, while impact investing, i.e. where investors seek positive social or environmental impact, reached EUR 108 billion in assets in 2018, Eurosif SRI study, 2018. In comparison assets managed by European asset managers amounted to EUR 23.8 trillion in 2017.

[115] A recent research covering the biggest 75 asset managers shows that only one-fifth of them have a dedicated policy on climate change and only two have committed to align all portfolios under management with the goals of the Paris Agreement Point-of-no-Returns.pdf (shareaction.org). A recent study shows that despite their high quality green innovation, energy intensive companies are disadvantaged by the current ESG investment strategies, L. Cohen, U. G. Gurun, Q. L. Nguyen "The ESG-Innovation Disconnect: Evidence from Green Patenting".

[116] This 'tragedy of horizons' is arguably clearest in the context of climate change, the impacts of which are felt beyond individual companies, but applies to all sustainability factors. See HLEG 2018 report.

[117] Reward Value Green Paper, 2020.

[118] Reward Value Green paper, 2020. The 5 most common financial targets are the share price, Earnings per Share (EPS), sales, Return on Assets/Invested Capital, and Free Cash Flow (FCF).

[119] Most absolute performance targets (typically: accounting and other targets) only have a 1-year horizon. Relative performance targets (virtually exclusively: share price/total shareholder return) have a 3-year horizon on average, overlapping annual vesting cycles imply a horizon that is often shorter.

[120] Kotnik et al., "Executive compensation in Europe: Realized gains from stock-based pay", 2018.

short-term[121]. Current **compensation designs** can drive directors to (short-term) inflate corporate performance to 'game' their pay-out. For example a 2017 study[122] finds that when CEOs' equity is about to vest, they cut R&D spending and CAPEX investment to maximise short-term profit and stock price. Short-term focused pay is a barrier for long-term value creation[123].

2.2.1.3. Directors' duties are misinterpreted as requiring short-term financial value maximisation

The link between short-termism and poor sustainability outcomes by the companies has been also highlighted in **company law research** where shareholder primacy in corporate governance has been pointed out as the most powerful barrier against more environmentally sustainable companies.[124] It is argued that while company law in general gives directors ample scope to take account of sustainability, company law has also facilitated the development of an almost exclusive focus on short-term financial value maximisation to the point of constituting the main barrier to more sustainable companies.

2.2.1.4. Stakeholders' voice is not sufficiently channelled into corporate decisions

A greater involvement of all stakeholders can help companies (listed and non-listed) to counterbalance short-term pressure from markets and short-term investors and give "voice" to subjects with a strong interest in the long-term sustainability of the company. However, **stakeholder involvement in corporate decision-making is rather limited**, especially when it takes place through voluntary company initiatives[125]. Mandatory requirements relate mainly to employees (minimum information and consultation of employees at EU level and legal requirements for board level employee representation in national laws[126]), whereas consultation or engagement with other stakeholders is more limited. The French due diligence law recommends setting the company's due diligence strategy in agreement with its stakeholders, but implementation of this recommendation appears to be weak[127]. Stakeholder engagement on human rights-related matters is

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[121] See also the Supporting study on directors' duties which finds that: "a substantial strand of literature argues that share-based remuneration of executives reinforces, rather than works against, the capital market pressure for maximisation of returns to shareholders in the short term".
[122] Edmans A., Fang V. A., and Levellen K.A., "Equity vesting and investment", March 2017.
[123] A study examining the effect of incentives in the Stoxx Europe 600 index of big European companies between 2014 and 2019 found a positive impact of high pay on performance over the short term (next 12 months). Yet no such relationship showed up over a three-year period, implying that the initial gains soon dissipated. Baeten, X., Van Hove, M., What to reward executives for?, 2021.
[124] The Sustainable Companies Project (2010–2014), led by Prof. Beate Sjåfjell of the University of Oslo.
[125] See, for example, EY study on directors' duties and sustainable corporate governance.
[126] Directive 2002/14/EC and Directive 2009/38/EC, see **Annex 8** for national laws.
[127] CGE-RAPPORT-devoir-de-vigilance, January 2020, p. 37.

generally low across Europe[128]. The public consultation shows diverging views for action in this area. [129]

2.2.1.5. Companies lack sufficient knowledge of their global value chains, including risks and dependencies related to these. They do not have the right tools to address sustainability risks and to identify impacts

The more supply chains are global, long or complex, the more limited is the knowledge of companies' of their full supply chains[130], as its traceability remains challenging. Key issues are **lack of transparency** due to inconsistent or missing data, fraudulent data, lack of interoperability of data systems between actors, lack of appropriate tools, financing and human resources in case of smaller companies[131,132].

This can represent a risk to companies' operation (for example if there are unknown dependencies on a particular supplier or country) or ability to adapt to sudden disruption in the supply chain.[133] Moreover, appropriate traceability helps industries in optimizing supply chain, knowing market status, improving product's quality etc.[134]

In addition, research reveals that human rights violations at the supplier level are often rooted in the buyers' own purchasing practices, particularly by timing demands, pricing pressures and last- minute order modifications, turning a blind eye to human rights issues. Therefore buyers' purchasing practices are central to protecting workers from human rights abuses or protecting the environment.[135] This is even more relevant for companies with thousands of suppliers in their supply chains.

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[128] The Alliance for Corporate Transparency Research Report 2019.

[129] 66 % of respondents believe directors should establish mechanisms for engaging with stakeholders in defining corporate strategy and due diligence processes. Most support (93.1%) is derived from NGOs while individual companies and business associations expressed hesitation with 68.0% disagreeing.

[130] Most recently exemplified in the lack of resilience of companies and disruptions of supply chains during the COVID-19 crisis. OECD (2020) COVID-19 and responsible business conduct; OECD (2021) Global value chains: Efficiency and risks in the context of COVID-19

[131] Is there a role for blockchain in responsible supply chains?, OECD paper (2019)

[132] The draft interim report of an ongoing study on Uptake of Corporate Social Responsibility by European SMEs and start-ups (June 2021) shows that SMEs face constraints to apply the principles of supply chain diligence in practice because SMEs lack the capacities (resources and time) to monitor their supply chains by themselves and investigate beyond their immediate suppliers. Also, the 2016 Timber Regulation evaluation found that costs of developing and exercising a due diligence system vary significantly, including depending on the number and geographic location of timber suppliers, complexity of the supply chains and the size of the company. SMEs seem to be in a disadvantaged position due to their low economies of scale, as the costs of the due diligence needs to be covered by a lower turnover. The evaluation shows that many small and micro firms have not only not implemented the Regulation but are still unaware of its implications.

[133] Undertakings that have taken proactive steps to address the risks related to the COVID-19 crisis in a way that mitigates adverse impacts on workers and value chains improve their viability in the short term and their prospects for recovery in the medium to long term.

[134] A. Regattieri, M. Gamberi, R. Manzini Traceability of Food Products: General Framework and Experimental Evidence, 2007.

[135] D. C. Snyder, S. A. Maslow, American Bar Association, Balancing Buyer and Supplier Responsibilities in International Supply Chains

Digitalisation and new technology tools hold great potential to help companies understand their value chain.[136] However, despite their availability, many companies still lack an overview of their entire value chain.[137] Progress on mapping supply chains and traceability is being made.[138]

The **integration of sustainability risks within companies' risk management** is at an early stage in all sectors[139], and there is a lower level of maturity in the identification and management of sustainability risks to the company itself as compared to human rights and environmental impacts. While there are broadly recognised international policy frameworks and voluntary standards on the measurement of adverse sustainability impacts, there are currently **no mandatory or commonly recognised frameworks, standards or guidelines for sustainability risks to the company and their management**[140]. To date, markets have not been pro-actively dealing with sustainability-related risks that can be disruptive to companies' activities and that are likely to affect in similar ways many companies operating in the same sector.

Standards on identification and mitigation of sustainability impacts are often not in line with scientific goals, although private standards tend to converge towards the climate neutrality and deforestation neutrality objectives.[141]

Furthermore, even where market tools facilitate appropriate impact mitigation, practice lags behind using them. This is in particular the case with setting corporate level targets aligned with the Paris Agreement targets for which the Science Based Targets (SBT) initiative has developed a target setting tool for companies in 47 sectors[142]. Most participating companies consider their SBT a win-win: 63% of companies say their SBTs drive innovation and 55% claim to have gained competitive advantage from SBTs. Other initiatives are developed for frameworks and tools to set Corporate Context-Based Water Targets[143] however, are so far not used by the majority of companies[144].

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[136] World Business Council for Sustainable Development (2019) Is technology a game-changer for human rights in corporate value chains?; BCG (2018) Pairing Blockchain with IoT to Cut Supply Chain Costs; McKinsey (2016) Big data and the supply chain: The big-supply-chain analytics landscape; Business Innovation Observatory (2015) Traceability across the Value Chain: Advanced tracking systems.

[137] Arviem (2018) White papers "Chemical Supply Chain Visibility" and "Food Supply Chain Traceability".

[138] Supporting study on due diligence (2020), p.71. e.g. Nestlé's practices in its supply chain are considered as a "notable example" on traceability while the new transparency policy of H&M is an example of how a company with a complex supply chain can achieve traceability.

[139] Supporting study on directors duties and sustainable corporate governance (2020).

[140] Ibid.

[141] For an overview of private responsible business standards, see ITC Voluntary standards (intracen.org)

[142] See data from EcoVadis' rating responses on use of SBTs as quoted above (footnote 89).

[143] Several financial institutions (including BNP Paribas and AXA) have joined in an initiative to develop a biodiversity assessment methodology and tool to assess the impact of investors' portfolios on biodiversity environmental advisory firm and a data provider. The aim is "to enable investors to integrate impacts to nature and biodiversity into their risk assessments". See also WWF work on context-based and science-based water targets, World Resources Institute work on setting Site Water Targets Informed By Catchment Context, etc., EU Taxonomy regulation, etc.

The public consultation shows the need for the development of adequate risk and impact management tools and also guidance related to due diligence.[145]

2.2.2. Regulatory Inefficiencies

2.2.2.1. Directors' duty to act in the interest of the company is often unclear, company law and corporate governance frameworks emphasise accountability towards shareholders

Directors' duties and liabilities are regulated in all EU Member States for all limited liability companies, all accepting the principle that directors' duties are owed to the company. The core duty of directors to **act in the interest of the company** as a whole is regulated in all Member States[146].

But not all national laws regulate what the **"interest of the company"** means and what specific interests directors need to take into account. In some Member States the law has lately required stakeholder interests to be taken explicitly into account, and even their priority over shareholder ones, but in most Member States **national law is largely unclear** about how directors should take into account the long-term consequences of decisions, the interests of employees and other stakeholders affected by the company' activities or the interests of the global and local environment[147].

As a result, **interpretations,** mostly by courts or academia, diverge in terms of interests to be protected (of shareholders, of stakeholders or of society). Within this general lack of clarity, the focus of directors on the short-term financial performance has become a **widely used practice**[148] over the last decades.

While the management's main role is to manage risks and the board oversees risk management, sets strategy and supervises its implementation, there are no obligations to manage risks linked to the environment, social factors, human rights and the company's adverse external impacts, or to integrate sustainability aspects into the corporate strategy. In some Member States (like Germany), there is a legal obligation for the board to set up and supervise a firm-wide compliance system for damage prevention and risk control[149].

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[144] The Alliance for Corporate Transparency Research Report 2019 shows that 36.4% of 1000 studied EU companies report on their climate targets, 13.9% report on the alignment of such target with the Paris Agreement/Science Based Targets. In the energy sector, these numbers stand at 36% and 24%.

[145] As regards developing adequate risk and impact management tools, respondents noted binding requirements would bring benefits "in term of risk management, resilience, environmental/social performances and reliability", and as regards developing guidance, respondents deemed it an effective tool specifically to ease the potential burden on SMEs.

[146] LSE study on directors' duties and liability, 2013.

[147] See **Annex 8** for more information on national frameworks and interpretations by courts.

[148] See Supporting study on director's duties and Horizon 2020 SMART research reports about the "social norm" of shareholder value maximisation

[149] See in particular § 91 paragraph 2 Aktiengesetz (Stock Corporation Act). Board members have been sued for not having established a group-wide risk management system for a specific non-financial matter Judgment by the Munich Regional Court of 10 December 2013, Siemens vs Neubürger, 5HK O 1387/10.

The existing **corporate governance codes'**[150] "comply or explain" character and recently adopted EU corporate governance rules (for example strengthened shareholder rights, including a shareholder "say on pay" and provisions on independent directors[151]) strengthen directors' accountability towards shareholders, but not the coverage of interests of other stakeholders and the environment.

2.2.2.2. Company law lags behind the emergence of globalized companies, groups and value chains

Over the past three decades, production has become strongly internationalised for EU companies of all sizes[152]. Global value chains account for almost 50% of global trade today[153]. Upstream production (mining, manufacturing, assembling) processes are often located in countries where labour and environmental standards are lower than in the countries where products are marketed[154]. The companies in the upstream parts of the value chain are rarely known to the consumer, therefore reputational risks have less chance to materialize, creating a moral hazard problem within the value chain. This is particularly clear in the case of supply of raw materials which in addition tends to be concentrated in countries with low levels of governance, which may result in harmful social and environmental impacts[155]. In certain cases, EU companies are also dependent on sourcing from those countries as no substitutes are available. Given the strong global competition for those materials, they may lack leverage in those countries.

National legal frameworks differ as to whether the board of a parent company has a duty to implement supervision or even governance over a subsidiary, a situation that is not conducive to creating a level playing field for companies in the internal market. The duty to oversee the subsidiaries is developing in a few jurisdictions[156] and may also be induced by EU legislation[157]. Parent companies' duty to adopt and implement a group-wide sustainability policy was introduced first by the French duty of vigilance act. That law is innovative also for recognizing that control can be exercised through contracts. Global value chains are a web of contracts which have the potential to exert control over suppliers and subcontractors, even beyond direct subcontractors as through the purchasing policy of the buyer company it can exercise control and influence on its

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[150] For more details on the functioning of Corporate governance Codes as voluntary "comply or explain" instruments, see **Annex 6**.
[151] Please refer to **Annex 6** for an overview of existing EU CG instruments.
[152] Eurostat, International trade in goods by enterprise size. In 2018, the share of EU SMEs in the number of extra-EU importers was 95%, the share of EU SMEs in the value of imports from outside the EU was 40%.
[153] World Bank, Trading for Development in the Age of Global Value Chains, 2020.
[154] According to Eurostat, close to 50% of EU imports of textiles originate from China and Bangladesh, where cases of forced labour and violations of health and safety standards and labour rights occurred.
[155] CEAP 2020 Staff working document 'Leading the way to a global circular economy: state of play and outlook', p.9.
[156] Germany, Netherlands.
[157] Special regulation applicable to financial institutions may require that the parent company takes responsibility for the governance of the whole group, especially from a risk management perspective, see, for instance, the Capital Requirement Directive, Articles 74 et seq. and Article 84 et seq.

suppliers' activities[158]. However, in particular beyond tier 1 suppliers, companies might not have sufficient leverage to do so. Furthermore, it might be more difficult to exert leverage in some countries where global competition for some very essential raw materials is strong. While some company law regimes recognize at least some duties of the parent company concerning subsidiaries based on control through group policies and corporate ownership, EU and national company law lags behind recognizing de facto control over value chain partners' adverse impacts.

2.2.2.3. Voluntary due diligence standards are not effective to mainstream adequate impact management, do not provide for legal certainty and many of them are not comprehensive

As explained in section 2.1.3, over the past decade, non-mandatory policy frameworks such as the UNGPs[159], the OECD Guidelines for Multinational Enterprises and accompanying due diligence guidance, private standards and initiatives have been developed[160] with different levels of ambition and coverage of human rights and environmental matters. All these guidance appear to lag behind the EU Green Deal's ambition in terms of climate and biodiversity neutrality and zero pollution. Given the "guidance" character of these documents, they recommend different ways in dealing with issues and sometimes include inconsistencies (for example when it comes to terminating business relationships). Given also their voluntary character, they do not provide for sufficient legal certainty for businesses, in particular in light of the Court cases where companies' responsibility is established. 82% of public consultation respondents, NGOs 95.9%, companies 68.4% and business associations 59.6 % saw the need for developing an EU legal framework for due diligence, and achieving legal certainty was one of the top 5 benefits expected. Industry sector initiatives and private standards are also evolving and, albeit helpful in many sectors, they present the same weaknesses. They are often incomplete, do not focus on all risks[161] and may lack credibility and transparency.[162, 163]

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[158] This line of reasoning is followed also in the Shell judgement (see part 4.4.25 Milieudefensie v. Shell): "It is not in dispute that through its purchase policy the Shell group exercises control and influence over its suppliers' emissions. […] This means that through the corporate policy of the Shell group, R[oyal]D[utch]S[hell] is able to exercise control and influence over these emissions. […]". The same applies for the emissions of the product of the company: "Through the energy package offered by Shell group, R[oyal]D[utch]S[hell] controls and influences the Scope 3 emissions of the end-users of the products produced and sold by the Shell group. […]".

[159] They provided the first global standard for preventing and addressing the risk of adverse impacts on human rights linked to business activity, and continue to provide the internationally accepted framework for enhancing standards and practice regarding business and human rights. See also Glossary (above).

[160] ITC: Mapping of voluntary sustainability schemes – the Standards Map project.

[161] Some initiatives relate to one specific impact, e.g. GHG emissions (e.g. the Science-based targets initiative), deforestation risks, some only relate to human rights issues (e.g. Action, Collaboration, Transformation (ACT) Initiative focussing on labour rights in the garment and textile industry), others only relate to the environment. See also the supporting study on due diligence, illustrating at p. 343 how different voluntary initiatives in the minerals sector focus on different selected human rights issues.

[162] Supporting study on due diligence, p. 243 et seq. with examples from the garment sector, regarding deforestation risks, and in relation to climate change. See also p. 334 et seq., 342. See also UN Human

These instruments **lack effectiveness to mainstream adequate due diligence practices,** as also evidenced by the results of the public consultation[164].

Such frameworks appeared to have incentivised only the frontrunners, as only 30% of large companies say they carry out comprehensive due diligence of human rights and environmental harm[165], and focus mostly on their first tier suppliers.

Due diligence law has been to a certain extent more effective to trigger change[166]. Evidence from some of the limited number of existing **mandatory sustainability due diligence national legal frameworks** in the European region shows that they **are effective in triggering change in the value chains regarding sustainability matters**. For instance the French Vigilance Law's effects had already become apparent a short time after its entry into force[167], showing also how – irrespective of personal scope – its impact trickles down the value chain and obligations are shifted on suppliers mostly without recognition (for instance in prices): 80% of French SMEs and midcaps (which are out the French law's scope) are asked by their contractors on CSR issues, whether to sign a charter or a code of conduct, to declare themselves in conformity with the main social and environmental standards (health/safety, waste management, business ethics or human rights), to sign clauses in their contracts or to undergo an extra-financial evaluation[168]. Also the due diligence requirements in the UK Bribery Act include the duty to prevent, coupled with a due diligence defence is more effective than the transparency regime of the Modern Slavery Act[169].

2.2.2.4. Emerging laws set diverging corporate due diligence and accountability requirements

Emerging EU and national laws on corporate due diligence differ. This situation creates fragmentation and emergence of barriers within the EU single market. Diverging rules

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Rights Council, "Report of the Special Rapporteur on extreme poverty and human rights: Climate change and poverty" (17 July 2019) at para 48.

[163] For instance, a study by Germanwatch on mineral supply chains demonstrates that audits and certification schemes alone, even independent and high-quality ones, are not sufficient to ensure that an approach is credible and has any benefits for rights-holders: Sydow J., Reichwein A. (2018). Governance of Mineral Supply Chains of Electronic Devices.

[164] As evidenced in sections 2.1.3 and 2.2.1.5 adequate due diligence practices are not mainstreamed, which is also supported by the findings of the public consultation whose respondents saw a clear need for a due diligence framework and saw potential benefits in: (1) harmonisation to avoid fragmentation (82.1%), (2) awareness of companies' negative impacts (79.9%), (3) effective contribution to a more sustainable development (76.5%), (4) levelling the playing field (75.5%) and (5) increased legal certainty (70.3%).

[165] Supporting study on due diligence.

[166] OECD (2016): Report on the Implementation of the Recommendation on Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas.

[167] Evaluation de la mise en œuvre de la loi relative au devoir de vigilance, January 2020.

[168] Enquête "RSE : La parole aux fournisseurs !", January 2020 , Devoir de vigilance : les PME en première ligne, sans être assez accompagnées par les donneurs d'ordre shows supply chain companies, in particular SMEs, complaining about price pressure and lack of recognition of their efforts in prices.

[169] Lebrun G., Rühmkorf A. (2017). Steering CSR Through Home State Regulation: A Comparison of the Impact of the UK Bribery Act and Modern Slavery Act on Global Supply Chain Governance.

are thus un-levelling the playing field for companies based in different Member States. Moreover, they lead to additional administrative burden and costs for firms operating across borders[170].

EU due diligence rules exist only for a limited number of products[171] in the Responsible (conflict) Minerals Regulation, the EU Timber Regulation, and in the Battery Regulation Proposal. Besides, they differ as regards the obligations for companies in their scope and relate to specific sustainability concerns. For instance, the Responsible Minerals Regulation covers armed conflict and related serious human rights abuses, the Deforestation initiative will cover deforestation risks.

National rules are in the making and although all seek to align with existing international standards, they are different in terms of scope, risks covered, level of detail, enforcement and liability. The French due diligence law applies to both human rights and environmental harm. The German law focuses on human rights and some specific environmental risks only[172]. The Dutch law applies to child labour only. In terms of concrete obligations, the French law includes only essential due diligence elements while the German law is detailed. Personal scope, enforcement and liability regimes differ. See further information on diverging national laws and EU due diligence rules in **Annex 8**. As referred to above, the public consultation shows that stakeholders consider harmonisation, to avoid fragmentation and levelling the playing field being among of the main benefits of an EU due diligence duty.

2.2.2.5. Victims face legal barriers to hold companies to account and get remedies

Victims of human rights violations or environmental harm may face barriers to claim access to remedy, which contributes to an accountability vacuum. This also contributes to companies insufficiently addressing adverse impacts. Cross-border incidents, in particular, when the harm occurred outside of the EU in the company's value chain present the biggest challenges for victims of harm caused by corporate action. These challenges may include uncertainty as to whether the involved non-EU companies or suppliers can be held liable, which is the competent jurisdiction, lack of information, increased costs, language and legal knowledge barriers among others[173].

The lack of a clear obligation to conduct value chain due diligence is an obstacle itself as it makes it uncertain whether the EU company can be held liable or whether claims can

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[170] The respondents to the open public consultation believe that the UK Modern Slavery Act is an example of no binding requirements and liability bringing no effect.
[171] Four minerals; timber and timber products; specific category of batteries. Six agricultural products in the planned Deforestation initiative.
[172] For instance, when they lead to human rights violations (e.g. poisoned water or violations of some specific international agreements).
[173] See, for example, chapter 3 of the FRA 2020 Report "Business and Human Rights – Access to Remedy".

only be directed towards the subsidiary or supplier in the value chain[174]. Even if the EU company could be sued in the EU, European private international law rules differ as to the applicable law to non-contractual obligations when the harm occurred in a third country depending on the nature of this harm (e.g. environmental damage is subject to a special rule allowing to choose the law of the country in which the event giving rise to the damage occurred, rather than relying on a general rule of applicable law in tort cases, i.e., law of country of the place of damage, such a choice does not apply to human rights' harms where a general rule applies)[175]. Other barriers include burden of proof, access to evidence, legal standing of the victims or their representatives, or limitation periods.[176]

Public consultation respondents confirmed such difficulties exist and listed a number of examples of barriers to justice (legal, procedural and practical) in holding European companies liable for the harm caused by their subsidiaries or value chain partners located in a third country.[177]

2.3. How will the problem evolve?

Identification of risks is expected to improve and general disclosure of sustainability information (from CSRD and taxonomy) will improve the situation at least in terms of awareness. Sustainability risk management is expected to improve to some extent as a result of growing financial impacts of such risks on companies and shifting consumer patterns. Standardised sustainability risk reporting and improving investor awareness partly due to regulation[178] is expected to have some positive impact on large companies and on listed companies in the EU single market. As regards human rights and environmental impact mitigation, EU law is developing, in particular as regards targeted climate change action, pollution and circular economy measures, which will result in reductions of adverse climate and environmental impacts primarily within the EU. The COVID crisis resulted in better awareness of the global exposure and dependencies in the EU supply chains.

At the same time, these developments are not likely to generate a change that is sufficiently quick, even, systemic and wide-spread across the economy as regards all risks and impacts. Pressure on natural capital is expected to significantly increase in the near future despite international commitments and this will exacerbate risks. EU law will

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[174] Existing non-mandatory policy frameworks, such as for example the UNGPs stress the responsibility of the company to identify and mitigate harm in its value chain. The liability of the EU company is meant to encompass only its own failure to conduct due diligence, identify, prevent and mitigate harm. Emerging jurisprudence (for example the Shell judgement) suggest a due diligence duty to mitigate adverse climate change impacts through the company's group and value chain.
[175] See Articles 4 and 7 of Regulation (EC) No 864/2007.
[176] What if, European Coalition for Corporate Justice.
[177] E.g. Boliden, KiK case and Shell case. Respondents suggest that EU laws and rules on jurisdiction should allow for the liability of parent and lead companies. In seeking the right to claim compensation, victims should be able to rely on EU law, which should provide for reasonable time limitations for bringing legal actions.
[178] See for example recent investor disclosure rules in **Annex 6**.

have impact primarily within the EU. Competitive pressures, investor short-termism as well as resulting short-term decision horizons are unlikely to decrease in global markets resulting in sub-optimal levels of corporate investments into longer term (innovative) projects and cost reductions will continue through outsourcing activities in third countries with mostly lower human rights and environmental standards. This will prevent companies from benefiting from opportunities the sustainability transition offers, including strengthening competitiveness. Furthermore, increasing fragmentation is expected due to a number of member states planning to come up with rules in the absence of EU legislation.

3. WHY SHOULD THE EU ACT?

3.1. Legal basis

The legal basis of the proposed initiative is Article 50 TFEU, which is the legal basis for company law legislation aiming for measures regarding the **protection of the interests of companies' members and others** with a view to making such protection equivalent throughout the Union, and Article 114 TFEU, which is a legal basis for harmonising measures for the establishment and proper functioning of the internal market.

3.2. Subsidiarity: Necessity and value added of EU action

3.2.1. The problems identified are European and to some extent global and Member States cannot tackle them effectively at national level

Member States' legislation alone in the area of sustainable corporate governance is unlikely to be sufficient and efficient as sustainability problems are of a European and global dimension and have cross-border effects (climate change, pollution, transnational supply and value chains). Unsustainable behaviour of companies in one Member State or in third countries affects other Member States.

As regards specific trans-boundary problems, such as climate change, pollution, etc., individual action is hampered by the inaction of other Member States. The achievement of international commitments such as the goals of the Paris Agreement on climate change, the post 2020 Biodiversity agreement and the UN SDGs by individual Member State action alone is unlikely, this is also the reason why commitments have been undertaken by the EU. Although Member States are making more progress towards achieving the SDGs by 2030 at different pace, meeting SDGs targets related to climate, biodiversity, and circular economy remained challenging for all of them[179]

[179] Europe Sustainable Development Report 2020: Meeting the Sustainable Development Goals in the face of the COVID-19 pandemic. Such efforts will be further supported by the recently adopted package of measures under "Fit for 55".

3.2.2. Companies and their investors operate and invest across borders, value chains are increasingly European and even global, short-termism is systemic

Many companies are operating EU-wide or even globally; value chains expand to other EU Member States and increasingly globally. Institutional investors which invest across the borders own a large part (38%[180]) of the total market capitalisation of large European listed companies, therefore many companies have cross-border ownership and their operations are influenced by regulations in some countries or lack of action in others. The market failure of short-term focus[181] affects the operations of European capital markets and beyond. Therefore, it is unlikely that individual action by Member States without the action of others would be sufficient to induce long-termism. If one Member State adopts directors' duties and due diligence rules, its companies owned by EU and international investors and operating in open markets would still be subject to short-term pressures creating a barrier to exploit their long-term potential. This is one of the reasons why frontrunner companies arguably cannot go as far as they would want to in addressing sustainability issues today[182] and ask for a cross-border level playing field. EU rules have better chances to mitigate such pressures on companies.

Market prices not reflecting externalities is also system-wide and cannot be successfully tackled by individual national action.

3.2.3. Member States' individual action leads to fragmentation and extra costs

Some Member States have recently introduced legislation on sustainable corporate governance[183] or due diligence[184], while others are in the process of legislating or considering action[185]. Existing Member State rules and those under way are or would most likely lead to diverging requirements, which risk being ineffective and leading to an uneven level playing field. New laws are considerably different[186] especially on due diligence despite the intention of all the Member States to build on existing international standards (UNGPs, OECD Responsible Business Framework). There are considerable indirect effects of diverging due diligence laws on the suppliers of companies that supply to different companies falling under different laws, as the obligations are in practice translated into contractual clauses. If duty of care on sustainable aspects and due diligence requirements are significantly different among Member States, this creates legal uncertainty, fragmentation of the Single market, additional costs and complexity for companies and their investors operating across borders as well as other stakeholders.

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[180] This number comes from the Impact Assessment of the Shareholders Rights Directive II.
[181] See above section 2.2.1.
[182] Sustainability frontrunner Danone has recently been forced to cut costs by investors on grounds of lack of short-term profitability, Can Anglo-Saxon activist investors whip Danone into shape? (The Economist)
[183] France, Ireland, Portugal.
[184] France, the Netherlands, Germany.
[185] Finland, Luxembourg, Belgium on due diligence.
[186] See in detail **Annex 8**.

Large companies across the board ask for greater harmonisation in the area of due diligence to improve legal certainty and level playing field[187]. However, there is less support from business associations for harmonisation of some aspects of directors` duties.[188] Citizens and stakeholders demand EU action and perceive the current regulatory framework as ineffective to ensure corporate accountability for negative impacts on the environment and human rights[189]. The European Parliament[190] and the Council[191] are calling on the Commission to legislate in these fields.

3.2.4. The EU has already regulated in this area

Corporate governance is already regulated at EU level[192]. New rules would build on this. Further action at the EU level has a much bigger chance of leading to a true sustainability transformation in the most cost efficient way than individual Member States action.

3.2.5. EU-level policy adds significant value for international action

Compared to individual action by Member States, EU intervention can ensure a strong European voice in policy developments at the global level, in particular regarding due diligence requirements in value chains[193].

In light of the above, EU regulation is both necessary and also adds value compared to national legislation.

4. OBJECTIVES: WHAT IS TO BE ACHIEVED?

4.1. General objectives

The general objective of this initiative is to **better exploit the potential of the single market to contribute to the transition to a sustainable economy**, to foster sustainable value creation and improve the long-term performance and resilience of EU companies.

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[187] List of large businesses, associations & investors with public statements & endorsements in support of mandatory due diligence regulation (business-humanrights.org). Open public consultation respondents agreed that an EU legal framework for due diligence needs to be developed, with companies supporting the need for action with 68.4% and business associations with 59.6 %.

[188] In the open public consultation, while businesses expressed slight support, business associations expressed disagreement when asked about if directors should be required by law to a) identify the company's stakeholders and their interests (64.6%), b) manage the risks for the company in relation to stakeholders and their interests (65.6%) and c) identify opportunities arising from promoting stakeholders' interests (69.9%).

[189] See **Annex 2** on stakeholders' consultation.

[190] For details see **Annex 12** on European Parliament reports.

[191] Council Conclusions on Human Rights and Decent Work in Global Supply Chains, 1 December 2020.

[192] For details see the section on "Legal context" above.

[193] In 2014, the UN Human Rights Council decided to establish an open-ended intergovernmental working group (OEIGWG) on transnational corporations and other business enterprises with respect to human rights, whose mandate shall be to elaborate an international legally binding instrument (LBI) to regulate, in international human rights law, the activities of transnational corporations and other business enterprises. In 2021, the OEIGWG released a third revised draft LBI on business activities and human rights, including due diligence measures and corporate liability for human rights abuses.

These objectives will be achieved through:

(1) increasing directors' accountability for sustainable value creation and incorporating (long-term) sustainability factors in decision-making of companies; and

(2) increasing corporate responsibility for preventing and mitigating adverse human rights and environmental impacts, including in companies' value chains, in line with the EU's international commitments regarding human rights and the environment.

4.2. Specific objectives

To reach the general objectives, the initiative pursues the following specific objectives:

a) clarify what is expected of directors in order to fulfil their duty to act in the interest of the company as regards stakeholder interests and the long-term interests of the company
b) foster the integration of sustainability risks (including from the value chain) and impacts into corporate risk management processes, impact mitigation processes, strategies, facilitate management of dependencies and ability to react to change;
c) increase accountability for identifying, preventing and mitigating adverse impacts, including in value chains, avoid fragmentation of due diligence requirements in the Single market and create legal certainty for stakeholders as regards expected behaviour and liability;
d) improve access to remedy for those affected by adverse corporate human rights and environmental impacts;
e) improve corporate governance practices to facilitate the integration of sustainability into directors' and company decision-making (e.g. in the area of stakeholder involvement).

The intervention logic can be found in **Annex 16**.

5. WHAT ARE THE AVAILABLE POLICY OPTIONS?

5.1. What is the baseline from which options are assessed?

5.1.1. Corporate due diligence

Under the baseline, the regulatory environment would continue to evolve along national corporate due diligence laws and EU initiatives focusing on certain issues, sectors or products, as well as evolving international non-binding policy frameworks[194], and industry voluntary initiatives. The principal characteristics of the baseline scenario are the following:

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[194] For example as regards the OECD responsible business framework, including OECD Guidelines for Multinational Enterprises, the OECD Guidance on Responsible Business Conduct and OECD sectoral

Voluntary action by companies not leading to a level playing field for the sustainability transition: The Corporate Sustainable Reporting Directive (CSRD)[195] and parallel EU measures on sustainability-related disclosures[196] are expected to intensify disclosure and reporting on sustainability issues by EU companies falling in their scope. It can be expected that a number of companies in the scope of those measures may become aware of their adverse impacts and adopt due diligence processes.[197] However, they will not require companies to prevent, address and mitigate adverse impacts effectively and following the same procedural standards in the single market.[198] As shown in detail in Section 2.2.2.3 above, a voluntary approach to due diligence has not been fully effective in mainstreaming due diligence practices and creating level playing field. Reporting rules have proven in the past to incentivise frontrunner companies only.[199] Emerging jurisprudence interpreting companies' standard of care under tortious liability (i.e. the general duty not to harm others) as encompassing climate change harm in their operations and the entire value chain[200] may result in an incentive for companies to build due diligence. In addition, the upcoming initiatives on empowering consumers[201] and on green claims[202] will reduce the amount of false claims, increase transparency and support the market for sustainable products. It is expected that increased transparency will help create consumer pressure that can incentivise companies to become more sustainable. However, all these incentives appear insufficient to foster systematic mitigation of adverse impacts and related risks in value chains across sectors. The EU institutions and the Member States are legally required to enable the collective achievement of the climate-neutrality objective.[203] In the consultation activities, all

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guidance, or the on-going UN negotiations on a legally binding instrument on business and human rights, as referred to in footnote 193 above.

[195] In this context, the European Financial Reporting Advisory Group (EFRAG) is responsible for developing new EU sustainability-reporting standards.

[196] This also includes Regulation 2019/2088. In addition, the delegated act in accordance with Article 8 of the Taxonomy Regulation aims at further increasing transparency in the market. Companies in the scope of the CSRD will have to disclose information to investors about the environmental performance of assets and economic activities of financial and non-financial undertakings. See the draft Taxonomy Regulation delegated act on article 8 (2021) .

[197] E.g., the 2020 study on the NFRD found some evidence of limited changes in company policies that could be partly attributed to the current requirements of the NFRD, but it is very difficult to disaggregate the effect of the NFRD from other factors that may drive changes in company policies and behaviour.

[198] A more detailed analysis of the new measures introduced by the CSRD can be found in **Annex 7**.

[199] See Supporting study on due diligence, p. 99 to 105; 218 to 220; p. 245 to 250.

[200] In Milieudefensie v. Shell, Shell group was required to bring its CO_2 reduction target in line with the 1.5°C climate scenario in own operations, business relationships as well as impacts linked to its products.

[201] The initiative on Empowering Consumers for the Green Transition will strengthen and improve information at the point of sale on the durability and reparability of products and provide better consumer protection against misleading practices in relation to sustainable purchases requirements that lengthen the life of products.

[202] The Green Claims Initiative on the substantiation of environmental claims strengthens the framework for establishing in a reliable and comparable manner the environmental performance of products.

[203] See Article 2 of the "European Climate Law" (Regulation (EU) 2021/1119).

categories of stakeholders agreed on the need for an EU legal framework on due diligence.[204]

- **A fragmented legal environment across the EU**: In addition to France and Germany, a number of other Member States are likely to introduce mandatory horizontal due diligence requirements.[205] Existing national laws differ with respect to the companies, sectors, risks and supply or value chains covered, and with respect to the enforcement regime. New national rules will add to this complexity. This undermines legal certainty for companies and for those whose rights are being protected in different ways across the EU. It results in an uneven playing field for companies in the EU single market. This situation would also result in unnecessary compliance costs. At the same time, some EU Member States are unlikely to introduce any national due diligence requirements.
- **A patchy legal framework at EU level that will not apply to companies in all sectors**: Existing and anticipated EU due diligence requirements would be applicable to certain sectors, sustainability issues and commodities.[206] Moreover, a range of other EU measures have been launched or are in the preparation phase under the European Green Deal, tackling specific sustainability impacts such as climate, environmental, human rights or employment issues.[207] To the extent that they address companies, they may entail positive competitive dynamics if sustainability considerations are increasingly integrated into corporate management processes. However, such sectoral measures, mostly limited to the EU, will not lead to a systemic change in corporate behaviour across sectors and across sustainability risks, in particular in value chains outside the EU. The new Generalised Scheme of Preferences (GSP) regime aims at making EU trade more sustainable by promoting the respect for core human rights. It will support and facilitate mandatory due diligence but cannot replace companies' accountability for sustainability impacts in their value chains. [208]

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[204] For instance, in the context of the public consultation (carried out before adoption of the CSRD proposal) 82% of respondents saw the need of developing an EU legal framework for due diligence and 92% indicated a preference for a horizontal due diligence regime.

[205] See an overview of Member States' laws and initiatives in **Annex 8**.

[206] These include in particular the Responsible (Conflict) Minerals Regulation and its implementation , the Timber Regulation and the potential new demand-side measures for deforestation and forest degradation associated with EU consumption, and the Proposal for a new Batteries regulation (COM(2020)798), as explained in Section 1.2.2 above and in **Annex 7**.

[207] For example the Fit for 55 package (including, amongst others, the revision of the Emissions Trading System, the Carbon Border Adjustment Mechanism and (CBAM), CO_2 emission performance standards for new passenger cars and for new light commercial vehicles), the proposal for a Pay Transparency Directive. Non-regulatory (voluntary) measures include the EU Eco-Management and Audit Scheme (EMAS), the future EU legislative framework for sustainable food system and EU Code of Conduct for Responsible Business and Marketing Practices which aims at improving the sustainability of the food value chain. Furthermore, a proposal for a legislative framework for sustainable food systems is planned by 2023 as part of the Farm to Fork Strategy.

[208] See **Annex 7** for more details on interlinked EU measures and added value of this initiative.

5.1.2. Directors' duties

Under the baseline, **action by companies will continue to be slow and uneven.** As the financial impact of (at least some) sustainability risks to the company will become more pervasive with sustainability-related losses increasing over time, awareness in the market is likely to increase. The CSRD is also expected to have a positive impact in terms of improved transparency, awareness and, to a certain extent, the management of some risks. Investors are likely to care more about sustainability risks and impacts[209], also as a result of the numerous actions completed under the Sustainable Finance Action Plan on investor disclosure and of the ECB's incorporation of climate risks into supervisory review[210]. However, as proper sustainability risk mitigation requirements for investors are only in the pipeline at this stage[211], such pressure may not be felt for still some time and will remain indirect for a large group of companies (e.g. many non-listed companies). In any case, at this stage, it is unlikely that such pressure will be strong enough to mainstream stronger sustainability risk management and directors' accountability for such risks, opportunities and impacts across industry. The accountability of directors will remain limited and the market will unlikely deliver in line with the needs of the broader economy, society and the goals enshrined in international agreements. Overall, progress is expected to be slow.

In addition, problems related to the EU legal framework will persist. The table shows some examples of how existing requirements at national level are incomplete and diverging; more detailed information on Member States laws and initiatives in **Annex 8.**

Extent to which the notion of company interest integrates the promotion of long-term value creation considering the interest of different stakeholders

	Examples of Member States
Expressly regulated by law	• **France**: Under a recent law, directors have to take into consideration the social and environmental challenges of the company's activity; • **Netherlands:** shareholder interests do not take priority over the interests of other stakeholders • **Ireland**: directors have to take into account the interests of employees; • **Portugal**: The interests of the company include those of other relevant parties such as employees,

[209] There is an increasingly wide range of research documenting the correlation between corporate attention to human rights and broader ESG issues and corporate financial performance. See, for example, Money, Millennials, and Human Rights and Cracking the ESG Code.

[210] Disclosure and risk management requirements on some financial intermediaries, Sustainable finance package, European Commission. Please see the ECB's *guide on climate-related and environmental risks*. Expectation 7.5 provides that institutions are expected to conduct a proper climate-related and environmental due diligence, both at the inception of a client relationship and on an ongoing basis.

[211] The renewed sustainable finance strategy aims at mainstreaming sustainability into risk management, Renewed sustainable finance strategy and implementation of the action plan on financing sustainable growth, European Commission.

	clients and creditors in ensuring the sustainability of the company.
Corporate Governance Codes[212] (comply or explain)	Belgium, Netherlands, Germany, Italy, Spain
Case law and legal literature	Poland, Spain

In the baseline scenario, there would be continued uncertainty and fragmentation as Member States' approaches differ with regard to directors' duty to act in the best interest of the company and with due care.

5.1.3. Directors' remuneration

In the baseline scenario, the rules on directors' remuneration of listed companies adopted in 2017 would apply:

Articles 9a and 9b of the Shareholder Rights Directive (SRD) (Directive 2007/36/EU, as amended by Directive (EU) 2017/828) Transposition was due by 10 June 2019 Companies have to establish a remuneration policy for directors and draw up a remuneration report	The **remuneration policy** shall inter alia - contribute to the company's business strategy and long-term interests and sustainability and shall explain how it does so; - on **variable remuneration** indicate the financial and non-financial performance criteria, including, where appropriate, criteria relating to corporate social responsibility, and explain how they contribute to the company's long-term interests and sustainability; - on **share-based remuneration**: specify vesting periods and where applicable retention of shares after vesting and explain how the share based remuneration contributes to the company's long-term interests and sustainability. The **remuneration report** shall contain, inter alia, where applicable: - an explanation on how the total remuneration complies with the adopted remuneration policy, including how it contributes to the long-term performance of the company, - information on how the performance criteria were applied; the number of shares and share options granted or offered, etc.

The current regulatory regime is largely based on disclosure. The Directive establishes that remuneration policy shall contribute to the company's long-term interests and sustainability, but does not regulate how. The company can decide whether variable performance criteria relating to corporate social responsibility will be used, and, if it uses them, is required to report on them. Shareholders have a "say on pay", therefore the company's performance on the environment and human rights is partly dependent on their willingness to stand by it through an effective remuneration policy. While it would be expected that the possible introduction of new due diligence obligations and directors'

[212] For detailed information on these Corporate Governance Codes please refer to **Annex 8**.

duties would impact the manner in which companies implement the existing provisions of the SRD, the provisions as they stand do not clarify that directors are incentivised or at least not hindered by remuneration conditions to drive their companies towards a sustainable transition.

Under the baseline, the future reporting standards under the CSRD proposal may cover disclosures around how remuneration is linked with sustainability factors or with the company's sustainability targets which may indirectly foster a better integration of sustainability into directors' pay.

5.2. Description of the policy options

5.2.1. Corporate due diligence requirement throughout the company's own operations and in the value chain

In line with the UNGPs and the OECD Framework,[213] the due diligence process consists of the following 5 steps:[214]

1. Identification of actual or potential adverse human rights and environmental impacts in own operations, in subsidiaries and in the value chain

Establish a system to properly address environmental and human rights adverse impacts occurring in own operations, subsidiaries and throughout the value chain. Identify actual or potential adverse impacts in operations and relationships where adverse impacts are most likely to be present. Regularly evaluate operations and the value chain.

2. Prevention and mitigation of adverse impact in own operations, in subsidiaries and in the value chain

Cease harmful activities, prevent and mitigate risks of possible adverse impacts. Preventive measures include codes of conducts, contractual clauses with direct contractors, including assurances that they will comply with requirements and adequately address them in their value chain as well as regular controls and assurances of controls from suppliers over their suppliers. Ceasing harmful impacts requires, as appropriate, joint development of corrective actions with the supplier or joining forces with other companies to exert influence on a value chain relationship where the company does not have sufficient leverage. Ordering companies are required to provide adequate support in fulfilling the requirements of SME partners in the value chain. Where the company cannot prevent or cease adverse impacts or cannot build sufficient leverage, it is expected to terminate the business relationship with the supplier as a last resort step in a

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[213] Including OECD Guidelines for Multinational Enterprises, the OECD Guidance on Responsible Business Conduct and OECD sectoral guidance

[214] See OECD-Due-Diligence-Guidance-for-Responsible-Business-Conduct including practical actions to comply with the different due diligence steps. Please note that step 1 of the OECD Due Diligence Process related to the embedding of responsible business conduct into policies and management systems would be covered by the policy options on directors' duties, see Section 5.2.2 below.

responsible way. Beyond direct contractors, the company is required to take every reasonable steps to fulfil these requirements. Adverse impacts shall be addressed in a way that takes into account the interest of the affected party (for example the victim of the human rights abuse).

3. Tracking the effectiveness of measures

Track the implementation and effectiveness of the company's due diligence activities.

4. Establishment of a complaint mechanism

Create a grievance mechanism, both as an early-warning mechanism for risk-awareness and as a mediation system, allowing relevant stakeholders to voice reasonable concerns regarding the existence of a potential or actual adverse impact.

5. Communicate how adverse impacts are addressed

Communicate externally relevant information on due diligence policies, processes, activities conducted to identify and address actual or potential adverse impacts, including the findings and outcomes of those activities. This element will be partially covered by the CSRD.

5.2.1.2. Discarded options on due diligence

In addition to the baseline, we considered a wide variety of possible policy options. The following policy options were discarded at an early stage: (i) non-regulatory measures, (ii) a mandatory due diligence requirement without a civil liability regime, (iii) options limiting the due diligence obligation to the company's direct suppliers, (iv) options limiting civil liability to harm caused at the level of the direct supplier.

Non-regulatory options such as a recommendation or guidelines building on existing standards such as the UNGPs, the OECD Framework and industry schemes and standards were excluded due to their limited effectiveness. Despite their beneficial influence, the actual compliance with voluntary due diligence standards for human rights and environmental impacts by businesses has been limited in practice. It is unlikely that non-regulatory measures can mainstream adequate risk and impact management and bring about the behavioural changes required for the transition to sustainability at a sufficient scale and pace. Furthermore, an EU recommendation would not necessarily be implemented by all Member States to the same extent. It would therefore not solve the problem of fragmentation of the regulatory framework and could even increase compliance costs and burdens for companies operating in several Member States.

A potential **policy option covering a mandatory due diligence requirement without a civil liability regime** has been discarded due to lack of effective enforcement. Experience shows that effective enforcement through administrative supervision alone remains a major challenge. Furthermore, civil liability is important to ensure that victims of adverse impacts can get access to remedy. International voluntary standards, such as the UNGPs already expect companies to remedy such harm.

Options limiting the due diligence obligation to the company's direct suppliers have also been discarded due to lack of effectiveness and inconsistency with the international voluntary framework[215]. The most salient adverse impacts on human rights and on the environment occur mainly outside the EU. They arise typically beyond direct suppliers, further upstream in the value chain, for instance at the stage of raw material sourcing and at initial manufacturing stages[216]. Besides, recognised existing international voluntary standards such as the UNGPs expect companies to undertake due diligence in their entire value chain, and most of the companies have tools at their disposal to create visibility and exert leverage beyond direct their suppliers e.g. through contracts, existing traceability or chain of custody schemes, cooperation, assessments shared through a collaborative initiative, identifying and cooperating with enterprises operating at control points of the supply chain, etc.[217] Moreover, an obligation covering only parts of a company's value chain could be easily circumvented by artificially establishing entities further in the value chain to avoid compliance.

Lastly, a **policy option covering whole value chain but limiting civil liability to harm caused at the level of the direct supplier** has been discarded. As explained above, most adverse human rights and environmental impacts take place beyond the level of the direct supplier. Such a policy option would not ensure an effective enforcement regime where it is most needed. Legal certainty concerns can be addressed by adopting a sufficiently clear liability regime as regards what can reasonably be expected from companies, in particular with respect to indirect business partners in their value chains.

For a detailed analysis of these policy options and an explanation of why they were discarded at an early stage, see **Annex 13.**

5.2.1.3. Options comprising a mandatory due diligence requirement for companies

Screening of possible policy options

After filtering out the above-mentioned non-viable policy options, a variety of potential options were screened focusing on three key elements: the companies to which the obligations apply (personal scope), the content or extent of the obligations those companies have to comply with (material scope), and how to ensure that companies

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[215] See OECD-Due-Diligence-Guidance-for-Responsible-Business-Conduct, see also the OECD's Sectoral Guidance, e.g. the OECD Due Diligence Guidance for Responsible Supply Chains in the Garment & Footwear Sector; United Nations Guiding Principles on Business and Human Rights; see e.g. commentaries to Principles 13, 17. See also the European Parliament resolution of 10 March 2021 (2020/2129(INL))

[216] See e.g. Ending child labour, forced labour and human trafficking in global supply chains, ILO Report, 2019; OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas.

[217] See OECD-Due-Diligence-Guidance-for-Responsible-Business-Conduct.pdf, p. 68 et seq., p. 75 et seq., p. 81 et seq., see also the OECD's Sectoral Guidance.

comply with the obligations (enforcement). The following considerations/building blocks were taken into account when deciding about the retained options to be further analysed:

Personal scope	Material scope	Enforcement
Company size, sector: - although entities beyond limited liability companies may do harm, it is difficult to legally define these entities - even if only companies of a certain size are in the scope, due diligence has impact on other companies in the group and in the value chain (trickle-down effect) - complementarity with CSRD scope as it includes the reporting obligations required also under due diligence - companies with higher risk of adverse impacts should pay specific attention to those risks. These are companies of a certain size and others operating in high-impact sectors **Non-EU companies:** - should be covered if they generate relevant turnover in the EU, even if not established in the EU	**Business relationships:** - need to build on existing international voluntary frameworks that are known to many companies and on existing voluntary initiatives that companies have invested in - take into account the existing EU sectorial due diligence law - the scope of due diligence should reflect the fact that most adverse impacts happen beyond direct contractors, further down in the value chain - however, as it is more difficult to receive reliable information, prevent and cease adverse impacts beyond direct contractors, including to build leverage if necessary, the due diligence duty should only require to take reasonable steps beyond direct contractors **Impact categories:** - due diligence may be limited to specific adverse impacts and related risks (e.g. forced labour), or cover full human rights and environmental adverse impacts and related risks - gradual approach adapted to the financial capabilities of companies: full human rights and environmental due diligence for larger companies only; reduced scope of impacts for smaller	**Administrative enforcement** - should be effective, including for certain third country companies that generate a significant turnover in the EU, therefore sanction regime could go beyond fines **Civil liability** - Remedying harm is already expected from companies based on international voluntary policy frameworks and emerging jurisprudence suggests that mitigating adverse climate change impacts throughout the group and the value chain is part of companies' standard of care vis-a vis others and society the breach of which needs to be repaired - Civil liability should be based on non-compliance by the company with the legal obligation to perform adequate due diligence - liability needs to clearly outline conditions under which a company can be held liable at different level of operation (own operation, subsidiary, direct and indirect contractors) - should not cover one-off subcontractors beyond tier 1, for efficiency reasons and as the impact prevention or mitigation may not have lasting effect

Personal scope	Material scope	Enforcement
	companies; phasing-in of the smaller companies **Contractual elements** to avoid passing on the burden to SME suppliers and fostering responsible purchasing practices, as human rights violations at the supplier level are often rooted in the buyers' own purchasing practices. **Accompanying measures at EU and Member state level** to facilitate the implementation and reduce the costs combined with supporting measures in third countries	due to the temporary nature of such relationships **Access to remedy** - overriding mandatory provisions may be necessary to ensure that due diligence is applicable irrespective of the law applicable in cases of damages occurred in third countries under current private international law

Policy options retained for further consideration

As explained in detail in **Annex 13**, the policy options retained for a detailed analysis are combinations of different approaches regarding the personal scope and the material scope (content of the due diligence obligation) and of different enforcement mechanisms:

Personal scope: Due diligence requirements cover limited liability companies. Policy options vary in terms of both size of the company and the industry sector of the company's activities to reflect proportionality.

The definition of company sizes will build on the definitions in the Accounting Directive.[218] However, we introduce additional categories for *very large* LLC companies, which are defined either (i) as having more than 1000 employees (option 2), (ii) as having 500 employees or more[219] or a turnover of more than EUR 350 million (option 3a), or having 500 employees or more and a turnover of more than EUR 150 million (option 3b). Complementing these, a category of *midcaps* is also used, where relevant, to differentiate companies that exceed the medium-sized limits but are not very large.

[218] Directive 2013/34/EU, according to which the limits of at least two of the three criteria mentioned in each company category must not be exceeded for a company to fall in the category: Micro-undertakings: 10 employees/0.7 MEUR turnover/0.35 MEUR balance sheet; small undertakings: 50 employees/8 MEUR/4 MEUR; medium undertakings: 250 employees/40 MEUR/20 MEUR; large undertakings: 250 - 1000 employees or turnover above 40 MEUR/20 MEUR balance sheet. These definitions are used where the scope is aligned with the CSRD proposal, while in other cases the definition is simplified (relying only on employee and turnover data).

[219] For very large companies with 1000+ employees and 500+ employees, the turnover thresholds are based on the EU Directive on Unfair Trading Practices in agricultural and food supply chain.

To avoid undue administrative and financial burden, both micro-companies and small companies are excluded from the scope of all options analysed, except for small (but not micro) listed companies (which are included in option 4 to align the scope of the full due diligence obligation with the scope of the sustainability reporting obligation under the CSRD proposal). Still, some of these will be indirectly impacted as part of the value chain by a trickle-down effect, i.e. when the larger EU company implements its due diligence obligation and asks its value chain to comply with its sustainability requirements.

Due diligence requirements will also apply to **companies without an EU establishment** but operating in the EU and having generated **a certain significant turnover** in the EU. The relevant threshold would need to be selected to constitute an adequate turnover that sufficiently connects to the EU territory[220] having also regard to the option eventually selected for EU companies.

Depending on the scope of the different options, certain companies – other than those subject to the full due diligence duty and those that are value chain partners or subsidiaries of these – operating in high-impact sectors will be subject to targeted and simplified due diligence obligations.[221] The companies under this regime will have to identify, prevent and mitigate their most relevant adverse human rights and environmental impacts only for selected impact categories[222].

Content of the due diligence duty: The policy options that have been retained for analysis in this report vary depending on the sectors or impact categories covered (theme-specific, i.e. covering only selected impacts, or horizontal covering all sectors and human rights impacts[223] and environmental impacts[224]), and the extent to which specific categories of companies have to fulfil the due diligence obligation.

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[220] The turnover generated in the EU would (together with the operations in the EU) establish the connecting factor with the EU territory required to cover third country companies (principle from the Lotus Case, PCIJ, 1927). Employee figures would not be relevant in this context.

[221] Such high-impact sectors would need to be identified and regularly reviewed as necessary. An indicative "maximum" and more limited lists of possible high-impact sectors are provided in **Annex 11**. These sectors have been selected based on the EU ETS, EU Benchmark regulation, national lists of risky sectors from a human rights perspective and other criteria, as explained in that annex.

[222] For example, chocolate company could be expected to focus on: right to life, child labour, climate change, biodiversity, forced labour; a textile company would be expected to focus on forced labour, health and safety, living wage, pollution, climate change; a chemicals company would be expected to focus on pollution through discharge of chemicals, biodiversity, climate change, health and safety, forced labour. To ensure legal certainty, it would be needed to specify which harms are the most relevant in a given sector in line with and also feeding into the work on the CSRD reporting framework, which will also focus on identifying issues relevant for determining sector-specific impacts. This would mean that first the high impact sectors would need to be identified, then the relevant impacts.

[223] See **Annex 17**. For the sake of completeness, human rights violations include any environmental damage, in particular harmful soil, water or air pollution, harmful noise emission or excessive water consumption, that impairs the natural basis for the preservation and production of food, denies access to safe drinking water, impedes access to sanitary facilities or harms the health of a person. See Section 2(2) No. 9 of the German Supply Chain law.

Human rights impacts are understood as the violation of human rights contained in international human rights conventions. Environmental impacts are those specified in selected international environmental conventions which contain duties that are implementable for companies.

The due diligence obligation will cover the whole value chain.

Accompanying measures, help desk and training services, industry collaboration, multi-stakeholder initiatives, use of modern technologies can facilitate companies' due diligence through their value chain. Additional support will be provided for value chain actors in producer countries through development policy. By lowering the risk of doing business with local suppliers in developing countries, this support will also immediately benefit EU companies[225]. Besides, the liability regime will be adapted to the difficulties companies may face in long and complex value chains.

Proportionality of the due diligence process will be ensured through different elements. On the one hand, depending on the option, specific companies operating in high-impact sectors would fall under a targeted risk-based regime. Each option will be combined with elements to limit passing on the entire compliance burden to value chain partners, especially SMEs.[226]

Reporting to the public on the value chain due diligence processes and outcome of prevention and mitigation measures will fall under the CSRD, as regards large companies and listed SMEs, and will be made based on the CSRD reporting standards, where applicable. As reporting applicable to high impact medium-sized companies would not fall under the scope of the CSRD, it will be needed to define these required reporting rules.

Enforcement: All option packages include both civil liability and administrative enforcement by national authorities (complaint-based and ex officio investigations, fines).

Regarding **civil liability** for failure to comply with the legal obligation to carry out due diligence and thereby causing harm directly or indirectly, no policy options have been retained which would not include civil liability or would limit civil liability to harm caused at the level of the direct supplier as explained above. However, under all options,

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[224] An environmental impact is the likelihood of a violation of one of the prohibitions set out in the environmental agreements listed in **Annex 17**. The list includes six specific agreements creating concrete obligations that can be complied with by individual companies. All those international agreements have previously been used in EU/national legislation creating individual obligations for economic operators.

[225] For more details on supporting measures see **Annex 18**.

[226] For instance by requiring that the business partner's interests is taken into account in directors decisions including when discharging the due diligence obligation and limiting imposition of unjustified costs in contracts, or by identifying a black list of elements that cannot be put into contracts to enforce the due diligence obligation and establishing model/standard contractual clauses (as done for the GDPR).

specific conditions apply for civil liability beyond tier 1. Only foreseeable risks may trigger liability.

The company will be liable for the harm that could have been ceased or prevented in its own operation and its subsidiaries where the company has ownership control, and at the level of direct suppliers/relationships where the company has control through contract or financing.

The lead company will also be liable beyond direct suppliers if it did not take reasonable steps to cease or prevent the harm, for example by requesting its suppliers through contractual clauses to ensure the cascading of the obligations, or preventing the harm through engaging in industrial schemes or by using financial means (considered as 'reasonable steps'). The burden of proof will not be regulated.

Third-country companies could be required to appoint a legal representative in the EU for the purpose of administrative supervision.[227] They will be subject to the same civil liability regime as EU companies.

Administrative supervision and a proper sanction regime - which is also effective against third country companies whilst not discriminating between third country and EU companies - will be foreseen. Such enforcement could rely, for instance, on "naming and shaming", imposing fines, or banning from public procurement contracts.

Other sanctions, such as withdrawal of products from the market linked to a serious adverse impacts, might be considered, however it requires questions of feasibility, proportionality and compatibility with a horizontal nature of this company law initiative to be addressed. Given that due diligence applies across a range of risks that are assessed, prioritised and mitigated by the company in the risk-driven exercise, it would necessitate establishing a link between the horizontal due diligence and a specific product (e.g. because such product area had been the subject of objectively important and specific risk indicators which a company had ignored). For instance, in proposed or existing Union legislation, such as for batteries, a certification mechanism is used to enable supervisory authorities to verify the conformity of product with certain requirements Such mechanisms have to date typically been established in a product legislation. Collaboration among enforcement authorities is in particular important to avoid uneven application across the single market.

The following table summarises the policy options retained for assessment in this report:

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[227] The proposal for a Digital Services Regulation requires a point of contact and a legal representative for supervisory purposes. The proposal for a Regulation concerning batteries and waste batteries, that establishes a due diligence obligation of economic operators that place certain industrial batteries on the market, requires that a manufacturer of a battery that is not established in a Member State may only place the battery on the EU market if the manufacturer designates a sole authorised representative who is considered the economic operator.

Option 1: Sector specific (option 1a) or theme-specific (option 1b) mandatory DD	
Personal and material scope:	• **Sectorial approach:** all large and medium-sized (i.e. all with 50+ employees and EUR 8m+ turnover), and (non-micro) listed LLCs in the specific sector • **Theme-specific approach:** large (250+ employees or EUR 40m+ turnover), medium-sized in high-impact sectors, and (non-micro) listed LLCs for the specific theme
Enforcement:	- **Administrative supervision** - **Harmonised civil liability** for own operation, direct suppliers and established business relations (i.e. excluding one-off relations) beyond tier 1 with specific conditions when liability is triggered (see above) - **Access to remedy**, i.e. possible overriding mandatory provisions as regards applicable law.
Option 2: Horizontal DD obligations only for very large companies	
Personal and material scope:	- **Very large LLCs** (1000+ employees) and **third-country** companies (with significant turnover in EU) : mandatory DD - **Other companies**: Not covered by mandatory DD, supporting measures for those indirectly affected, elements to limit passing compliance burden on to smaller companies in value chain.
Enforcement:	same as in option 1
Option 3: Horizontal DD obligations combined with targeted regime for midcaps and medium-sized companies in high-impact sectors	
Personal and material scope:	• Option 3a: - Very large LLCs (500+ employees OR EUR 350m+ turnover) and third-country companies (with significant turnover in EU): mandatory DD - **Medium-sized and midcap LLCs** (50 to 500 employees OR EUR 8m to 350m turnover) **in high-impact sectors**: mandatory DD limited to selected impact types (risk-based approach) and phased in. • Option 3b: - Very large LLCs (500+ employees AND EUR 150m+ turnover) and third-country companies (with significant turnover in EU): mandatory DD - **Medium-sized and midcap LLCs** (50+ employees and EUR 8m+ turnover but smaller than very large companies with 500+ employees and EUR 150m+ turnover) **in high-impact sectors**: mandatory DD limited to selected impact types (risk-based approach) and phased in.
Enforcement:	same as in option 1
Option 4: Horizontal obligation combined with targeted regime for medium-sized companies in high-impact sectors – most wide-reaching approach	
Personal and material scope:	- **All large LLCs** (exceeding 2 out of 3: 250+ employees / EUR 40m+ turnover / EUR 20m+ balance sheet total), all (non-micro) **listed** companies and **third-country** companies (with significant turnover): mandatory DD - **Non-listed medium-sized LLCs** (50 to 250 employees and EUR 8 to 40m turnover) **in high-impact sectors**: mandatory DD limited to selected impact types (risk-based approach) and phased in.
Enforcement:	same as in option 1

A detailed presentation of the options can be found in **Annex 13**.

5.2.2. Directors' Duties

In order to attain the identified objectives of this initiative, evidence points to the need to clarify that directors of limited liability companies, when acting in the best interest of the company, should take into account the likely medium and long-term consequences of their decisions and resolutions, and should also take into account the employee-related, environmental and other stakeholder-related issues (alongside the interests of shareholders). Such stakeholders include the company's members or shareholders, its employees (including those in the value chains), local communities and other groups of people that are affected by the company's operations, as well as the local and global environment.

In addition, this general duty would be specified as including the following duties:

- Identifying relevant stakeholders and their interests,
- managing risks to the company linked to stakeholders ("sustainability risks"), including dependencies of the company linked to these stakeholders or stakeholder interests, setting up and overseeing corporate risk management systems. Stakeholder related/sustainability risks should be identified in a short, medium and long-term time horizon and should also extend to the value chain;
- setting up and overseeing corporate due diligence processes, policies and measures;
- incorporating stakeholders' interest and sustainability aspects (risks, opportunities, impacts) in the corporate strategy, including science-based targets for greenhouse gas emissions` mitigation; and
- engaging with stakeholders.

Annex 13 provides a more detailed description of the directors' duties concerned.

5.2.2.1.Discarded options: only non-regulatory measures

Non-legislative options could include **enhancing voluntary steps by non-regulatory measures or soft EU law instruments** such as Commission-led or EU-funded awareness-raising campaigns and trainings for directors, Commission Guidelines for directors, or a Commission Recommendation for Member States to adjust the Corporate Governance Codes or to clarify their national laws.

As the Non-financial Reporting Directive already requires disclosure on sustainability risks and their management by certain large companies, and evidence shows that mandatory reporting was not sufficient to mainstream good practices to a satisfactory level, the effectiveness of non-legally binding intervention in addressing the problems is likely to be limited. The consultation activities show some support for regulatory

intervention rather than for soft law, but also reveal differences in the views of businesses[228].

Against this background, the possibility of **clarifying directors' duties in Corporate Governance Codes**, as suggested by certain stakeholders, has been carefully considered. However, there are several reasons that lead to discard this option with regard to the general duty of directors to act in the interest of the company. These include the limited effectiveness in making the necessary paradigm shift because of the limited scope (only EU companies listed on EU regulated markets) and "comply or explain" nature of the Codes[229], and because the problems to be addressed are, at least partially, rooted in the lack of clarity of national company laws that regulate the duty of directors to act in the interest of the company. For the same reasons, other **purely non-legally binding EU solutions were discarded as well**. Please refer for details to **Annex 13**.

5.2.2.2.Options including regulatory measures

All options retained for further assessment include the clarification of the **general duty** of directors to act in the interest of the company in a **legally-binding,** EU regulatory measure that would apply to the directors of **all EU limited liability companies**.

In order to find the most efficient and proportionate solution, options that restrict the **personal scope of mandatory application** were considered, including with a differentiated scope as regards specific duties (risk assessment, due diligence oversight, strategy with science-based targets). Reduction of compliance burden was sought, also by including an option for the specific duties to be promoted in an EU Recommendation (except for risk management) and by phasing in the entry into force of the specific duties for SMEs. The following table summarises key elements with regard to these key aspects:

Personal scope	Content
Company size, sector: - The general duty should apply to all LLCs, including to micro enterprises with limited liability because this clarification concerns a concept included in national company laws which does not differentiate by size of companies.	**General duty:** - Is key to empower directors to balance the short and long-term interests of the company and make sustainability investments, including affecting the value chain. It reflects the legal tradition of Continental Europe.

[228] In the public consultation a large majority of overall respondents answering the relevant questions expressed support or strong support for corporate directors being required by law to: identify and balance stakeholders' interests, manage the risks for the company in relation to stakeholder interests and identify the opportunities, set up adequate procedures and measurable (science-based) targets to ensure impacts on stakeholders are addressed and integrate sustainability risks, impacts and opportunities into the company's strategy, decisions and oversight. However, about half of the businesses disagreed with the need to clarify the need to balance stakeholder interests in legislation. For more details see **Annex 2**.

[229] Corporate Governance Codes are instruments based largely on incentivising through reporting, with less binding nature than the NFRD, so their impacts are expected to be even more limited.

Personal scope	Content
- The directors of companies facing greater sustainability risks, having greater impact, affecting more stakeholders, and having bigger capacities should be required to do more. These are large companies and companies operating in high-impact economic sectors. **Consistency with CSRD and a corporate due diligence obligation:** - The scope of the duties related to due diligence should be consistent with that of the corporate due diligence obligation. As regards specific duties related to risk management and strategy, build on the CSRD scope as that contains the reporting obligations. - The science-based green gas emissions` mitigation target setting could be limited to very large companies. **Non-EU companies:** - cannot be covered as the duties of their directors are not governed by EU law.	- Necessary to frame all key decisions in a company. **Specific duties:** - Risk management duty: duty to manage stakeholder related risks to the company should be self-standing, in line with the double materiality concept of the CSRD - Directors' responsibilities regarding risk and impact management, implementing such processes and approving the strategy are in line with EU corporate governance traditions - Sustainability should not be a separate strategy but should be embedded into the corporate strategy, in line with the CSRD - The duty to engage with relevant stakeholders could apply in a simplified manner, in particular to smaller companies.

4 policy option packages[230] reflect different levels varying along the 2 key aspects. The following table shows the duties of directors contained in each option package.

Options	Applicable duties for the various company categories
Option 1	• **General duty** is legally binding (mandatory) for all LLCs. • **Mandatory risk management duty** for all large, and – phased in – for non-micro listed SMEs and other (non-listed) high-impact medium-sized LLCs (CSRD scope + high impact medium). • **All other specific duties** set out in an EU Recommendation for large and high-impact medium-sized companies.
Option 2	• **General duty** same as in option 1 • **Risk management duty** same as in option 1 • **Duty to set up and implement due diligence processes and measures**, and **a strategy that includes science-based targets** are legally binding for all very large companies and for high-impact midcaps and medium-sized companies (scope aligned with the middle-ground scope for

[230] A complementary element to all options is the reporting to the public under the Commission's proposal for a Corporate Sustainability Reporting Directive (i.e. the revised NFRD).
[230] When referring to micro enterprises, small, medium-sized and large companies (LLCs), these should be understood as complying with the definitions of the Accounting Directive, unless otherwise specified in the related corporate due diligence option.

Options	Applicable duties for the various company categories
	corporate due diligence: i.e. option 3)
Option 3	• **General duty** same as option 1 • **Risk management duty** same as in option 1 • **All other specific duties** are also legally binding for all large, and – phased in – for non-micro listed SMEs and other (non-listed) high-impact medium-sized LLCs (CSRD scope + high-impact medium), **except**: • **Duty to set up and implement due diligence processes and measures** is legally binding as in option 2, and • **Strategy that includes science-based targets** applies only to very large companies with more than 1000 employees.
Option 4	• **General duty** same as option 1 • **All specific duties** are legally binding for all large and – phased in – for listed non-micro SMEs and high-impact non-listed medium-sized LLCs (scope aligned with the most wide-reaching scope for corporate due diligence: option 4)

5.2.3. Directors' remuneration

A regulatory option introducing a **general clause** could be considered to ensure that **remuneration schemes facilitate or at least do not hinder compliance with the due diligence and directors' duties**, applying to all companies in the scope of the initiative.

More specific regulatory options – which would most likely target listed companies in line with the scope of the Shareholders' Rights Directive – **are not being considered** in this Impact Assessment at this point in time as it appears useful to first await the application of that Directive. Non-regulatory options have been discarded from the outset as they would necessarily be targeted at updating Corporate Governance Codes; the weaknesses of this approach have been previously outlined.

6. WHAT ARE THE IMPACTS OF THE POLICY OPTIONS?

This section assesses the impacts of each of the non-discarded policy options identified in the previous section for each main area covered by the initiative. For this, we first **identified and assessed the significance of the initiative's possible economic, social, human and labour rights impacts,** and of its expected **impacts on climate change, as well as on the local and global environment more broadly**. Such impacts include direct and indirect, immediate and prolonged, one-off and annually recurring costs and benefits for the company, for the economy as a whole, for the companies' stakeholders, for society, and they also include the costs of supervision and enforcement by the public authorities. This mapping and the detailed assessment of the impacts is set out in **Annex 4**. The calculation of business compliance costs and the enforcement costs to be borne by the public administration, is also included in the same annex.

We then assess the policy options for each of the three areas covered on the basis of the detailed mapping and assessment of the impacts. Because the main difference between

the options retained for detailed assessment concerning due diligence and directors' duties is the magnitude of the expected impacts (due to their larger or smaller scope of application, depth of the requirements, their mandatory or voluntary nature and the breadth of the enforcement regime), the assessment of the options already contains a **comparison** drawn not only with regard to the baseline scenario but also to the more far-reaching option(s). The assessment consists of the following steps:

(1) We analyse the **effectiveness** of the measures included in the option to show the extent to which the option concerned would achieve the specific – and ultimately the general – objectives of this initiative. While all three areas would contribute to all specific and general objectives, not all of them have the potential to contribute to each objective to the same extent. Accordingly, the assessment of the various sets of alternative options focuses in particular on the following specific objectives:

Options for means to attain them: / **Specific objectives:**	Due diligence options	Directors' duties options	Measures on remuneration
Bring clarity on what directors are expected to do to fulfil their duty to act in the interest of the company and to integrate stakeholder interests and the long-term interest of the company into directors decisions		✓	
Foster the integration of sustainability risks (including from the value chain) into corporate risk management processes, facilitate management of dependencies and ability to react to change	✓	✓	
Increase accountability for identifying, preventing and mitigating adverse impacts, including in value chains, avoid fragmentation of due diligence requirements in the Single market and create legal certainty for stakeholders as regards expected behaviour and liability;	✓	✓	
Improve access to remedy for those affected by adverse corporate human rights and environmental impacts;	✓		
Improve corporate governance practices to facilitate the integration of sustainability into directors' and company decision-making (e.g. in the area of stakeholder involvement).		✓	✓

(2) We analyse the **costs** of each policy option, taking into account the mapping and the calculations provided in **Annex 4** for companies as well as benefits.

(3) Then we also explain **the expected impact on the broader economy, as well as environmental, social and fundamental rights impacts** that have not yet been taken into account under the effectiveness and the cost assessment.

(4) We assess the **efficiency** of each option by weighing its effectiveness in reaching the objectives and other positive impacts (benefits) of the option against its expected costs. Proportionality of the identified options is taken into account in the efficiency assessment.

(5) We then address the **coherence** with the other main areas covered by the initiative and with other EU policies where appropriate.

(6) Finally, we assess the **stakeholders' feedback** submitted to the open public consultation that are relevant for the various options.

In general, the impacts will not be counted twice in the case of directors' duties closely related to the company's due diligence obligation.

6.1. Corporate due diligence requirements throughout the company's own operations and in its value chains

6.1.1. Effectiveness

The following table summarizes our findings on how effective the four options would be in reaching the relevant specific objectives, using a scale from – (not effective at all) to ++++ (very effective), compared to the baseline (scoring 0s everywhere):

Options: **Specific objectives:**	**1**	**2**	**3**	**4**
Foster the integration of sustainability risks (including from the value chain) into corporate risk management processes, facilitate management of dependencies and ability to react to change	-/+	+	+++	+++
Increase accountability for identifying, preventing and mitigating adverse impacts, including in value chains, avoid fragmentation of due diligence requirements in the Single market and create legal certainty for stakeholders as regards expected behaviour and liability	-/+	++	+++	+++
Improve access to remedy for those affected by adverse corporate human rights and environmental impacts	-/+	++	+++	++++
Prevent and reduce adverse human rights (including labour rights) and environmental impacts of EU companies and their value chains worldwide	-/+	++	+++	+++

6.1.1.1.Option 1:

Option 1 would entail a sector- or theme-specific approach. It would be similar to the method of various EU measures which already set out certain due diligence obligations or which are currently being prepared[231], addressing specific sustainability concerns that are present in a specific sector or that are related to specific products.

This option would make a limited contribution to achieving some of the specific objectives but could not ensure that any of the objectives are fully met. The principal limitations would be as follows:

- The majority of industry sectors or, depending on the case, sustainability impacts would not be covered by the due diligence duty. However, risks of adverse impacts on the environment and on human rights are present in many industries' global value chains, not only in the most salient sectors. Moreover, global value chains typically embody more than one or a few sustainability impacts. The above specific objectives would be achieved for the regulated theme or sector only.
- The approach would not prevent a multiplication of diverging national horizontal due diligence regimes. Several EU Member States/EEA countries have already adopted horizontal due diligence laws. Others, like the Netherlands, are working on a horizontal legislative initiative that would be adopted in the absence of an EU legal framework. Still other Member States, for instance Sweden and Finland, are likely to start working on a horizontal due diligence instrument in the absence of EU rules. The increasing fragmentation of due diligence requirements across sectors of industry, Member States and areas of application would create lack of legal certainty for companies and stakeholders.
- Stakeholders affected by human rights and environmental harm would have access to remedies for the limited theme or in the regulated sector only.

Compared to the other policy options, option 1 would be least effective in terms of reaching the specific objectives of this initiative.

There is a strong consensus amongst stakeholder groups that a horizontal EU framework is necessary to address the identified problems. 92% of respondents indicated that they prefer a horizontal approach as regards the content of a possible corporate due diligence duty over a sector-specific or thematic approach.[232]

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[231] The EU Timber Regulation, the Conflict Minerals Regulation, the proposal for a Batteries Regulation, the Deforestation initiative and the Sustainable Product initiative, as explained above.

[232] This is true also for Member States respondents. 13 respondents (from Belgium, Czechia, Estonia, Finland, France, Germany and Spain) prefer a horizontal approach. One respondent from Luxembourg prefers a thematic approach. One respondent from Italy and one from Netherlands think that none of the provided options are preferable.

6.1.1.2.Option 2:

This option would make a moderate contribution to achieving the specific objectives. Around 8 900 companies would be in the scope of this option and companies in their value chains would be indirectly impacted.

For this number of companies, this policy option would contribute to the specific objectives of this initiative. However, the effectiveness of this option has limitations:

- A third of very large companies already carry out human rights and environmental due diligence, albeit do not always cover all their value chain.
- While companies in the value chain of the companies in scope will be impacted indirectly, the large majority of companies will continue not sufficiently integrating sustainability risks (including from the value chain) into corporate risk management processes, nor benefit from better managing dependencies.
- Accountability for identifying, preventing and mitigating adverse impacts, including in value chains will not be increased for the large majority of companies.
- The vast majority of EU companies will not get more clarity about what is expected from them as regards addressing sustainability impacts in their value chains and the circumstances under which they possibly may be held liable, as international voluntary standards would remain the only benchmark for them and those do not differentiate between company sizes.

Therefore**, the limited scope of this option would result in its being only moderately effective in contributing to the specific objectives of this initiative**.

6.1.1.3.Option 3:

This option, through its design along two variables, employees and turnover, thus more representative of capturing relevant companies, and its additional scope covering also companies operating in high-impact sectors, would make a more effective contribution to achieving the specific objectives of this initiative, with variations depending on the sub-option.

The reference to turnover filters would also ensure that the companies having more of an impact on the economy would be captured (whilst not being the only proxy of the company's economic impact, turnover is considered a good proxy of such impact and is used in other pieces of Union legislation to this effect).

500+ employees is a reliable benchmark for capturing companies of a sufficient size and companies above 500 employees generate 59% of the overall turnover of limited liability companies in the EU.

Sub-option 3a targets companies that have more than 500 employees or generate a turnover of at least 350 million. This would capture smaller companies with substantial

turnover [possibly as from 250 employees]. Around 23 000 companies would be covered, accounting for around 38% of large limited liability companies in the EU[233].

Sub-option 3b targets companies that have more than 500 employees and generate at least 150 million turnover. This would target only those companies that generate a sufficient impact in their supply chains. Given that it is a double filter, the turnover is lower than in option 3a. This cumulative criteria would capture around 9 400 companies. This would result in covering 15% of large limited liability companies. In terms of number of companies, this is a slightly broader scope than option 2; at the same time, it represents a broader diversity among the companies covered in terms of operational and financial capacity.

Subsidiaries and value chain business relations of these companies will also be indirectly impacted.

Under both scenarios, in addition to the group of companies fully in the scope of the due diligence duty, large companies between 250 and 500 employees and medium-sized companies (50 employees),[234] operating in high-impact sectors, would be included in the personal scope of the initiative. This approach allows to capture medium to large companies which, because of operating in sectors representing higher risk from a human rights and environmental perspective, are likely to have significant individual or cumulative adverse impact. The combination of such size and qualitative criteria is justified by proportionality: smaller high risk or larger low risk companies are not covered. This additional group of companies ranges between 9 520 to 46718 individual companies as per sub-option 3a and between 10 199 to 49 486 individual companies as per sub-option 3b, however part of these companies are not likely to incur additional burden as they are a member of the group of the first category of companies, and as they will be impacted indirectly by the obligation applying to the first category company, see explanation in **Annex 11**. In total, options 3a and 3b would cover maximum 55 900 and 44 000 companies (indirectly affected subsidiaries of large parent companies are not included). This leads to a significantly more effective contribution to the objectives of this initiative than options 1 and 2, which at the same time remains targeted at highest impacts in terms of turnover and risks.

This option could therefore effectively contribute to reaching the specific objectives of this initiative.

6.1.1.4. Option 4:

This option has a wider personal scope than options 2 and 3. Under option 4, 65 000 individual companies would be covered, which represent 49000 company groups. They account for 85% of large limited liability companies in the EU as defined by the NFRD.

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[233] Calculating with 60000 large limited liability companies on the basis of Orbis data.
[234] Number of employees is combined with thresholds of annual turnover.

These companies account for 76% of the turnover of EU limited liability companies. In addition, as under option 3, all other limited liability companies that are at least medium-sized and operate in a high-impact sector would be in the scope, i.e. an estimated range from 5 717 to 28 732, but only part of these would bear additional costs. Consequently, maximum 85112 companies (indirectly affected subsidiaries of large parent companies are not included) would bear additional costs. This option would cover virtually all large limited liability companies, plus high impact medium companies, and thus may go beyond what is necessary to reach this initiative's objectives, given that much impact is passed through the value chain. A turnover filter at lower level (40 million) does not allow to effectively focus on companies with highest impact in the value chains.

Options	Effectiveness
Option 1	+
Option 2	++
Option 3a	+++
Option 3b	+++
Option 4	+++

6.1.2. Costs

6.1.2.1. Business compliance costs

The due diligence obligation will include one-off (initial) and recurrent (annual) costs. A comprehensive assessment of the compliance costs and calculations are included in **Annex 4**, this section only gives a summary of the cost analysis.

The compliance costs will consists of three main parts:

1) **The costs of establishing and operating the due diligence processes and procedures.** These costs include, first of all, the cost of impact mapping and tracking: collecting data to initially identify actual and potential adverse impacts in the company's own operations and in its value chains, analysing such information, monitoring the development of such impacts and tracking the effectiveness of actions taken to reduce adverse impacts where such impacts have been identified. Costs will also be implied by the need to better control the supply chain (for example through contracts), possibly also by taking part in collective engagement, and to incorporate human rights and environmental sustainability standards in contracts with suppliers and other business partners or to develop suppliers' codes of conduct. These costs are both one-off and recurring costs and **Annex 4** analyses such cost impact **quantitatively**.

2) **Transition costs, i.e. the expenditures and investments necessary to change the company's own operations and value chains in order to comply with the due diligence obligation to cease and mitigate actual and prevent potential harm.** These costs are particularly relevant for companies that identify actual or potential adverse impacts. They will need to undertake further steps to enforce the contractual terms and standards enshrined in codes of conduct, to exercise the leverage over the value chain,

possibly to reorganise their upstream and downstream supply chains. As a last resort, companies may need to terminate relationships with non-cooperative or non-compliant suppliers and switch to new suppliers complying with the required standards. Companies may also need to adjust their production processes, products or services. For instance, they may need to invest into climate-friendly or resource-efficient production processes, into research and innovation, into human capital, or upgrading facilities, etc. They may possibly need to change their business models. Most of these costs constitute one-off costs but companies would not necessarily incur them immediately after the entry into force of the rules. Instead, they are likely to be spread across several years, in particular where the due diligence duty requires achieving a result through gradual implementation, for example in the case of climate change mitigation. As such costs depend on the current individual circumstances of the companies which are difficult to control, **Annex 4** assesses such costs qualitatively, with exemplary **quantitative data** to demonstrate such effects.

3) **Cost of reporting to the public**: while there would be no additional reporting costs for companies which are required to publish the necessary information under the revised NFRD (CSRD), others – i.e. non-listed high-impact medium-sized companies – would incur some reporting costs as a result of this initiative.

The assessment of the compliance costs takes into account the following considerations, among others:

- **Certain companies already perform some kind of due diligence** and have risk management processes, even if limited, including because of existing obligations under social and environmental legislation. Supplementing already existing processes costs less than establishing new ones. On the other hand many companies which already perform due diligence often go until their first tier suppliers only. Therefore companies with existing processes may also incur substantial additional costs.

- The reporting obligation under **CSRD would require setting up some basic processes of information gathering and analysis which partly overlap** with the due diligence obligation. Such overlap is accounted for.

- Companies falling under a **simplified regime may incur lower costs**, while many of those do not do any due diligence today and are therefore required to set up most processes, even if they cover only more limited risk areas.

- Many **factors contribute to reducing costs substantially**, including industry collaboration and modern technological solutions.

Furthermore, the transition costs and therefore the overall cost burden will be different depending on the business model of the companies and the extent to which they have already embedded in their organisation sustainability considerations as well as a certain awareness of the impact of their activities on human rights:

- The costs are expected to be lower for companies that rely on suppliers which themselves carry out sustainability due diligence.
- Conversely, companies with certain business models (for example the provision of the lowest cost goods, high-speed delivery that places pressure on warehouse workers, land use in countries where ownership rights may be contested, etc.) are likely to incur more costs.
- Companies with more business partners, longer and more complex supply chains or value chains that are not transparent or located in countries with lower human rights and environmental standards are likely to incur higher compliance costs.

Some companies (subsidiaries, value chain partners) that are not under the scope of the initiative would bear higher trickle down costs in particular in case they operate in high-impact sectors or are selling their products or services, directly or indirectly, to larger companies operating in high-impact sectors. However, under the due diligence obligation safeguards will be provided so that large companies do not impose unjustified compliance burden on their SME value chain business relationships. Large companies could thus be incentivised to share information or cooperation platforms, etc. with its suppliers which in turn could lower the cost for anybody else in the chain.

Based on the calculation of **Annex 4**, the following table summarizes the compliance costs for individual companies, based on the different scope options:

Total direct incremental compliance costs of mandatory DD (without transition costs) in EUR:	**Recurrent costs**	**One-off costs**
Micro LLCs, Small LLCs, Medium-sized LLCs not in high-impact sectors	Not covered, only indirect costs	
Listed SMEs (full due diligence, covered only in Option 1 and 4)	22 950	6 300
Medium-sized LLCs in high-impact sectors subject to the targeted due diligence obligation	24 200	7 250
Midcap LLCs ("moderately" large) in high-impact sectors subject to the targeted due diligence obligation	39 150	11 100
Large and very large companies (including midcaps where subject to full due diligence obligation)	52 200 – 643 300 (cost numbers at the upper end of this range estimated for about 300 largest LLCs only)	14 800 – 190 300 (cost numbers at the upper end of this range estimated for the about 300 largest LLCs only)

**One-off costs are not immediate costs and can spread across several years.*

For medium-sized companies and listed SMEs, these costs amount to about **0.09 to 0.10% of their revenue**, and for midcaps, large and very large companies to about **0.004 to 0.006%**.

The following table present the ***estimated direct compliance costs as per scope options taking into account the number of companies affected:***

Aggregated direct business compliance costs (in EUR)	**Option 1a: Sectoral e.g. C13 subsector** (manuf. of textile)	**Option 1b: Thematic approach** (one impact in all sectors)	**Option 2 (Horizontal full DD only for very large with 1000+ empl.)**	**Option 3a (+ targeted DD for high-impact midcaps & medium-sized targeted)**	**Option 3b (+ targeted DD for high-impact midcaps &medium sized with different definition for midcaps)**	**Option 4 (full DD for CSRD scope + targeted DD for high-impact midcaps & mediums)**
Recurrent	0.06 bn	0.63 bn	0.64 bn	2.37 bn	1.72 bn	4.09 bn
One-off	0.02 bn	0.18 bn	0.18 bn	0.68 bn	0.50 bn	1.17 bn

6.1.2.2.Supervisory costs for public authorities

Public authorities will have to monitor and enforce compliance with the due diligence obligations and handle situations in case non-compliance is identified through ex officio investigations or based on complaints. These actions impose costs to public authorities. Member States may designate one or several existing authorities as competent under this initiative (involving authorities responsible today for human and labour rights and for environmental matters) but they may also decide to set up a new authority that is competent to deal with due diligence-related questions (including checking the strategy and the targets) for all sustainability aspects.

Rather than calculating the costs on the basis of the examples of the existing instruments at EU level, where the authority does not have the same role[235], we estimate the supervisory costs relying on the recent detailed estimations of the German government

[235] "Conflict minerals" Regulation or Timber Regulation.

that supported its draft bill on corporate due diligence in supply chains[236], making the necessary adjustments: we take into account the difference in the sustainability aspects covered (material scope) and also the broader personal scope, using proportionately smaller costs, where relevant, for overseeing medium-sized and midcap companies, as the German bill covers very large companies only.

The costs include one-off and recurrent labour costs and out-of-pocket costs (OOPC) for the various risk-based steps of the supervisory tasks, starting from overviews and plausibility checks of the information published by the companies on their adverse human rights and environmental impacts and their due diligence practices (as part of the sustainability reports disclosed under the SCRD or, for non-listed medium-sized companies, under the reporting rules introduced by this initiative), through in-depth assessment and reviewing supply and value chain management to on-site inspections[237]. The estimations include training costs and also the costs of administrative offence proceedings. The general cost calculations apply to the systematic supervisory review of large companies and SMEs (high-impact medium-sized companies and listed SMEs) falling under the scope as per the various policy options. The detailed calculations are explained in Annex 4, with the following table summarising the results:

Enforcement costs in EU27 (in EUR)	**Option 1b[238]**	**Option 2**	**Option 3a**	**Option 3b**	**Option 4**
Total recurrent:	8.00 million	2.51 million	11.24 million	7.86 million	19.52 mill.
Total one-off:	0.13 million	0.13 million	0.13 million	0.13 million	0.13 mill.

6.1.3. Benefits for companies

As explained in **Annex 4**, various meta-studies, including two recent ones, on the relation between companies' sustainability and financial performance demonstrate a positive correlation between companies paying attention to their stakeholders' interests, sustainability risks, impacts and opportunities and their financial performance. This positive correlation has also been confirmed by a large seminal meta-analysis of about

[236] Referentenentwurf des Bundesministeriums für Arbeit und Soziales Gesetz über die unternehmerischen Sorgfaltspflichten in Lieferketten, adopted by the Federal Government of Germany on 3 March 2021. The law would apply to large companies with more than 3000 employees, and would focus on human rights aspects, covering environmental factors to a limited extent.
[237] As relevant disclosures become machine readable (including sustainability reporting under the revised NFRD), which allows for deploying artificial intelligence more, supervisory costs could become lower.
[238] In option 1a, for example covering subsector C13 (Manufacture of textile), the recurrent supervisory costs would amount to about EUR 150 000.

2000 different sources[239]. The positive impact of integration of stakeholder interests on the company's resilience in crisis situations too was confirmed in the Covid crisis[240].

The sources of such improved financial performance may be manifold: operational efficiency, cost-saving, reputational gains, more attractiveness for talent, more innovation, first-mover benefits in global markets. **Annex 4** analyses available evidence in greater detail. Not all benefits will arise immediately, most may manifest in the medium to long-term. As explained in **Annex 4**, switching to low CO_2-emission technologies or more resource efficient technologies for example can be expected to directly result in lower operating costs and can therefore bring cost efficiencies also in the short-term but are generally expected to be a more profitable investment in the medium to long run. For example a report from 2020[241] shows the business case for low-carbon investments. The study covering 882 European companies shows that emissions reduction initiatives typically yield cost savings in excess of the initial investment at an average profit of EUR 17 per tonne of CO_2[242].[243] Companies also identified new revenue opportunities from low-carbon goods and services – more than six times the investment needed to realize them.

Not all potential benefits will arise equally to all companies in the scope:

- All companies (even those indirectly impacted) may derive performance benefits linked to, for example, operational cost savings due to more efficient operations, less reliance of scarce raw materials, better relationships with and trust from stakeholders, better knowledge of the supply chain and its environment, better commercial relationships, etc.

- Improved branding and reputational benefits, benefits arising from attracting talent, etc. arise less when a large number of companies are subject to the new rules, i.e. within the single market. However, as EU companies may be first movers in global markets, they may derive these benefits on those markets.

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[239] See Friede, Busch and Bassen (2015) "ESG and financial performance: aggregated evidence from more than 2000 empirical studies".

[240] See Cheema-Fox et al., 2020, Corporate Resilience and Response During COVID-19; OECD Centre for Responsible Business Conduct note "COVID 19 and Responsible Business Conduct"; European Capital Markets Institute's Commentary ESG resilience during the Covid crisis: Is green the new gold?, 67-2020.

[241] Doubling down Europe's low carbon investment opportunity, February 2020

[242] While the companies anticipated more than 2.4 GtCO2e of cumulative emissions reductions over the lifetime of their initiatives – more than the annual emissions of Germany, the United Kingdom, Italy, Poland and France combined –, they also expected to achieve €65 billion of cost savings over the lifetimes of their investments. Compared to their initial €24 billion of investments (in 2019) this represents a net €41 billion contribution to bottom line.

[243] The most profitable emissions reduction initiatives were expected to be investments in energy efficiency processes but significant abatement profits were also anticipated from investments in transport electrification and low-carbon energy.

- Companies with more advanced impact management may derive less benefits but may still benefit from cost savings linked to harmonisation, increased level playing field, etc.
- Benefits related to cost of capital and financing are likely to increase over time in light of ongoing measures requiring proper sustainability risk management in banks and some other financial institutions and growing awareness about sustainability risks in the finance sector.

However, benefits will not arise to those companies which cannot bear the initial compliance burden, this risk has been reduced considerably in option 2 and 3 the scope does not cover medium companies only if active in high impact sectors, it does not cover small and micro companies, safeguards that large companies share the compliance burden of SMEs, even if only indirectly impacted, different support measures, coverage of third country companies, etc. (see in more detail under "efficiency").

6.1.4. Environmental, social and fundamental rights impacts, and impacts on the economy

For a complete analysis referring to available evidence, please refer to **Annex 4**.

As one major objective of this initiative is help delivering on the sustainability transition and to have positive impacts on human rights, including labour rights, and on the environment, only those options have been retained for further analysis that are at least to a reasonable extent effective in reaching this objective. The magnitude of these beneficial impacts increases with the scope of application to companies, impacts covered, extension of the duty to the entire value chain and with the efficiency and credibility of the enforcement mechanisms.

The **human rights, including labour rights, and environmental benefits** are closely interrelated (for example environmental pollution can impact on people's health and access to food).

While all these impacts would benefit European citizens, workers, companies, and other stakeholders in the EU, the rules have the potential to significantly benefit people, companies, communities and the environment **in the EU and third countries**. For example, mandatory due diligence is expected to lead to **safer and more decent working conditions** for employees throughout EU companies' value chains, such as less forced labour, child labour or less exposure to hazardous materials or dangerous working sites and overall health and safety related benefits.

The involvement of stakeholder groups can further increase awareness of companies of their actual or potential adverse human rights, including labour rights, and environmental impacts, which can contribute to the mitigation thereof.

The French law is considered to have resulted in fostering more awareness in host countries about low human rights standards or insufficient enforcement[244] and the EU law is expected to have an even stronger impact on the local laws and enforcement regimes in third countries, which would further increase benefits for vulnerable people.

As regards possible negative impact on human rights, including labour rights, and the environment which may arise as a result of abandoning suppliers or territories affected by, for example, systemic human rights issues, please see below in section 6.1.5.

While in the short-term, EU companies will be at a relative disadvantage in cost competitiveness compared to non-EU companies in global markets, additional firm-level costs as percentages of companies' revenues are still relatively low.

On the other hand, the new EU legislation will decrease distortions between EU and non-EU companies by creating more equal standards for EU companies, third country companies generating a high turnover in the EU as well as EU and non-EU suppliers.

As in the mid to long-term, corporate benefits are expected to outweigh costs (in terms of efficiency gains, more resilience, better financial performance through innovation, etc.) and possibly also lead to first mover advantages in global markets (including securing access to resources, technology, secure market shares in global markets and gain economies of scale vis-à-vis later market entrants), the cumulative impact of these benefits is expected to lead to competitiveness gains for the economy in the mid to longer term. The measures are likely result in reduced dependency on scarce natural resources and more resilience to sustainability related shocks.

Finally, the due diligence obligations imposed on companies does not have any negative impact either on the freedom to conduct a business or to the right to property of the shareholders. It sets the boundaries to business activities at the level of harm caused to people and the environment.

6.1.5. Impacts on third countries and developing countries

By including European companies' global supply chains into their scope, and by recognising that the most salient adverse impacts on human rights and on the environment occur mainly outside the EU, the policy options have a strong external dimension through their impacts on supply chain actors and stakeholders in third and developing countries.

The policy options can have a positive impact on third and developing countries by preventing and reducing adverse human rights (including labour rights) and environmental impacts of EU companies and their value chains worldwide. Developing

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[244] ILO report Achieving decent work in global supply chains, February 2020; France's General Council of Economy, January 2020, Evaluation de la mise en œuvre de la loi n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre .

countries, where the risk of adverse social, environmental and governance impacts tend to be highest, will benefit from meaningful engagement of EU companies with value chain partners on identifying and mitigating these impacts. These benefits can substantially be amplified through mutually reinforcing initiatives, including development of voluntary sustainability standards, support of multi-stakeholder alliances and industry coalitions, as well as accompanying support provided through EU development policy and other international cooperation instruments.

A duty for EU companies to conduct human rights and environmental due diligence in their own operations and global supply chains relations can, at the same time, lead EU companies to prioritise risk avoidance through disengagement from suppliers and producers in developing countries over meaningful engagement in risk prevention and mitigation. The safeguards mentioned above regarding cost sharing with SME value chain partners, the requirement that stakeholder interests (including value chain partners and victim of an abuse) are taken into account in impact mitigation measures, etc.), and the cost implications of restructuring value chains reduces the risk of abandoning third country value chain partners.

6.1.6. Efficiency

The analysis looks at cost efficiency at company level and overall cost efficiency with respect to all possible benefits.

Within the sector or theme specific **option 1,** the cost per company of a **theme specific due diligence obligation** will be lower than due diligence applying to all impacts or most relevant impacts. On the other hand, setting up due diligence processes for checking one impact only is less cost efficient for the company, than setting up processes to cover more or all impacts as the relative cost of extending existing processes to additional impacts is lower. Therefore, from the perspective of company specific cost-efficiency, the theme specific obligation is the least cost efficient. This is also true for overall efficiency: **with slightly lower overall cost impact than a duty applying to all themes, much less benefits will accrue not only for companies but also for stakeholders, i.e. as regards social and environmental impact.** If the theme specific obligation applies only to child labour there will not be any benefit for the environment and the social benefits will also be limited.

As regards the **sector specific option**, the due diligence obligation would require addressing all impacts in that specific sector, for example garment and footwear. The cost implications for the company operating in the sector will be similar to the cost implications of the horizontal duty per company, as all impacts will be covered. However, a garment company could not benefit from the impact mitigation actions of companies operating in other sectors. So, for example, if a company operating in the automotive sector buys textile from the same supplier as the garment company, this latter cannot share costs with the automotive company through cross-industry cooperation. For the garment company the cost impact will be more considerable than if there are cross industry cooperation possibilities. As regards overall efficiency, **the sectorial option's benefits will mostly be limited to that sector.**

While this option will have lower short-term cost impact on the economy, given the comparatively very low positive economic, social and environmental benefits and low effectiveness of this option to achieve the specific objectives, option 1 is least efficient among all options.

Option 2 covers very large companies across sectors which are subject to full due diligence. While only large companies are directly covered, their subsidiaries as well as value chain members will also be indirectly impacted. As a third of very large companies already do some form of due diligence but mainly limited to their tier 1 suppliers, these companies could mainly benefit from the financial performance improvements (better knowledge of value chain, dependencies, streamlining value chain, etc.) harmonisation, increased level playing field and cost sharing with other companies under the scope.

As under this option, a smaller portion of companies will be directly and indirectly impacted than in Option 3 or 4, fewer companies are likely to derive more benefits too, than if more companies would be covered, as some benefits are relative to the performance of the competitors. The companies under the scope could derive more benefits from better reputation, better access to capital, attracting talent, but also financial benefits from more efficient production processes, less risk, etc.

As regards overall efficiency of **Option 2**, the initial negative competitiveness impact on the economy will be smaller. But the medium to long-term positive economic impact will also be smaller as well as the overall social and environmental positive impacts and the effectiveness of the option to contribute to the specific objectives. Companies that are not directly or indirectly impacted will not derive benefits from their transition to more sustainable production and operation, which, in the medium to longer term, will negatively affect their operations and the economy. This option **is effective only to a limited extent** to increase accountability for adverse impacts and improve access to remedy due to its limited scope.

The scope of **option 3** is larger than that of Option 2. This option combines the advantage of covering companies beyond very large ones, thereby contributing to an all economy transition, but applying a targeted approach in terms of turnover and risk which avoids excessive burden on SMEs. Micro and small companies could only be indirectly impacted and high-impact medium-sized companies and midcaps would fall under a targeted due diligence regime which implies simplified requirements. This option thus takes into account the constraints on EU businesses' operations and profit margins in the Covid crisis[245].

As regards cost efficiency at the level of the company, there may be economic benefits which are felt more immediately, such as better knowledge and management of supply chains, better awareness of dependencies (short-term gains). There are also economic

[245] For more details on the effect of the COVID-19 pandemic, please refer to Annex 14.

benefits which may occur in a mid to long-term perspective, such as gains from increased efficiency, environment-friendly investment or innovation leading to growth opportunities, increased market share, other first mover advantages in global markets.

Having effective enforcement mechanisms in place (liability and administrative supervision) might increase not only the compliance by companies but also the credibility of their due diligence activities and parallel reporting. This could potentially also increase the economic benefits arising from the initiative.

As regards certain medium companies but also other SMEs indirectly impacted, as the initial cost burden is considerable and most benefits materialize in the mid-to long-term, the content of the due diligence measure was carefully crafted to ease compliance and respond to their specific needs. The measures are expected to foster cost sharing between the large buyer and the small supplier, several support measures are being developed, and high impact medium companies will only be phased in which allows for preparing for the news rules. Furthermore, industry collaboration is likely to continue and further develop, and SMEs can also benefit from the impact mitigation efforts of large companies which get supplies from the same supplier as them. On the other hand, the short-term cost impact may be significant in particular for medium companies notably for those which are not part of the value chain of a larger company and cannot share costs through industry cooperation.

As regards overall efficiency, while the short-term cost impact of this option on the economy is significant, overall more economic benefits are expected in particular in the mid to longer term. This assumption is in line with the views of respondents to the public consultation (even businesses) which considered that benefits of due diligence outweigh the costs. Furthermore, the benefits will spread more equally across sectors. Because of the numerous measures aiming at reducing the risk of excessive burden on smaller companies, it is not expected that the duty would have very significant negative impact in the short-term on any parts of the economy. Furthermore, with the coverage of third country companies making significant turnover in the EU, the initial negative cost competitiveness effects on EU companies and on the economy will also be reduced.

This option 3 has a better score for effectiveness than Option 1 and 2 and will therefore also result in more positive social and environmental impacts as outlined in section 6.1.4. Taking into account the safeguards introduced to limit negative impact on companies (both on large and small, both in the short and longer term) the potential of this option to share costs more effectively across companies and across industry sectors thereby increase per company cost efficiency, its efficiency rating therefore shall be higher than those of the previous options but the efficiency of sub-option a) is more of less the same as the one for sub-option b) as the difference in scope and thus the cost sharing opportunities are not very significant.

Option 4 has its scope largely aligned with the CSRD and covers therefore the largest share of LLC and of the Union economy. It would imply at least a double of the compliance costs of option 3, while benefits may only be less high as some will

materialize even less per company when more companies are covered (such as for example attracting talent, reputation) .

As certain economic benefits resulting from operational efficiency, innovation etc. do not depend on a relative advantage vis-a-vis competing firms, but all firms can simultaneously benefit from them as explained above, a broader application of a new regulation could provide more benefits. Furthermore, it is likely that there will be more cost sharing opportunities under scope 4 given the significant scope of coverage, therefore per company benefits compared to costs could be even higher.

On the other hand, this option is not targeted as Option 3 in a sense that it may apply to many more large or medium companies even if these present less risk, therefore the overall benefits may also be lower. It is also more likely that the same suppliers would be checked by many more companies, which reduces the overall efficiency of this option also as regards human right and environmental benefits, compared to Option 3. For these reasons the efficiency rating of option 4 should be lower than that of Option 3.

Options	Efficiency
Option 1	+
Option 2	++
Option 3a,3b	+++
Option 4	++/+++

6.1.7. Stakeholders' views[246]

Mandatory due diligence rules have been called for from a broad range of stakeholder groups, including civil society representatives[247], EU citizens[248], businesses[249] as well as business associations[250], who see benefits in an EU harmonised approach rather than the current situation of emerging national initiatives.

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[246] For more detailed information on the results of the stakeholder consultation, please refer to **Annex 2.**

[247] E.g. https://responsiblebusinessconduct.eu/wp/wp-content/uploads/2020/09/Principal-elements-of-an-EU-mHREDD-legislation.pdf; https://cleanclothes.org/news/2021/fashioning-justice, etc.

[248] A October 2021 YouGov poll shows that over 80 percent of citizens from across multiple EU countries support strong laws to hold companies liable for overseas human rights and environmental violations.

[249] https://www.business-humanrights.org/en/latest-news/list-of-large-businesses-associations-investors-with-public-statements-endorsements-in-support-of-mandatory-due-diligence-regulation/.

[250] E.g. Business for Inclusive Growth: https://www.b4ig.org/articles-all/b4ig-leads-the-way-on-the-european-framework-on-mandatory-human-rights-due-diligence /; Federation of the European Sporting Goods Industry: https://fesi-sport.org/wp-content/uploads/2020/10/FESI-position-paper-on-due-diligence-July-2020.pdf; Amfori: https://api.fairwear.org/wp-content/uploads/2020/04/Responding-responsibly-to-the-COVID-19-crisis-110520.pdf;.https://fesi-sport.org/wp-content/uploads/2020/10/FESI-position-paper-on-due-diligence-July-2020.pdf; etc.

The results of the open public consultation[251] follow suit[252], with respondents agreeing that an EU legal framework for due diligence needs to be developed. [253]

92% of respondents preferred a horizontal approach as regards the content of a possible corporate due diligence duty over a sector specific or thematic approach.[254] The most preferred option was a minimum process and definitions approach, complemented with further requirements[255].

52% of companies indicated that they feared the risk of competitive disadvantages vis-à-vis third country companies that do not have to same duties. Therefore, 97% of respondents across the board agreed that due diligence rules should also apply to third country companies which are not established in the EU but carry out (certain) activities in the EU.[256] For those who recommend that the due diligence system should apply to third country companies, most expressed that turnover generated in the EU should determine whether third country companies are subject to EU legislation.[257]

Regarding an enforcement mechanism accompanying a mandatory due diligence duty, 71% of respondents across the board indicated that supervision by competent national authorities with a mechanism of EU cooperation/coordination is the most suited option.[258]

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[251] Summary of the open public consultation for the initiative on sustainable corporate governance.

[252] Breakdown of responses by stakeholders groups is highlighted only in case of differences in the opinions occur.

[253] NGOs supported the need for action with 95.9%, companies with 68.4% and business associations with 59.6 %.

[254] This is true also for Member States respondents. 13 respondents (from Belgium, Czechia, Estonia, Finland, France, Germany and Spain) prefer a horizontal approach. One respondent from Luxembourg prefers a thematic approach. One respondent from Italy and one from Netherlands think that none of the provided options are preferable.

[255] The order of preference differed in the case of individual companies and business associations which preferred a minimum process and definitions approach without further requirements. Campaign respondents expressed preference for a minimum process and definitions approach while petition signatories in turn, prefer a minimum process and definitions approach complemented with further requirements.

[256] All Member State respondents agree with this statement as well. The respondents who didn't express agreement expressed their concern about the difficulty and unfeasibility of the procedure of a due diligence rule applying also to certain third country companies which are not established in the EU but carrying out certain activities in the EU.

[257] To a lesser extent, other respondents think that (1) companies operating within EU borders, (2) companies with a link to the EU market, (3) companies with parts of their supply chain located or active in Europe, and (4) companies listed on EU stock markets should be subject to EU legislation. Finally, some respondents refer to other legislation to determine what link should be required (e.g. the Timber Regulation and Directive 2019/633 on Unfair Trading Practices).

[258] It was followed by the option of judicial enforcement with liability (49%) and supervision by competent national authorities based on complaints about non-compliance with effective sanctions (44%).

In relation to non-binding guidance and binding law **all stakeholder groups indicated binding law with targets as the option that entails the most costs[259], however also the most benefits overall[260].**

Some of the overall most cited benefits were reductions in adverse impact on human rights, land and environmental defenders; safer and more decent working conditions for supply chain workers including those in non-EU countries; reductions in incidents of labour exploitation, human trafficking, other forms of forced labour, and child labour; reductions in land grabs; improvement in the environmental impact of business operations; creation of long-term and trust relationships through the use of meaningful stakeholder engagement processes and progress towards the achievement of the Sustainable Development Goals. Although most respondents can see the positive elements on third countries, a subset of respondents fear a potential negative impact of due diligence rules on third countries if companies investing in third countries with weak social, labour, and environmental rules, would have to withdraw from these countries. However this was indicated as one of the least preferred solutions for companies, evidenced by the results of both the open public consultation[261] as well as preliminary due diligence study survey results[262].

6.1.8. Coherence

The due diligence duty is a crucial contributor to the success of many Commission strategies aiming at implementing the UN SDGs and fostering sustainable value creation and will support and render more effective other EU policies and initiatives on climate mitigation, environmental protection, free and fair trade, better social and human rights standards. **Annex 7** explains the added value of the sustainable corporate governance initiative compared to existing law and other initiatives in the pipeline and how it interrelates with ongoing initiatives and complements them.

The sector or theme specific approach would be a somewhat less coherent option than the others given that the sustainable products initiative is also meant to cover specific products or product groups in specific sectors as explained in **Annex 7**.

6.1.9. Proportionality

Small and micro companies, accounting for around 98 % of LLCs in the EU, are excluded from the due diligence duty under all policy options analysed. For this category

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[259] Administrative, litigation and other costs. Businesses and business associations gave the costs of binding law with targets the highest rating, followed by NGOs and environmental organisations, EU citizens and consumer organisations while trade unions give a low mean rating.

[260] Performance, competitiveness, risk management and resilience, innovation and productivity, environmental and social performance. Trade unions give the benefits of binding law with targets the highest rating, followed by EU citizens and consumer organisations, while company/business organisations and business associations rate these benefits lower.

[261] For a more detailed overview please refer to **Annex 2**.

[262] Study on due diligence requirements through the supply chain (2020), p. 16.

of companies, the financial and administrative burden of setting up and implementing a due diligence process would be relatively high. For the most part, they do not have pre-existing due diligence mechanisms in place, they have no know-how, specialised personnel, and the cost of carrying out due diligence would impact them disproportionately (they will still be exposed to certain extent to some of the costs and burden through a trickle-down effect). At the same time, exposure of such small or micro companies individually to sustainability impacts will as a general rule be lower than the exposure of larger companies. Therefore, under options 2 to 4, only large to very large companies would be within the scope of the full due diligence obligation, because both their potential sustainability impact and their capacity to set up and implement due diligence processes and to bear cost and administrative burden would be higher. In particular, the selected turnover criteria in options 3 and 4 will filter in accordance with the companies' impact on the economy, with option 3 focusing on those companies having the largest impact on the EU economy, and option 4 including also companies with less impact. Moreover, there will be measures to limit the passing on the burden from those large companies to the smaller suppliers in the value chain.

As far as companies with lower turnover/less employees[263] are concerned, the due diligence obligation is limited to companies active in particularly high-impact industry sectors and their most relevant sustainability issues in options 3 and 4. This limitation aims to create a balance between the interest in achieving the goals of the initiative and the interest in minimising the financial and administrative burden on companies.

As regards private enforcement of the due diligence obligation, the policy options, which include civil liability provisions going beyond harm done at the level of the direct supplier, do not go beyond what is necessary. Effective enforcement of the due diligence duty is key to achieving the objectives of this initiative. Civil liability is particularly important in enabling victims to obtain a remedy for damage done. However, it will in practice be difficult to prevent all risks through global value chains, which are characterised by a multitude of layers and supply networks. It would therefore not be proportionate to impose a duty making companies responsible for any harm that has happened in the value chain. Options 1 to 4 limit liability to harm done in the value chain beyond tier one to specific conditions. The options analysed thus aim at creating a balance between the need for an effective enforcement regime and the need for companies to operate with legal certainty.

The proposed measures in all policy options related to public enforcement of the due diligence duty do not go beyond what is necessary either. They entail the national supervisory authorities' power to investigate and impose proportionate sanctions. Non-compliance may also lead to "naming and shaming", withdrawal of products and bans from public procurement. The power of public authorities to supervise and impose

[263] I.e., medium-sized and, under option 3, also large companies from 250 to 500 employees as those would not be covered by the full horizontal due diligence duty.

proportionate monetary sanctions in case of on-compliance is key to an effective enforcement regime.

Other sanctions, such as withdrawal of products from the market linked to a serious adverse impacts, might be considered, however it requires questions of feasibility, proportionality and compatibility with a horizontal nature of this company law initiative to be addressed. Given that due diligence applies across a range of risks that are assessed, prioritised and mitigated by the company in the risk-driven exercise, it would necessitate establishing a link between the horizontal due diligence and a specific product (e.g. because such product area had been the subject of objectively important and specific risk indicators which a company had ignored). For instance, in proposed or existing Union legislation, such as for batteries, a certification mechanism is used to enable supervisory authorities to verify the conformity of product with certain requirements Such mechanisms have to date typically been established in a product legislation. Collaboration among enforcement authorities is in particular important to avoid uneven application across the single market."

In cases where administrative fines would be difficult to enforce vis-à-vis third-country companies, such sanction could have a sufficiently deterrent effect on them.

Furthermore, this initiative does not entail unnecessary costs for the Union, national governments, regional or local authorities. The Directive would leave it up to the Member States to organise enforcement. Administrative supervision can be carried out by pre-existing authorities.

6.2. Directors' Duties

6.2.1. Effectiveness

Each option contributes to a variable extent – and more effectively compared to the baseline – to meeting the initiative's objectives. In line with the overall perception in the public consultation namely that the more precise the duties are, the more effective they will be in meeting the initiative's goals and in bringing benefits, we can assume that the more specific the duties directors have to comply with, the more effective an option will be in reaching the objectives of this initiative. The more companies are within the scope of the initiative, the greater the number of companies whose directors will incorporate long-term and sustainability aspects in their decision-making. In this sense, the four policy options are increasingly wide-reaching, with Option 1 contributing least and Option 4 contributing most effectively to achieving the specific objectives of this initiative.

The following table summarizes our findings on how effective the 4 options would be in reaching the relevant specific objectives, using a scale from – (not effective at all) to ++++ (very effective), compared to the baseline (which has 0s everywhere):

Specific objectives: / Options:	1	2	3	4
Clarify what is expected of directors in order to fulfil their duty to act in the best interests of the company and to incorporate the interests of stakeholders and long-term interests of the company into their decisions	++	+++	+++	+++
Foster the integration of sustainability risks (including from the value chain) into corporate risk management and impact mitigation processes and strategies, facilitate management of dependencies and ability to react to change	++	+++	+++	+++
Increase accountability for identifying, preventing and mitigating adverse impacts	+	+++	+++	+++
Improve corporate governance practices to facilitate the integration of sustainability into directors' and company decision-making (e.g. in the area of stakeholder involvement)	+	+	+++	++++

6.2.1.1.Option 1:

Option 1 would make a limited contribution to reaching the objectives of this initiative. It would partially achieve the objective of clarifying what is expected of directors in order to fulfil their duty to act in the best interest of the company and to incorporate the interests of stakeholders into directors' decisions. It would only make a partial contribution to reaching the specific objective of integrating sustainability risks and impacts into corporate risk management, impact mitigation processes and corporate strategies, and to the specific objective of improving corporate governance practices to facilitate the integration of sustainability into directors' and company decision-making. This option may not ensure that the duty to establish and carry out due diligence is situated at the board level and that directors have to engage with stakeholders. As these duties would be included into a recommendation only, the effectiveness of it would depend on how many Member States implement it and how. Furthermore, if such recommendation is transposed into "comply or explain" corporate governance codes only, the scope of application may be limited to listed companies, and effective implementation is not guaranteed.

Clarifying that stakeholder interests and the long-term interest of the company need to be taken into account in decisions may already prompt proper identification of stakeholders, their interests and managing stakeholder related risks. However, the fact that the rules do not specify what exactly needs to be done could lead to uncertainties and limited effectiveness. Furthermore, the specific duties in this option do not go beyond risk management and the due diligence duty will not, in itself, ensure that directors will consider that it is their responsibility to set up processes and measures, in particular, as the liability for failure to carry out due diligence will be on the company. Therefore this

option is more effective in fostering directors' focus on risks to the company and is only effective to a limited extent to foster focus on impacts.

6.2.1.2.Options 2 and 3:

These policy options are slightly more effective than option 1.

Both options would be more effective in achieving the goal of clarifying what is expected from directors as part of their duty to promote the interests of the company. They go beyond risk management and include also duties to set up and oversee due diligence processes and measures. Option 3 covers also the specific duties of integrating sustainability risks and impacts into the corporate strategy and requiring stakeholder engagement. Option 2 and 3 would therefore achieve more effectively that both stakeholder related company risk and external impacts are tackled at directors' level, integrated into corporate governance processes, and option 3 will also ensure that sustainability risks and impacts are considered as strategic and as such has a bigger potential to affect the business model of the company. These options will also contribute to increase accountability for identifying, preventing and mitigating adverse impacts, as directors would be required to set up due diligence processes and measures. Option 2 and 3 will foster a more long-term approach with all the benefits it brings as explained in **Annex 4**. Option 2 is more effective as it has a larger scope for the setting of corporate strategy including the science based targets on climate mitigation. Option 3 also covers stakeholder engagement which is a tool to effectively channel relevant stakeholder interest into corporate decision-making.

6.2.1.3.Option 4:

By virtue of it containing all specific duties, this option would significantly contribute to enhancing clarity and by its large scope it is effective to ensure more accountability of directors. It would be effective in clarifying what is expected of directors in order to fulfil their duty to act in the best interests of the company and to incorporate the interests of stakeholders into their decisions and in fostering the integration of sustainability risks into corporate risk management processes, facilitate management of dependencies. The overall effectiveness of this option (also because of its coverage of issues and its scope) is similar to that of Option 3).

Options	Effectiveness
Option 1	+
Option 2	+++
Option 3	+++
Option 4	+++

6.2.2. Costs and other possible negative impacts on the company

The substantive requirements introduced for directors of European companies would create additional compliance costs for the companies in accordance with the scope of the various policy options. In most companies, internal processes and management systems

would need to be revised to ensure that directors are able to meet their clarified general duty to promote the best interest of the company, and their harmonised specific obligations.

The cost of **setting up, operating and overseeing corporate due diligence procedures** to mitigate adverse sustainability impacts is already included in the cost calculations for the corporate due diligence options.

Additional cost arising from the duty to **identify all stakeholders and their interest** could be minimal as this would be relatively straightforward in the case of some stakeholders (e.g. employees), and the due diligence process would also contribute to the identification of potentially affected people as well as environmental risks and impacts.

A major part of the additional cost impacts of directors' duties would be related to the requirements to **identify, assess and manage risks that the company faces in relation to its stakeholders and sustainability matters**. However, several factors underpin the assumption that addressing sustainability risks would not result in significant cost increases in addition to the (new) due diligence obligation and the public reporting obligation under the CSRD. First of all, there is a potential **overlap** between stakeholder-related (sustainability) risks to the company and the impacts of the company on its stakeholders, and some form of **due diligence** is traditionally part of the company's overall risk management and damage prevention system. Also, companies under the scope of the **CSRD** would already incur information gathering and data analysis costs as they will be required to report to the public on their sustainability risks and impacts. Many companies in the scope already have a risk management system and they may only need to **extend** that. Furthermore, as part of the sustainability risks to the company derive from a failure to prevent or mitigate adverse sustainability impacts, the **recurrent cost implications** of managing sustainability risks to the company are to some extent covered by operating due diligence processes. Accordingly, we will not calculate with additional **recurrent** costs.

The **one-off cost of setting up a risk management system** is estimated to be around EUR 5 000[264] for a listed company and it can be assumed that it is less for SMEs (listed or not). Similarly to the impact assessment of the CSRD, we can assume that around half of companies already have risk assessment and management processes applying at least to financial risks (such structures are already required by banks and investors) and we can also assume, in line with the OECD due diligence study, that adding the additional risk factors related to stakeholders and sustainability matters would not amount to significant cost increases. Furthermore, compliance costs are expected to be company-specific, largely depending on risks, and for companies that are frontrunners on sustainability, the cost increases may be minimal, compared to other companies in high-

[264] See draft Bill of the German Federal Government to strengthen financial market integrity, BT-Drucksache 19/26966 of 24 February 2021, p. 62.

impact sectors. Because of these complexities, we can reasonably calculate with an **additional EUR 2 500 one-off costs on average for high-impact medium-sized companies and listed SMEs, and with EUR 5 000 for large companies** as, similarly to the German impact assessment related to the draft Bill to strengthen financial market integrity[265], we assume that only a fraction of companies would need to bear the additional one-off cost of EUR 5 000.

Additional costs could be linked to **increased litigation against board members,** under the respective national laws. However, the initiative does not aim at creating new actions against directors. Thus, the shareholder general meeting and the (supervisory) board will typically be empowered to initiate processes to hold directors to account under national law. In addition, the initiative does not aim at affecting the **"business judgement rule"** whereby the Courts refrain from substituting themselves for directors when it comes to business decision, **nor enlarging the conditions for bringing enforcement actions**. Therefore, it is likely that litigation cost increases will be negligible and, as a consequence, that litigation risk will make companies less dynamic and more risk averse.

Integrating sustainability risks, impacts and opportunities, targets and actions into the corporate strategy may result in administrative cost, which is however is difficult to quantify. Likely changes to production processes, business models, etc. are difficult to quantify for the reasons explained in **Annex 4** and they would, to some extent, anyway fall under the transition cost induced by the due diligence obligation. Nevertheless, **the specific cost of setting science-based targets as part of corporate strategy** should be considered as an additional cost of the directors' duties in line with the scope of the various policy options as this implies a **fee – currently** amounting to **EUR 5 000**[266] **– for the external validation.**

The following table summarises the **incremental aggregated compliance costs of directors' duties** per option:

	Option 1	**Option 2a**	**Option 2b**	**Option 3**	**Option 4**
Number of companies incurring additional cost of risk management:	*95 000 (in all options)*				
Aggregated additional compliance cost of risk management duty:	€ 400 million (in all options)				

[265] Ibid.

[266] This is the cost of the validation of two targets (e.g. one preliminary and one final) by the Science Based Targets initiative (SBTi), which is a partnership between CDP, the United Nations Global Compact, World Resources Institute (WRI) and the World Wide Fund for Nature (WWF). See SBTi's website.

	Option 1	Option 2a	Option 2b	Option 3	Option 4
Number of companies incurring additional cost of science-based target setting:	*0*	*56 000*	*44 000*	*8 900*	*86 300*
Aggregated additional compliance cost of the science-based target setting duty:	€0	€280 mn	€220 mn	€45 mn	€432 mn
Total aggregated additional compliance costs of directors' duties:	**€400 mn**	**€680 mn**	**€620 mn**	**€445 mn**	**€832 mn**

Regarding other possible negative impacts on companies, some business respondents to the Commission's open public consultation considered that balancing the interests of different stakeholders will **make decision-making difficult**, as it is hard to balance possibly conflicting interests. Directors will have to manage the company in line with a complex combination of interests from shareholders and diverse stakeholders. This risks creating blurred lines of command and increase principal-agent problems. In this context, it has to be stressed that balancing short and long-term interests, and potentially conflicting interests **has always been part of corporate decision-making**. Furthermore, evidence shows that all stakeholders', including shareholders' as well as their beneficiaries' (future pensioners, insurance policy holders, etc.) **interests align** to preserve and promote the good long-term performance of the business. The **general duty therefore does not exacerbate principal-agent problems but creates an enabling regulatory framework where all the factors that contribute to the long-term success of the company can be properly taken into account** and harnessed in directors' decisions. It should also be underlined that **directors' duties do not go beyond the interest of the company** and they do not require the directors to make, for example, environmental investments which are not in the (long-term) interest of the company (even if such investments would provide a general benefit).

For the same reason, it is **unlikely that companies in which directors balance the interests of all stakeholders better**, as well as the companies' short- and long-term interest, **will have reduced access to capital**. On the contrary, evidence listed in **Annex 4** shows that **more stakeholder-orientation is positively correlated with better access to capital**. This is even more likely as EU legislation is in the pipeline requiring banks and insurance companies to properly manage environmental, social and corporate governance risks at the level of their clients and as different investor types are already today required to disclose information on ESG matters as regards their investments. This has a potential to improve access to capital for companies that integrate stakeholder interests better into their decisions.

As regards the argument that companies will become less innovative, evidence in the problem definition as well as in **Annex 4** shows that sustainable companies are among

the most innovative ones today, and a **long-term and sustainability focus is positively correlated with innovation**.[267]

Some respondents see a **risk of new directors' duties leading to director-dominated companies**. It is difficult to judge ex ante the extent to which such duties would reinforce the role of directors in practice, and that also depends on the characteristics of the specific company. At the same time, the purpose is to involve more stakeholders in decision making, and therefore it is reasonable to argue that **the general duty of directors, together with more engagement with stakeholders, is likely to result in corporate governance where all the interests relevant from the company's perspective are more properly channelled into decision making**. Furthermore, the global financial crisis of 2008-2009 revealed that as opposed to being very present, shareholders (even long-term oriented pension funds and insurers) lack proper long-term engagement with companies. It is therefore more likely that **better involvement of other stakeholders will prompt more interest from shareholders as well**.

6.2.3. Benefits for companies

In terms of benefits, options 2 to 4 will result in directors of companies covered to pay greater attention to sustainability aspects in allocating company's resources. As the meta studies in **Annex 4** show, integrating sustainability aspects into corporate decisions is directly correlated with operational cost reductions, resilience, more innovation, better access to capital, better financial performance of businesses, which can materialize in the short-run but is likely in particular in the medium to long run. Benefits could result from costs avoided by early risks detection, better management of dependencies, more holistic risk management, positive effects from investment (CAPEX, R&D, new technologies and training), more trust and better engagement from stakeholders, including in the value chains. As market pioneers in global markets, EU companies could make pre-emptive investments in production capabilities by securing access to resources (e.g. suppliers, skilled personnel, etc.), technology (e.g. through patenting), and gain economies of scale vis-à-vis later market entrants. It would make companies also more resilient to adverse consequences of changed environmental or social circumstances, or to sudden crises, as in the COVID-19 pandemic. Moreover, such rules would secure a level playing field across EU and also some degree of standardisation in directors' responsibility for sustainability, reducing discrepancies and providing companies with a common reference and thus more legal certainty in that regard. Moreover, introducing harmonised EU rules can also have benefits in making companies more interesting for sustainability-oriented investors, public procurers, consumers, and various potential contractual parties, with

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[267] Evidence also shows that capital markets' companies have been struggling to innovate in the last decade due to persistent pressure to deliver on short-term earning commitments and reduced ability to invest into innovation, see for example the Kay review referred to above.

positive consequences in terms of turnover increase. For more detail, please refer to **Annex 4**.

In the public consultation all respondent groups, including businesses and business associations considered that the benefits of sustainable corporate governance will outweigh the costs. Respondent were also of the view that binding law with targets would bring the highest benefits.

Which companies would benefit more from specific directors' duties?

-The risk management duty would benefit in particular those companies which are exposed, including through their value chain, to potentially high or disruptive sustainability risks with significant impacts on et performance, see further in **Annex 4**.

- Companies already having developed risk management and impact mitigation processes may have less costs but may also benefit less from the requirements.

- All companies may benefit from integrating stakeholder related risks and impacts into the corporate strategy. It may lead to a necessary transformation of production processes, business models. Smaller companies may also benefit, for example if they are part of a value chain and they need to keep up with the transition efforts of the large buyer company.

6.2.4. Environmental, social and fundamental rights impacts, and impacts on the economy

Environmental and social impacts are expected to be positive, as explained above for due diligence duties (**Annex 4**), with option 4 having the biggest positive impact.

The directors' duties are expected to result in increased attention by the board to the social and environmental risks and impacts associated with its operations, eventually leading to adopting more sustainable and long-term oriented policies on employees (for instance increased investments in policies and programmes aimed at workforce training, reward and retention, human capital development) and for the environment (protection and improvement of the natural capital of the company, investment into environment friendly production processes, ceasing investments that result in adverse impacts on the environment and thereby affect the long-term performance of the company). For employees, the impact might be particularly positive in those EU countries where board-level representation of workers is either absent or limited. Considering other stakeholders, all options might contribute to an increased focus on the satisfaction of consumers, with more sustainable and high-quality products for them. Importantly, also stakeholders less able to influence the financial performance, but equally impacted by the company's activities, such as the local and global communities, would likely receive higher attention.

Directors' duties are not expected to have negative impacts either on the freedom to conduct a business or to the right to property of the shareholders. Shareholders will not lose any of their rights, i.e. those related to decision making, such as voting, approval

rights, or to the share of the profit, such as right to dividend. They preserve their power to hold directors to account according to the rules of national and EU law. The so called "business judgement rule" as referred to above will remain applicable.

As regards economic impacts, as directors' duties focus to a large extent on preventing risks which could affect the resilience and long-term viability of the company and enabling directors to make long-term value–enhancing investments, including into research and development, human capital development, new technologies, innovation, CAPEX, sustainable production processes and resilient value chains, the macro-level impacts of such actions and investment are likely to be positive. This may bring competitiveness benefits in the mid to longer term. As explained in the problem definition, at macro-level, in the long term, a trend of decrease in CAPEX and investments in R&D as share of total revenues by companies might harm the level of productivity and the innovative capacity of the economy as a whole.

Furthermore, better risk management, lower dependency on increasingly scarce natural resources and resulting resilience, including to sustainability-related shocks (e.g. climate change) is likely to have an overall stabilising impact on the entire economy and should improve its resilience and shock-absorbing capacity.

6.2.5. Efficiency

In option 1 the general duty together with the risk management duty applying to a sufficiently large scope of companies would be effective to contribute to a stronger focus on holistic risk management and thereby to the achievement of the following specific objectives:

- fostering the integration of sustainability risks (including from the value chain) into corporate risk management,

- facilitating management of dependencies and ability to react to change.

The compliance cost of EUR 5 000 or 2 500 depending on the size of the company should be assessed against to the benefits that better risks management brings for the company, in particular if it is exposed to a wide range of sustainability risks and/or if such risks are significant or disruptive. Furthermore, many large companies already have risk management systems and may only need to extend that instead of setting up new processes. This is also why the German law referred to above calculates with EUR 5000 for a listed company of any size, ranging from large to very large, independently of turnover or other criteria.

The scope of companies falling under the risk management obligation would also be aligned with the scope of the CSRD proposal, under which companies will be required to report on environmental, social, human rights related, etc. risks. Given the expected compliance burden coming already from the reporting regime, in particular as regards risks identification and assessment, the additional cost implications are relatively low, but the efficiency of the duty is considerably higher as directors will be required to manage risks properly and could therefore be made accountable for not having carried out risk

analysis and proper risk management. Reporting will allow scrutiny of directors' actions and facilitate enforcement of the duty.

The duty would be slightly wider in scope than the CSRD. High impact medium-sized LLCs would also be covered. This can be considered proportionate as medium companies can also face significant risks and the cost implications are relatively low. Furthermore, as banks will be required to manage sustainability risks linked to their clients themselves, proper risk management for medium sized companies wanting to rely on bank financing would become a necessity over time. Such requirement for medium sized companies operating in high impact sectors therefore does not appear to be disproportionate.

As regards the other specific duties, they would be included into a recommendation. The efficiency of a recommendation is difficult to predict as it would depend on how many Member States would decide to implement the recommendation. Proportionality is also ensured by not imposing any specific administrative burden either on medium sized companies or on small sized companies.

The main beneficiary of such positive impacts would be the company itself and all its stakeholders. However, as explained in the problem definition, sustainability risk management can have wide-ranging positive impacts beyond the company. For example, directors managing transition risks arising from future devaluation of assets (for example not investing into a coal fuelled plant) protects the long-term interest of the company as such investments will result in considerable financial loss in the future, but has positive consequences for the environment.

Better focus on stakeholder-related issues has the potential to build trust and loyalty from stakeholders, including through the value chain. Investment into human and environmental capital reinforces stability and resilience, but also dynamism, as intellectual capital is the most important contributor to most company's success and stakeholder related capitals are the largest contributors to companies' performance today.

Under option 2 and option 3, further to the general duty and the risk management duty which were analysed above, a specific requirement for directors to implement due diligence processes and measures, include sustainability risks and impacts in the corporate strategy including science-based targets would apply.

Integrating sustainability risks and impacts, targets and actions into the corporate strategy result in rather low administrative cost. The cost of the responsibility to implement due diligence processes and measures has been calculated as part of due diligence costs.

These options, in addition to the benefits mentioned under option 1, will also ensure more accountability related to impacts, elevating sustainability matters at the level of the corporate strategy thereby fostering more sustainable business models, and hence expectedly more efficient and thorough implementation of the general, risk management and diligence duties as well. These benefits would materialize without imposing significant additional compliance burden compared to the risk management and due

diligence duties. These options are therefore more cost efficient than option 1. Based on the evidence demonstrating that reporting requirements were not sufficient in ensuring wide uptake of sustainability risk and impact management (see under problem definition) and therefore resulted in limited economic, social and environmental benefits, one can assume that imposing duties on directors to take responsibility for such matters is likely to result in significant benefits with relatively low compliance cost impact. Option 3 is cost-efficient to deliver on the specific objectives as regards the corporate strategy as it applies to a larger scope of companies (CSRD scope) and the duty to integrate sustainability into the corporate strategy is highly cost efficient.

Option 2 and 3 both include a duty to include science based targets in the corporate strategy. While the substantial climate mitigation obligation derives from the due diligence obligation itself, the target is a tool for the directors to plan climate change impact mitigation action, integrate those into the corporate strategy and measure progress against the target. In option 3 the science based target setting as part of corporate strategy applies only to very large companies. As the development and disclosure of the target does not raise major costs, it can also be considered cost-efficient in terms of its potential to help reap the benefits of the climate mitigation actions, including better access to capital, more efficient production processes, better risk management with relatively low cost.

As directors are responsible towards the company, the duty to implement due diligence processes does not make the directors liable towards harmed people in case due diligence is not carried out properly, but the directors can be made accountable by the general meeting, minority shareholders or the board depending on national law if the necessary processes are not set up or are not properly implemented.

As regards overall efficiency, the rating of option 2 and 3, is higher than that of option 1, because these contain measures to elevate sustainability to a strategic level, align sustainability objectives in corporate design, business plans and overall management, which are likely to contribute to better implementation of risk management and better cost efficiency across the company.

These additional measures help make directors even more accountable and will even more increase the ability of companies to react to and potentially benefit from changing environment while having positive social and environmental impact.

In option 4 all specific options apply to the widest scope of companies (CSRD). In terms of its efficiency, one could argue that the more companies are in the scope of the duties, the less benefit an individual company derives from its sustainability performance. As explained in **Annex 4**, this is likely for competitiveness benefits such as reputational benefits or benefits arising from attracting talent, but certain benefits are not likely to reduce because more companies are covered by the scope of the obligation (such as for example benefits arising from more cost efficient production processes, better risk management, more motivated staff because of investment into training and human capital, better yield due to protecting natural capital). Yet, similarly to the due diligence obligation, one could argue that extending the specific obligations and therefore the cost

burden to a very wide range of companies, which, however may have less sustainability related risks and impacts would not result in an equal or increasing level of overall benefits, including social and environmental benefits, so the efficiency rating of this option should be lower than that of Option 2 and 3.

Options	Efficiency
Option 1	+
Option 2	+++
Option 3	+++
Option 4	++/+++

6.2.6. Stakeholders' views[268]

78.2% of respondents to the open public consultation[269] agreed[270] that companies and their directors need to take account of stakeholder interests[271] in corporate decisions. [272]Recent calls for action of prominent CEOs as well as leading scholars and experts on company law[273] support this view as did survey respondents[274] of the Supporting study on directors' duties[275].

While 70% of overall respondents believe corporate directors should be required by law to a) identify the company's stakeholders and their interests, b) manage the risks for the company in relation to stakeholders and their interests and c) identify opportunities arising from promoting stakeholders' interests, individual companies expressed slight

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[268] For more detailed information on the results of the open public consultation, please refer to **Annex 2**.
[269] Summary of the open public consultation on the sustainable corporate governance initiative
[270] NGOs supported the need for a holistic approach with 93.2%, companies with 60% and business associations with 58.6% of respondents expressing an opinion. Some of the 22.500 campaign respondents and petition signatories strongly agreed on the need for action on all elements of directors' duties. A small group of respondents indicated that these interests should only be considered to the extent that these issues are relevant for the financial performance of the company (18.5% of those expressing an opinion).
[271] When asked about the interests that are relevant for the long-term success and resilience of a company, respondents highlighted the interests of employees, customers, likely consequences of long term decisions, persons and communities affected by operations of the company, local and global natural environment (including climate), employees in the company's supply chain, society and shareholders are important.
[272] This result is in line with the results of the survey in the Supporting study on directors' duties, where 91% of respondents agreed with the statement that the company's interest should encompass the interest of stakeholders and the environment other than the interests of shareholders.
[273] Call to Action on Sustainable Corporate Governance: https://corpgov.law.harvard.edu/2021/03/09/call-to-action-on-sustainable-corporate-governance/.
[274] 91% of respondents agreed with the statement that the company's interest should encompass the interest of stakeholders and the environment other than the interests of shareholders.
[275] Feedback to the inception impact assessment (roadmap) to this initiative, various position papers to the open public consultation for this initiative as well as employers' organisations within the social partners' dialogue highlighted concern about the methodology applied in the supporting Study on directors' duties and the need for legislative intervention on directors' duties as such as it might put into question the fundamentals of freedom of enterprise and property/ownership. In particular obstacles identified were mostly linked to diverging interests of stakeholders. They and cautioned about the possible negative effects on dynamism and innovation, which require the avoidance of lock-in effects, investors' willingness to invest which could result in reduction of foreign investment and thus a loss of competitiveness. In turn, according to this line of reasoning, uncertainty and a reduction in the shareholder surplus could negatively affect funding for the development of environmentally friendly technologies.

support, and business associations disagreement.[276] Similarly, as regards a legal requirement that corporate directors should set up adequate procedures and measurable (science-based) targets, while 70% of overall respondents expressed agreement, individual companies were acquiescent, and business associations expressed disagreement.[277]

Regarding the need to clarify in legislation as part of directors' duty of care that corporate directors should balance the interests of all stakeholders, instead of focusing on the short-term financial interests of shareholders, 68% of overall respondents expressed support, with businesses and business associations expressing some disagreement[278]. 86% of overall respondents, including businesses and business associations, supported the need to integrate sustainability risks, impacts and opportunities into a company's strategy, decisions and oversight within the company.[279]

In terms of expected impacts, respondents believe that binding law with targets would have the most impact on administrative, litigation and other costs, but would also bring the highest benefits (performance, competitiveness, risk management and resilience, innovation and productivity, environmental and social performance).[280]

6.2.7. Coherence

All options would be coherent with other main EU policy objectives and initiatives. Option 4 presents the best technical coherence with the CSRD proposal as their scope and content are largely aligned and option 2 and 3 are also largely coherent with the CSRD in terms of their content.

All four options would strengthen directors' duties related to sustainability by making explicit that acting in the best interest of the company entails taking into account the interest of the shareholders with other interests, including the likely (social and

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[276] Individual businesses expressed slight support (a: 54.3%, b: 59.2%, c: 46.8%) while business associations expressed disagreement (a: 64.6%, b: 65.6%, c: 69.9%). NGOs, on the other hand, mostly agreed (a: 93.7%, b: 91.8%, c: 83.7%). Member States respondents mostly agreed, with 10 responses (from Belgium, Czechia, France, Germany, Luxembourg and Spain) expressing support and one respondent from France and one from Spain disagreeing to some extent.

[277] Individual companies were acquiescent (49.4% expressing support) while business associations mostly expressed disagreement (73.9%). 93.1% of NGOs expressed support. As regards Member State responses, 8 responses (from Belgium, Czechia, France, Germany, Italy, Luxembourg and Spain) agreed. One respondent from France, one from Spain and one from Italy disagreed to some extent.

[278] While 92.4% of NGOs expressed agreement, individual companies expressed disagreement with 53,9% and business associations did so with 77.5%. As regards Member States, 7 respondents (from Belgium, Germany and Spain) agree and 5 disagree (from Finland, France, Italy, Luxembourg and Spain). Within the framework of social partner's dialogue, trade unions considered that clear and broad definition of directors' duties and the company's interest should be defined in EU law.

[279] Individual companies and business associations expressed support (70,6%). In the case of NGO respondents, 92.4% agreed. As regards Member State respondents, 11 respondents agree (Belgium, France, Germany, Italy, Luxembourg and Spain), while 1 respondent from France disagrees.

economic) consequences of decisions in the longer term (beyond 3-5 years). Largest scope Option 4 would certainly contribute best to the goals of the European Green Deal.

All four options would also complement, on the corporate side, the clarification of fiduciary duties of investors under EU Regulation on disclosures relating to sustainable investment and sustainability risks, which promotes a better disclosure on the integration of ESG factors into investment decisions and advice by financial market participants.

They are also largely coherent with the sustainability risk management duty in the pipeline for the banking sector.

Options	Coherence
Option 1	+++
Option 2	+++/++++
Option 3	+++/++++
Option 4	++++

6.2.8. Proportionality

As the duty to act in the interest of the company applies to all LLCs in national law, any narrower option in terms of scope (e.g. exclusion of SMEs) would not be easily implementable and legally sound. This duty is general and therefore does not impose any immediate and specific administrative cost linked to its implementation on SMEs. Cost and administrative burden would thus be limited for the vast majority of SMEs whilst still involving all LLCs in the shift towards a sustainable corporate governance.

Proportionality was also considered for specific duties. Depending on the option, the specific duties are contained either in a recommendation or apply with phase-in and only to high impact medium companies and or listed SMEs. For further detail, see under efficiency.

6.3. Directors' remuneration

6.3.1. Effectiveness

The option considered on directors' remuneration (general clause to ensure that the variable component of remuneration schemes facilitates or at least does not hinder compliance with the newly introduced due diligence and directors' duties) could contribute to this initiative's specific objective of improving corporate governance practices to facilitate the integration of sustainability into directors' and company decision-making.

The considered general provision could be complementary to the other measures on due diligence and directors' duties as considered in this impact assessment and would thus aim at ensuring that the integration of sustainability considerations as fostered by the other measures within this initiative is ideally incentivised and in any case not contradicted by the structure of the remuneration policy.

While it could be expected that the manner in which companies (falling within the scope of the Shareholders' Rights Directive, i.e. listed ones) implement its existing provisions relating to the remuneration policy, would have to be adapted to the new rules on due diligence and directors' duties, a general clause would stipulate clearly (for all companies falling under this initiative) that such adaptation should take place. As such, the due diligence and directors duties with their clear content would be a benchmark which would need to be considered when determining variable remuneration. The existing provision of the SHRD does not link the expectation of the remuneration policy contributing to sustainability to any concrete benchmark. A general provision would provide further guidance whilst leaving flexibility for implementation. It would, for instance, allow companies to choose which environmental and social indicators to link to variable remuneration and how exactly to establish this link. At the same time, such margin of discretion would need to be exercised with the overall objective of facilitating or at least not hindering compliance with due diligence and directors. This would exclude devising unsuitable or conflicting remuneration policies. As explained above, more prescriptive or specific measures, have not been considered pending further experiences with the application of the Shareholders' Rights Directive. Also, the offered flexibility would allow companies to find solutions taking account of their needs and specific circumstances on a case by case basis. On the other hand, in light of the greater clarity on directors' duties that would be offered by the proposal, for all types of limited company within scope of those obligations, it could be considered that such a complementary general provision on remuneration might have quite marginal effects – or at least, additional effects whose reach is difficult to anticipate - in securing compliance with such explicit obligations, which would in any case be enforceable by both public authorities and shareholders.

6.3.2. Costs

Companies would need to revise their remuneration policies and bear the related adjustment costs. These costs should be very small: listed companies already are required to have and disclose the remuneration policy and the remuneration report according to the Shareholder Rights Directive, any disclosure costs[281] are not linked to the new measure. Other companies neither have to publish their remuneration policy nor to report on this, so would not incur any costs in this regard.

6.3.3. Benefits for companies, efficiency

This complementary remuneration measure would strengthen the benefits that will be achieved by the newly introduced directors' duties, as explained above. While companies currently make limited use of the possibilities to set their remuneration schemes to

[281] See the Impact Assessment of the proposal for the Shareholder Rights Directive II (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=SWD:2014:0127:FIN).

correspond to sustainability objectives[282], and indirect effects of any newly introduced duties on remuneration schemes could be expected, the considered general clause would give a push to ensure that remuneration policies do not produce contradictory incentives but rather create a catalyst for compliance with the newly introduced duties. To the extent that a complementary remuneration measure would foster companies' adaptation of remuneration policies (for all companies falling under this initiative, i.e. beyond the scope of the Shareholders' Rights Directive), it could be expected to reinforce positive effects for businesses. It also strengthens the strategic view of directors on sustainability matters in line with the directors' duties with their potential to enhance positive impact (innovation, operational efficiency, etc.) At the same time, for the same reason as in section 6.3.1, it is difficult to ascertain objectively whether such a measure would have more than marginal additional effects in securing for businesses themselves the benefits flowing from the newly clarified or defined directors' duties.

6.3.4. Environmental, social and fundamental rights impacts, and impacts to the economy

A complementary measure on directors' remuneration is expected to lead directors to become more focused on sustainability aspects and foster long-term-oriented business decisions, in line with the other measures taken under this initiative. In this sense, the measure should strengthen the positive impacts on the company and ultimately on the economy as well as on stakeholders.

There is no expected negative impact for the right to property of directors as shareholders, neither to the freedom to conduct a business.

6.3.5. Coherence

The considered option would be coherent with the existing disclosure rules introduced (for listed companies) by the Shareholder Rights Directive II. It would not interfere with the application of that disclosure regime which could be evaluated as such in due time.

6.3.6. Stakeholders' views[283]

Stakeholders' views on remuneration topics are diverse: respondents to the open public consultation in favour of further regulating directors' remuneration favoured options including restricting the use of shares for 4 or 5 years, or limiting or banning the payment of executives with shares or share options altogether. Those disagreeing with restrictions to pay directors with shares believe that share-based remuneration is the best way to increase long-term orientation of management. [284]

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[282] See in problem description.

[283] For more detailed information on the results of the stakeholder consultation, please refer to Annex 2.

[284] When it comes to ranking options, among the limited answers received - overall, approximately half of the respondents did not answer the question, among individual companies and business associations only one in three provided an answer - respondents scored highest among the proposed options the followings:

A group of respondents expressed disagreement with further regulating remuneration as they consider that the current European hard law framework contains sufficient provisions regarding remuneration structures, such as the Shareholder Rights Directive II, or the banking rules. Some respondents plead to leave management remuneration up to the company as they find it the most qualified to determine how executive remuneration aligns best with its business model, strategy, and long-term goals.

6.3.7. Proportionality

The considered measure would respect the principle of proportionality as it would not go beyond what is necessary to address the identified drivers (i.e. that directors' remuneration incentivises improving short-term share price performance and short term financial value maximisation) and contribute to the specific objectives of the initiative.

It would create new obligations for companies under the scope as regards adapting their remuneration schemes, but with very limited costs, and leaving to companies the possibility to choose how to adapt to this requirement to their business model and sectorial specificities.

This would go in the direction of a more proportionate intervention for businesses, at least relative to other, more far-reaching possible interventions, since they expressed strong concerns, as evidenced in their feedback to the options proposed in the public consultation, as regards interventions in remuneration policies at this stage and flagging the risks of too prescriptive rule. This being said, due to the difficulty in anticipating, even qualitatively, the additionality in practice of such a general remuneration provision relative to the other provisions envisaged in respect of directors' duties, the assessment of necessity – an inherent part of the proportionality assessment – is finely balanced.

7. HOW DO THE OPTIONS COMPARE?

Options[285]	Effectiveness	Efficiency	Coherence
Corporate due diligence options:			
option 1	+	+	++
option 2	++	++	++++
option 3	+++ (option 3a) +++ (option 3b)	+++	++++
option 4	+++	++/+++	++++

making compulsory the inclusion of sustainability metrics linked, for example, to the company's sustainability targets or performance in the variable remuneration (average score of 5.3 on a 7-point scale), taking into account workforce remuneration and related policies (average score of 5.2 on a 7-point scale) and the requirement to include carbon emission reductions, where applicable, in the lists of sustainability factors affecting directors' variable remuneration (average score of 4.8 on a 7-point scale).

[285] The remuneration measure has not been considered in this table, as explained under 6.3., it would complement the measures on due diligence and directors' duties considered in the package.

Options[285]	Effectiveness	Efficiency	Coherence
Directors' duties options:			
option 1	+	+	+++
option 2	+++	+++	+++ / ++++
option 3	+++	+++	+++ / ++++
option 4	+++	++/+++	++++

8. PREFERRED OPTION

Based on the above analysis, the preferred option and direction to take is the combination of the following elements:

- option 3a or 3b from among the due diligence options,

- option 3 from the directors' duties options, and

- possibly complemented by the described measure on remuneration.

8.1. Combined impact preferred option

For the reasons explained above, the combination of these options is best suited to achieve the objectives of this initiative. This combination is therefore recommended for political endorsement. Due diligence and directors' duties are key pillars for achieving the objectives of the initiative. They are also closely interrelated. Clarity on directors' duties and fostering long-term oriented business decision are key for due diligence to deploy its full potential. Clear rules on risk an impact management and a strategic focus on sustainability are most efficient to foster change and necessary investments for the transition.

Despite good practice of many frontrunner companies, market failures affect the entire market and slow down the spread of good governance. Given the urgency of tackling sustainability challenges, legislative intervention is necessary and likely to have significant positive impact, in particular in the mid to longer term on the economy. Compliance costs have been reduced to the maximum.

Complementing mandatory due diligence and directors' duties with the considered measure as regards variable remuneration could contribute to enable corporate directors to focus on long-term sustainable value however, the fine balance of impact considerations allows this to be left to political appreciation.'

The costs and benefits of the preferred options are summarised in Annex 3.

9. HOW WILL ACTUAL IMPACTS BE MONITORED AND EVALUATED?

To monitor progress towards meeting the specific – and ultimately the general – objectives, the Commission would rely on the reports of various stakeholders, including in particular industry associations, industry initiatives, consultancy firms, environmental and human right defender civil society organisations, international organisations (e.g. OECD, UN) and public authorities that continuously or periodically monitor developments in corporate governance and companies' sustainability performance.

The Commission will consider how to best draw on surveys and studies to specifically focus on some of the indicators that were used to demonstrate the existing problem and its drivers. Our own studies and stakeholders' reports and surveys could, for instance, include:

- surveys among corporate leaders which show how time-horizons in strategic decision making will have evolved and been extended to take into account broader stakeholder interests and which assess if directors' perceptions on short-term pressures and motivations will have changed;
- reports and case studies on human rights abuses and environmental harm linked to EU companies;
- ranking of Member States' environmental, social and human rights spill-over impact on other countries' abilities to achieve the SDGs;
- assessments and estimations on EU companies' (and their value chains') contribution to overall environmental footprints, e.g. GHG emissions, pollution etc. and on possible changing trends;
- reports and case studies on reorganisation of supply and value chains, changing production processes, business practices and business models, changing product features, possibly covering high-risk sectors, products, materials, issues or specific impacts;
- analysis of possible changes in directors' pay structures and links with the evolution of corporate (long-term) R&D spending, CAPEX investments, short-term profit or share price, and the companies' performance in the various sustainability areas or its performance (viability or survival) in the longer run;
- comparative analysis of the development of directors' remuneration versus non-executive and employee wages to see the impact on income inequality.

It could also be considered to engage with competent national authorities to gather part of the required data to measure progress and to also assess progress towards the general objectives to the extent possible. It should be noted that monitoring progress towards meeting the general objectives as such is very complex, since it would be methodologically challenging to distinguish between the impacts of the proposed initiative and other possible causes.

An evaluation of the package of preferred policy options should be carried out in line with the evaluation criteria under the Better Regulation Guidelines to allow an evidence-based judgement of the extent to which the intervention is effective, efficient, relevant given the current needs, coherent both internally and with other EU interventions and has achieved added value. An evaluation would be carried out by the Commission on the basis of the information gathered during the monitoring exercise and additional input collected from the relevant stakeholders, as necessary. An evaluation report could be issued 5 years after the end of the transposition period, taking into account the time needed for application and data collection.