Comments on

The Corporate Sustainability Due Diligence Directive

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Proposal for a

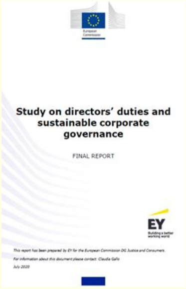
DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

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

AGENDA

- Background: sustainable corporate governance
- Key points in the proposal
- Likely effects
- Conclusion: what to do about it?

Background: Sustainable Corporate Governance


European Commission

Study on directors' duties and sustainable corporate governance

FINAL REPORT

EY
Building a better working world

This report has been prepared by EY for the European Commission DG Justice and Consumers.

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- Fierce criticism of the precursor report on "Directors' Duties and Sustainable Corporate Governance" – e.g. from the Nordic countries, Business Europe, the European Corporate Governance Institute ECGI, Harvard University etc
- EU-Commission's Regulatory Scrutiny Board (RSB) rejected the report twice: It was "not sufficiently clear about the need to regulate directors' duties on top of due diligence requirements" and did no present "convincing evidence that EU businesses [..] do not already sufficiently reflect sustainability aspects or do not have sufficient incentives to do so".
- Nevertheless the Commission has now inserted key elements of this proposal into Corporate Sustainability Due Diligence Directive citing "political importance" and "urgency of action".
- A violation of the EU's Better Regulation Principles which mandate "evidence-based and transparent EU law-making based on the views of those that may be affected"

Key Points in the proposal	Comment
Mandatory net zero climate plans	Shifts net zero responsibility to companies Who pays the costs?
Climate incentives for directors	Bad track record for complex incentive schemes, fixed pay or long-term ownership as an alternative
Directors' duties to include climate action, human rights and the environment	Diffuse, uncertain liability
Directors duties to include the entire value chain and both short and long-term consequences	Diffuse, uncertain liability
Enhanced civil liability	Litigation regime?
Sustainability regulators	Orchestrated by the Commission, maybe FSAs, open to NGO complaints, pecuniary sanctions

Applies to large companies > 500 employees, mid size companies > 250 employees and foreign subsidiaries > turnover €150m

Director liability effects

Naaraayanan and Meisner (JFE, 2021)	Expert directors are more likely to exit, lower firm value
Marsulis, Shen and Shou (SSRN, 2020)	Lower director quality (experience, education)
Guan et al. (JCF, 2021)	Less innovation
Choi and Jung (MF, 2021)	Less innovation (R&D, patents)
Basu and Liang (JAR, 2019)	Greater accounting conservatism
Melis and Romby (CGIR, 2021)	Higher director pay
Choi and Jung (AEL, 2021)	More CSR if directors are not insured
Akey and Appel (JF, 2021)	Less pollution with greater corporate liability
Roi and Brownlee (CHOC 2021) Survey paper: Does Tort Deter?	No deterrence, lower service, defensive practices, higher costs (exception shareholder liability)

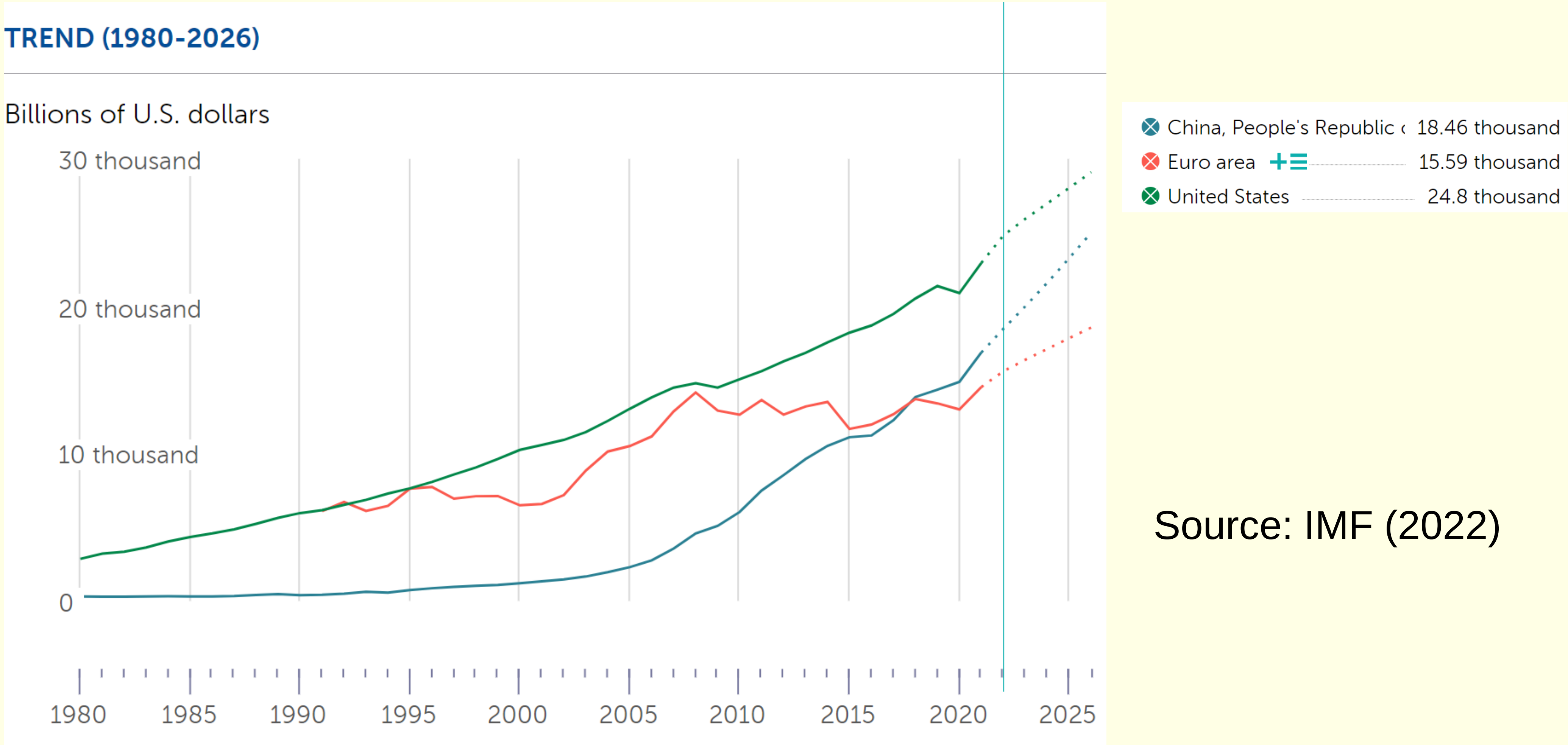
Likely consequences

- Risk aversion – loss of dynamism and European competitiveness (cf Guido Ferrarini 28 March)
- Deglobalization and welfare loss in poor countries
- Bureaucracy
- Litigation regime

In 2019, the share of the European Union in the global gross domestic product based on purchasing-power-parity amounted to an estimated 15.4 percent. (Statista 2022)

GDP

Current Prices



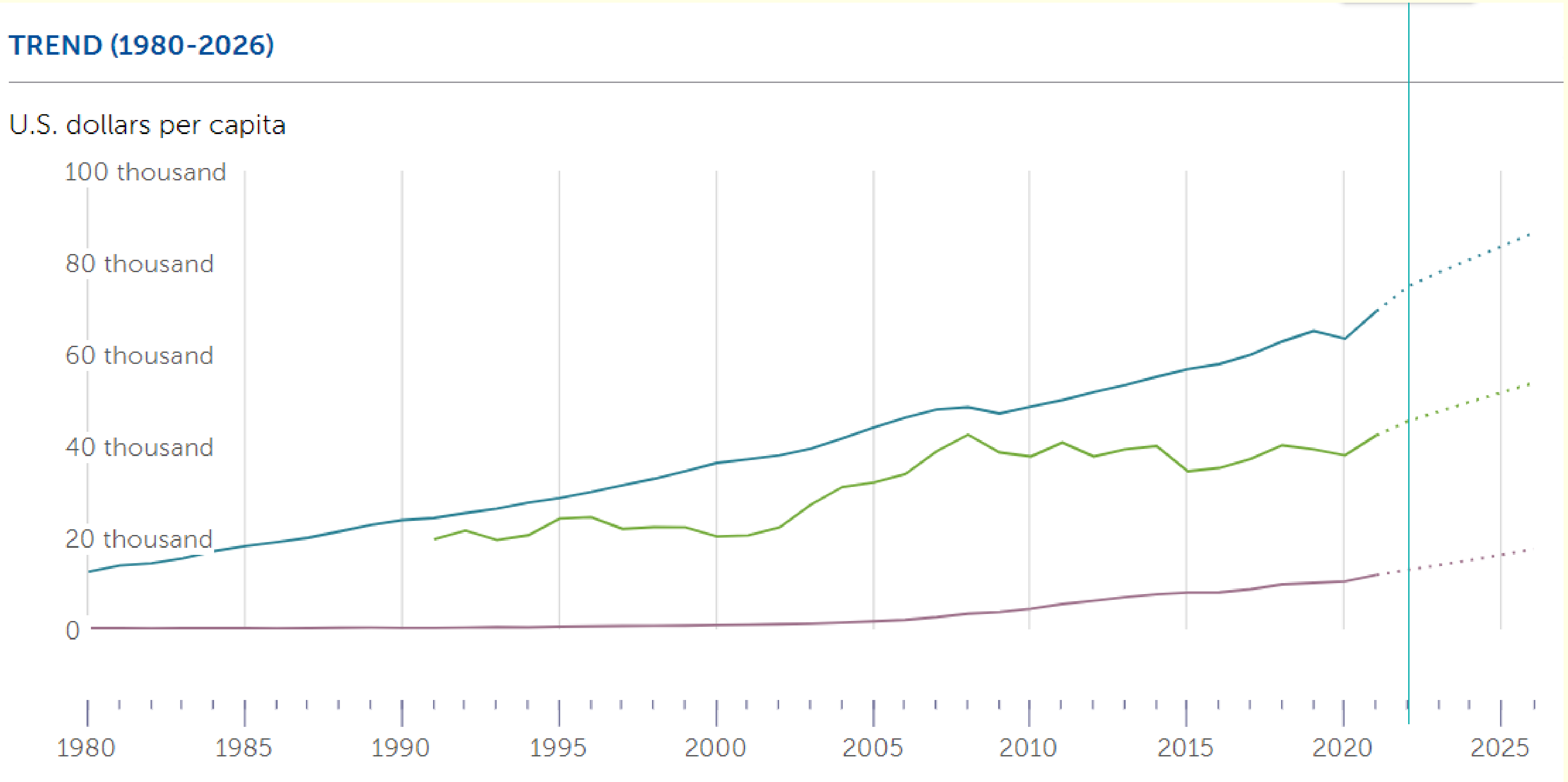
Source: IMF (2022)

Recommendations

- Partnership with business (SDG 17), not Gov control
- Respect EU better regulation principles =>
- Drop directors duties aspect – existing rules are sufficient Boards are already fully responsible for lawfulness
- Supply chain due diligence limited to direct business partners
- Build consensus: Not a good time for dissension in the EU

Tak!

GDP per capita



Euro area	45.39 thousand
China, People's Republic of	12.99 thousand
United States	74.73 thousand

Mandatory Climate Plans

- *(50) In order to ensure that this Directive effectively contributes to combating climate change, companies should adopt a plan to ensure that the business model and strategy of the company are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement. In case climate is or should have been identified as a principal risk for or a principal impact of the company's operations, the company should include emissions reduction objectives in its plan.*

- => Reintroduction of the planned economy in the climate area
- => The Union's ambitious climate goals – net zero in 2050 – thereby become an obligation for European companies
- => Mandatory climate plans become a political and bureaucratic instrument
- => Already made obsolete by Russia's invasion of Ukraine and the new energy security scenario

Mandatory climate incentives

- *(51) With a view to ensure that such emission reduction plan is properly implemented and embedded in the financial incentives of directors, the plan should be duly taken into account when setting directors' variable remuneration, if variable remuneration is linked to the contribution of a director to the company's business strategy and long-term interests and sustainability*

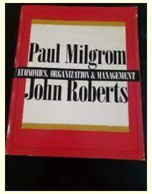
- Company directors incentivized to comply with the EU's climate goals

- => Complex incentive systems for managers have a really bad track record
- => Fixed pay for non-executives and long-term incentives for executives as a simple, workable alternative

Five situations when weak incentives are optimal

- 1. when good measures of the agent’s efforts or performance are not available;
- 2. when good measures are available for a particular activity but multitasking is desired and there are not good measures for the other desired activities;
- 3. when cooperation among different agents is desired;
- 4. when it is important to encourage experimentation;
  5. when it is important to induce obedience from agents who disagree with the principal about the right course of action.

- Roberts (JITE, 2010) Designing incentives in organizations



Directors' Duties

- *(63) In all Member States' national laws, directors owe a duty of care to the company. In order to ensure that this general duty is understood and applied in a manner which is coherent and consistent with the due diligence obligations introduced by this Directive and that directors systematically take into account sustainability matters in their decisions, this Directive should clarify, in a harmonised manner, the general duty of care of directors to act in the best interest of the company, by laying down that directors take into account the sustainability matters as referred to in Directive 2013/34/EU, including, where applicable, human rights, climate change and environmental consequences, including in the short, medium and long term horizons. Such clarification does not require changing existing national corporate structures.*

- => Directors duties should now be interpreted and applied in accordance with the directive rather than existing national law
- => Extremely diffuse and comprehensive duties

- Note. If the intention was to reinforce national law as stated, there would be no need to mention it in the directive

Board responsibility for supply chain due diligence

- *(64) Responsibility for due diligence should be assigned to the company's directors, in line with the international due diligence frameworks. Directors should therefore be responsible for putting in place and overseeing the due diligence actions as laid down in this Directive and for adopting the company's due diligence policy, taking into account the input of stakeholders and civil society organisations and integrating due diligence into corporate management systems. Directors should also adapt the corporate strategy to actual and potential impacts identified and any due diligence measures taken.*

Civil liability

- (56) ..civil liability of companies for damages arising due to its failure to comply with the due diligence process. The company should be liable for damages if they failed to comply with the obligations to prevent and mitigate potential adverse impacts ….
- (57) As regards damages occurring at the level of established indirect business relationships, the liability of the company should be subject to specific conditions. The company should not be liable if it carried out specific due diligence measures. However, it should not be exonerated from liability through implementing such measures in case it was unreasonable to expect that the action actually taken, including as regards verifying compliance, would be adequate
- (59) the civil liability of a company for damages arising due to its failure to carry out adequate due diligence should be without prejudice to civil liability of its subsidiaries or the respective civil liability of direct and indirect business partners in the value chain.

- => Litigation regime (US style)

A sustainability regulator

- *(53) In order to ensure the monitoring of the correct implementation of companies' due diligence obligations and ensure the proper enforcement of this Directive, Member States should designate one or more national supervisory authorities. These supervisory authorities should be of a public nature, independent from the companies falling within the scope of this Directive or other market interests, and free of conflicts of interest. In accordance with national law, Member States should ensure appropriate financing of the competent authority. They should be entitled to carry out investigations, on their own initiative or based on complaints or substantiated concerns raised under this Directive. Where competent authorities under sectoral legislation exist, Member States could identify those as responsible for the application of this Directive in their areas of competence. They could designate authorities for the supervision of regulated financial undertaking also as supervisory authorities for the purposes of this Directive.*

- A new public regulator (instead of courts) to hear complaints – or the subjugation of all companies to the Financial Standards Authority?

Sanctions

- *(54) In order to ensure effective enforcement of national measures implementing this Directive, Member States should provide for dissuasive, proportionate and effective sanctions for infringements of those measures. In order for such sanction regime to be effective, administrative sanctions to be imposed by the national supervisory authorities should include pecuniary sanctions. Where the legal system of a Member State does not provide for administrative sanctions as foreseen in this Directive, the rules on administrative sanctions should be applied in such a way that the sanction is initiated by the competent supervisory authority and imposed by the judicial authority. Therefore, it is necessary that those Member States ensure that the application of the rules and sanctions has an equivalent effect to the administrative sanctions imposed by the competent supervisory authorities.*

- => Fines decided by the regulator