Shift

The EU Commission's Proposal for a Corporate Sustainability Due Diligence Directive

SHIFT'S ANALYSIS

March 2022

Executive Summary: Our Key Reflections on the Commission's Proposal

March 2022

On **February 23, 2022**, the European Commission released its, *Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence*.[1] Its overall objective is to, "ensure that companies active in the internal market contribute to sustainable development… through the identification, prevention and mitigation, bringing to an end and minimization of potential or actual adverse human rights and environmental impacts connected with companies' own operations, subsidiaries and value chains."[2]

Shift welcomes the EU stepping into a leadership position on the need for mandatory measures to increase the breadth and depth of human rights and environmental due diligence, given the urgency of the sustainable development challenges facing us all. The Commission's initiative is an opportunity with few parallels in terms of its potential to drive sustainability into the heart of how business gets done.

With the right framing, a Directive could advance better outcomes for people and planet by **scaling** quality due diligence processes that focus on the most severe human rights and environmental risks, **encouraging** creative forms of individual and collaborative leverage by companies to tackle risks across their value chains, **enhancing** internal governance and accountability on sustainability risks, and **expanding** pathways to remedy for those harmed by business activity. **However, for these significant opportunities to be realized, and for the Directive to meet its stated ambition, to ensure that companies in the single market contribute to sustainable development by preventing and addressing adverse impacts, it is critical that the Directive is firmly grounded in the key international standards on sustainability due diligence adopted by the UN and the OECD.**[3]

In analyzing the Commission's proposal, we compare central elements of the draft Directive against the soft law standards contained in the UN Guiding Principles on Business and Human Rights and OECD Guidelines for Multinational Enterprises. We focus on those areas where we believe that a lack of alignment with the international standard will hinder the Directive's ability to meet its stated objectives, and we provide our initial thoughts on how they could best be addressed. **In brief, our five key reflections are as follows:**

1. THE SCOPE OF THE DUE DILIGENCE DUTY

The draft Directive proposes the same scope of civil liability as for the responsibility to do due diligence itself. In so doing, the Directive deploys the novel and untested concept of 'established business relationships' to limit the scope of due diligence, based on the ease for business of identifying risks and using leverage in these more proximate or strategic relationships. Yet this runs counter to the international standards, under which companies' responsibilities flow from the connection between negative impacts at any point in the value chain and companies' operations, products and services, and not from the ease with which impacts can be identified and addressed. The

last decade of practice shows that the concept of prioritization based on severity is the key factor in making due diligence manageable for business, as well as ensuring it tackles the most salient risks to people, yet it does not drive the logic of the due diligence duty proposed in the draft. Limiting civil liability to 'established business relationships,' but aligning the scope of the duty to do due diligence with the international standard, could help address these challenges.

2. DEMONSTRATING COMPLIANCE

The draft Directive understandably and necessarily reflects the need for companies to be able to demonstrate, and for judicial and administrative bodies to be able to assess, compliance with the duty to do due diligence. However the draft appears to fall into the trap of trying to achieve this through a heavy reliance on contractual assurances and audit/verification processes, which have been proven to be of limited efficacy in delivering improved outcomes for people, while generating significant costs to companies and often shifting responsibility from lead companies onto their business partners without attention to the role of their own practices in generating risks to people. There are better ways to demonstrate and assess compliance that properly reflect the range of approaches to managing sustainability risks expected under the UN Guiding Principles and OECD Guidelines, including greater attention to the role of the Board.

3. THE CENTRAL ROLE OF AFFECTED STAKEHOLDERS IN DUE DILIGENCE

The draft Directive contains important references to engaging with affected stakeholders and their legitimate representatives, but does not give their perspectives the role and weight that the international standards do. Meaningful engagement with affected stakeholders is central to making human rights due diligence under the UN Guiding Principles and OECD Guidelines effective in practice; it may also be the most challenging aspect to translate into a legally binding duty. However, there are clear opportunities to strengthen the draft's provisions on engagement with affected stakeholders, on complaints procedures and on ensuring remedy where harm has occurred to both better align with the international standards and advance the Directive's aims of enhancing corporate accountability for impacts and access to remedy.

4. THE SCOPE OF COMPANIES COVERED BY THE DUTY

The draft Directive defines the scope of companies covered by the duty to do due diligence to include all 'very large' companies as well as 'large' companies in only three sectors (textiles, agriculture and extraction of minerals). No SMEs are covered. This risks limiting the Directive's potential to create a truly level playing field – a central factor motivating many companies that support regulation at EU level. While recognizing that there may be good reasons to stagger the imposition and/or implementation of new legal duties across different types of companies over time, the current draft does not provide consistent risk-based rationales for why certain companies are in and others are out of the initial scope.

5. DUE DILIGENCE IN THE FINANCIAL SECTOR

The draft Directive creates several exceptions for the financial sector which do not align with the UN Guiding Principles or OECD Guidelines and are also out of step with existing practice in the sector. For example, by restricting due diligence by financial sector companies to the pre-contractual phase of relationships and to the activities of large corporate clients, the draft ignores the fact that such companies are already showing the feasibility and benefits of directing their due diligence efforts towards the most severe sustainability risks – based on their clients' sectors, operating contexts and value chains – and using leverage to tackle them throughout the duration of the relationship. The Directive should avoid undermining the important role and responsibility of the financial sector in addressing human rights risks based on the international standards, and the catalytic effect this can have for other sectors, as we have seen in the case of climate risks.

We provide these reflections as an input into the legislative debate as it now moves forward at the level of the European Parliament and the Council, and we welcome further dialogue on them.

A. Context

For over a decade now, the expectations in the UN Guiding Principles and OECD Guidelines have informed the efforts of states and other standard-setting bodies to encourage, incentivize and require more effective management of human rights and environmental risks connected to corporate operations and value chains. Shift welcomes the EU stepping into a leadership position on the need for mandatory measures to increase the breadth and depth of human rights and environmental due diligence, given the urgency of the sustainable development challenges facing us, through the comprehensive due diligence obligation in the EU Commission's Proposal for a Corporate Sustainability Due Diligence Directive.

"The UNGPs comprise 31 Principles and Commentary on what each means and implies for all actors: states, enterprises, as well as affected individuals and communities. They are not merely a text. They were intended to help generate a new regulatory dynamic, one in which public and private governance systems, corporate as well as civil, each come to add distinct value, compensate for one another's weaknesses, and play mutually reinforcing roles—out of which a more comprehensive and effective global regime might evolve."

Professor John Ruggie | Keynote Address at the December 2019 Finnish EU Council Presidency Conference

As the explanatory memorandum to the draft Directive explains, it has five specific aims:

(i) to **improve corporate governance practices** to better integrate sustainability risk management into corporate strategies;

(ii) to **avoid fragmentation of due diligence requirements** in the single market and **create legal certainty** for businesses and stakeholders;

(iii) to **increase corporate accountability** for adverse impacts and **ensure coherence for companies** across existing and proposed EU initiatives on responsible business conduct;

(iv) to **improve access to remedy** for those harmed; and

(v) to complement more specific sustainability measures on certain topics or sectors.[4]

The draft Directive references the UN Guiding Principles and OECD Guidelines as setting the authoritative expectations on due diligence in numerous places and it seeks to draw on their provisions. However, to fully achieve its aims, it will be critical to align the substance of the Directive more closely with the core concepts of the UN Guiding Principles and OECD Guidelines.

The experience of the last decade of implementation of the international standards has provided us with some clear lessons on how to ensure effective human rights and environmental due diligence. Building on this experience is essential if we want to ensure that due diligence focuses on tackling the most severe risks to people and planet, including through the creative use of leverage. Not doing so risks reducing due diligence to a series of resource-intensive 'command-and-control' management techniques, the logic of which is often driven by concerns about risk to the business.

In this note, we highlight five key ways in which closer alignment with the international standards can help the Directive better meet its central aims. We provide these reflections as an input into the legislative debate as it now moves forward at the level of the European Parliament and the Council, and we welcome further dialogue on them. We focus our comments on the human rights aspects of sustainability due diligence.

B. Five Key Aspects of the Draft Directive

1. THE SCOPE OF THE DUE DILIGENCE DUTY

The draft Directive proposes the same scope of civil liability as for the responsibility to do due diligence itself. In so doing, the Directive deploys the novel and untested concept of 'established business relationships' to limit the scope of due diligence, based on the ease for business of identifying risks and using leverage in these more proximate or strategic relationships. Yet this runs counter to the international standards, under which companies' responsibilities flow from the connection between negative impacts at any point in the value chain and companies' operations, products and services, and not from the ease with which impacts can be identified and addressed. The last decade of practice shows that the concept of prioritization based on severity is the key factor in making due diligence manageable for business, as well as ensuring it tackles the most salient risks to people, yet it does not drive the logic of the due diligence duty proposed in the draft. Limiting civil liability to 'established business relationships,' but aligning the scope of the duty to do due diligence with the international standard, could help address these challenges.

The draft Directive proposes a duty on companies to prevent and address their actual and potential adverse impacts on human rights and on the environment by carrying out due diligence. The Commission's explanatory memorandum rightly notes that the UN Guiding Principles and OECD Guidelines extend the expectation to do due diligence to the full scope of value chain. The Directive's recitals also observe that adverse impacts can occur, 'in particular at the level of raw material sourcing, manufacturing, or at the level of product or waste disposal or recycling,' and that '*in order for due diligence to have a meaningful impact*, it should cover… adverse impacts generated throughout the life-cycle of production and use and disposal,' including throughout the value chain.[5]

Yet Article 1 of the draft Directive limits the scope of due diligence to a company's own operations, its subsidiaries and its 'established business relationships' – which are defined as 'lasting' relationships based on the 'intensity' or 'duration of the relationship,' and which are not a 'negligible or merely ancillary part of the value chain.'[6] 'Business relationships' are defined in turn to include an entity with which the company has a commercial agreement of some kind or one that 'performs business operations related to the products or services of the company *for or on behalf of the company*.'[7]

This narrow scope creates a clear risk that in practice the focus of due diligence will be defined not by where the most severe risks and impacts occur in a company's value chain, but by whether or not a business relationship can be characterized as 'established' in line with the various novel tests introduced in the draft. It reflects a fundamental divergence from the international standards in how the scope of the duty to do due diligence is defined – and also from the practice of due diligence in line with those standards over the last decade.

The UN Guiding Principles deliberately did not limit the scope of due diligence to a particular set of closely related business relationships such as 'established business relationships' precisely because this would have led companies into looking for risks and impacts primarily among their strategic suppliers and other proximate relationships, and ignoring impacts in more remote parts of the value chain, where they are often more severe. It also would have grounded the responsibility to do due diligence in a concept that lends itself to being gamed through legal or tactical decisions to manage value chain relationships in ways that avoid them coming into scope. For instance, the use of 'established business relationships' creates incentives for companies to avoid relationships that would need to be categorized as 'lasting' and thus within scope of the due diligence duty. [8]

In the recitals to the draft Directive, paragraph 20 states that limiting the scope of due diligence to 'established business relationships' is necessary to 'allow companies to properly identify the adverse impacts in their value chain and to make it possible for them to exercise appropriate leverage.' Yet Professor Ruggie was explicit in the development of the UN Guiding Principles that the extent of leverage is not an appropriate basis for determining the responsibility of companies.[9] Instead, it is the fact of a potential or actual impact being connected with a company's operations, products or services that generates the responsibility, from which flows a discussion of what leverage the company has or can reasonably create in order to effect change. **To make leverage the basis for determining the scope of due diligence runs directly counter to the UN Guiding Principles and OECD Guidelines and reduces the potential of the Directive to deliver on its own stated aim of improving corporate accountability for adverse impacts throughout the value chain.**

Moreover, the significant number of companies that have been investing in carrying out due diligence in line with the UN Guiding Principles and OECD Guidelines for over a decade now have not needed such a limitation in order to make due diligence manageable. Instead, they have relied on the severity of risk to people as the basis for making difficult decisions about when to prioritize attention and effort where resources are limited, as is stipulated in the international standards. The draft Directive acknowledges the relevance of severity (along with other factors), but does not use it as the central concept for prioritizing effort and resource in the context of due diligence.

For all these reasons, while the concept of 'established business relationships' may have value as a basis for defining the scope of potential civil liability, using it to define the scope of the responsibility to carry out due diligence is problematic. Helpfully there are existing, accepted definitions of 'business relationships' in the international standards that have been road-tested through company and stakeholder approaches for over 10 years now, which the Directive can adopt. This would also align with the Parliament's recommendations in its proposals of March 10, 2021 to require due diligence to the full scope of the value chain in line with international standards, and to limit civil liability to a narrower set of situations (for example, where a company causes or contributes to harm, including through a company that it controls).[10] This would then enable the Directive to take advantage of the complementary roles of civil liability and administrative supervision as distinct modes of enforcement with different strengths and limitations instead of – as is currently proposed – giving them an entirely overlapping scope.[11]

2. DEMONSTRATING COMPLIANCE

The draft Directive understandably and necessarily reflects the need for companies to be able to demonstrate, and for judicial and administrative bodies to be able to assess, compliance with the duty to do due diligence. However the draft appears to fall into the trap of trying to achieve this through a heavy reliance on contractual assurances and audit/verification processes, which have been proven to be of limited efficacy in delivering improved outcomes for people, while generating significant costs to companies and often shifting responsibility from lead companies onto their business partners without attention to the role of their own practices in generating risks to people. There are better ways to demonstrate and assess compliance that properly reflect the range of approaches to managing sustainability risks expected under the UN Guiding Principles and OECD Guidelines, including greater attention to the role of the Board.

The draft Directive sets the expectation that covered companies should do due diligence, drawing on the OECD Guideline's 6 step process in the definition of due diligence in Article 4. However, while starting from the right basis, the draft then diverges in some critical respects from the key aspects of those steps, and particularly from the kinds of action that both the UN Guiding Principles and OECD Guidelines expect companies to take to prevent and address risks. If the Directive's ambition is to avoid fragmentation and ensure that companies are accountable for effectively addressing adverse impacts, then these differences matter.

In determining whether a company has acted appropriately, the draft emphasizes the need to consider the proportionality of a company's response to the severity and likelihood of the risk or impact, in addition to any reasonable constraints on its ability to take action. However, in specifying key actions that covered companies should take, the relevant Articles (7 and 8) focus heavily on the use of (a) 'contractual assurances' by business partners that they will comply with the covered company's supplier code or similar policy and that they will cascade these contractual promises in turn to their own partners, and (b) verification of partners' compliance with these requirements, including through third-party audits or industry initiatives (which the Commission 'may' at some point develop fitness criteria for, per Article 14(4)).

While both contractual terms and verification mechanisms are relevant elements of a company's due diligence, they are clearly not sufficient for effectively preventing and addressing human rights impacts. This is why the international standards focus instead on the central role of leverage – the ability of a company to influence the behavior of an entity causing harm. A clause in a contract can be an essential foundation for exercising leverage with a partner, but it is only a foundation. Companies need to consider their own potential contributions to adverse impacts (for example, whether their own purchasing practices make it harder for their partners to meet human rights commitments) and whether there are adequate incentives for a supplier to share rather than hide problems from them. They also need to use all the creative means at their disposal to influence the relevant entities that are causing harm (which may not be their own business partner) – from commercial leverage to the provision of expertise and capacity-building through wider aspects of the relationship, to collaboration with peers, NGOs, international organizations or through multistakeholder initiatives to exercise collective leverage – depending on the nature of the impact and what is likely to be effective.

Articles 7 and 8 do refer to 'making necessary investments' with business partners and 'collaborating with other entities' as relevant approaches. But the emphasis is clearly on the use of contracts and verification of compliance, including in dealing with partners further away in the value chain,[12] and in considering whether the company has carried out appropriate due diligence in the context of a civil claim.[13] **This risks sending a message to companies that ignores the last few decades of extensive evidence about the significant limitations of 'command-and-control' compliance approaches in addressing human, including labor, rights risks in global value chains, and the inability of many audit and certification schemes to effectively detect systemic impacts and help address their root causes, even when those schemes are well-resourced.**[14]

It is positive that the draft recognizes that companies should focus their efforts on trying to prevent and address impacts occurring in connection with their business relationships, not cutting and running, drawing on the lessons from the field of child labor remediation in particular.[15] The draft Directive rightly recognizes that temporary suspension of a relationship may be an appropriate use of leverage, and that termination may be necessary where impacts are severe and mitigation efforts are not successful (Articles 7(5) and 8(6)). But to align with the international standards, this should explicitly take into account any additional human rights consequences of such termination, as these may involve significant harm to affected stakeholders. The Directive should encourage companies to strive for 'responsible exit' where impacts are severe and the company lacks leverage to address them.

More generally, we recognize that there is a challenge in the need to identify means by which companies can demonstrate implementation of the expectations of human rights due diligence as part of translating it into a binding standard of conduct. However, a focus simply on the ease of measuring things (the existence of clauses in contracts, the number of corrective action plans, the number of relationships terminated for non-compliance) will drive an over-reliance by covered companies on approaches that have been shown not to be effective in delivering improved outcomes for people.

The dominant role for audit and verification suggested in the draft Directive risks generating extensive additional audit costs (with social auditing already a multi-billion dollar industry). These will be borne in some cases by covered companies but can be expected in many instances, given current practice, to be passed on to suppliers and other partners, including SMEs. These costs might be justifiable if such approaches had proven over the last thirty years to be effective in driving improved outcomes for affected stakeholders, yet the evidence is largely to the contrary. The failure of contractual clauses to deliver change has many causes, but is in part due to the failure of contracts to also require the companies that impose them to commit to address any of their own practices – such as purchasing practices – that can make it difficult or impossible for their suppliers or other partners to meet the human rights standards expected of them.[16] While audit and verification of compliance with contract clauses can – *if well executed* – play a certain role in risk management, the net effect of this over-emphasis on these tools will be to generate extensive costs while diverting attention and resources from more effective approaches that more fully reflect the letter and intent of the UN Guiding Principles and OECD Guidelines.

In evaluating whether a company is serious about its duty in an individual case, it will always be necessary to consider the particular features of the risk or impact at issue and what a reasonable response might be, based on a range of factors. However, there are other, overarching features of a company's approach that are also measurable and which shape how it responds to any specific situation – that is, the features of its governance of sustainability risks.

Importantly, the draft Directive sets out the responsibility of directors for overseeing due diligence in Article 26, including the expectation that they ensure that the results of due diligence inform the company's strategy. **The Directive could go further in specifying the features of governance that are evidence that a company is more likely to be managing its sustainability risks appropriately.** For example, these include evidence that the company's most senior governing body:

- regularly discusses progress and challenges in addressing its salient human rights and environmental risks, supported by appropriate expertise;
- reviews and challenges the company's business model, and any proposed changes to it, to ensure any inherent sustainability risks are identified and addressed;
- has structures or processes in place to ensure it is informed about the perspectives of affected stakeholders;
- formally approves high-level targets for addressing salient sustainability risks and evaluating the company's progress; and
- holds company leadership accountable for addressing salient sustainability risks, including through performance incentives where those are used for other aspects of performance.[17]

With regard to setting appropriate targets, we welcome the inclusion of an expectation that covered companies should adopt a plan in line with the Paris Agreement and assess climate change risks in Article 15. There is a clear opportunity to require the company to specifically consider the associated human rights risks and impacts to ensure it is managing its climate impacts while contributing to a just transition. Also, as proposed above, there is no reason why the use of performance incentives should be limited to this issue, if the company uses performance incentives for other sustainability matters.

3. THE CENTRAL ROLE OF AFFECTED STAKEHOLDERS IN DUE DILIGENCE

The draft Directive contains important references to engaging with affected stakeholders and their legitimate representatives, but does not give their perspectives the role and weight that the international standards do. Meaningful engagement with affected stakeholders is central to making human rights due diligence under the UN Guiding Principles and OECD Guidelines effective in practice; it may also be the most challenging aspect to translate into a legally binding duty. However, there are clear opportunities to strengthen the draft's provisions on engagement with affected stakeholders, on complaints procedures and on ensuring remedy where harm has occurred to both better align with the international standards and advance the Directive's aims of enhancing corporate accountability for impacts and access to remedy.

"First of all, human rights due diligence is not a transactional process. You are not looking to buy a piece of property and you want to make sure that there is a title to it. You are undertaking a long-term relationship with people so the focus needs to be on those people, whose lives, activities, and opportunities you can affect. That means that stakeholder engagement is absolutely critical to human rights due diligence. It is one of its distinctive features, differentiating it from conventional due diligence processes."

Professor John Ruggie | Keynote speech at Corporate Due Diligence and Civil Liability Webinar by NOVA Law School

Human rights due diligence is fundamentally about assessing risks to people, rather than risks to the business. This means that people need to be at the center of due diligence processes. We see at least two ways in which the draft Directive could strengthen the centrality of affected stakeholders and their perspectives in the due diligence obligations for companies.

First, the draft Directive should more clearly recognize meaningful engagement with affected stakeholders or their legitimate representatives (including trade unions where workers are unionized) as a central feature of due diligence. Under the UN Guiding Principles and OECD Guidelines, companies should engage with affected stakeholders (or with credible proxies where direct engagement is not possible) with the objective of understanding and responding to their interests and concerns, particularly of those who are likely to be the most vulnerable to impacts in connection with the company's operations or value chain. Where engagement involves trade unions or Indigenous peoples, it must meet international standards related to collective bargaining and free, prior and informed consent respectively.

Engagement with affected stakeholders is not something to be done only 'where relevant' in the opinion of the company – as that may be interpreted to mean when necessary to the company pursuing a business objective like obtaining a license or permit. It is particularly important when assessing risks and when tracking the effectiveness of the company's approaches. Without it, the company cannot be sure that it has appropriately assessed the severity of impacts to inform its prioritization of risks, nor can it be sure whether its approaches are having their intended effect in practice. Indeed, companies themselves report the value of such engagement in alerting them to new issues, prioritizing issues for attention and taking effective action to prevent and address risks.

The important role of affected stakeholders in informing risk assessment is underplayed in Article 6, presumably in part because the draft does not emphasize the concept of severity as the central criterion in making difficult decisions about what to prioritize. Their role is not mentioned at all in Article 10 on monitoring. Similarly, Article 11 on communicating refers only to formal reporting and not to the broader concept in the UN Guiding Principles and OECD Guidelines of communicating with interested stakeholders, including affected stakeholders, about the company's efforts outside the context of formal reporting.

It is positive that the draft expects companies to establish 'complaints procedures' under Article 9, which affected stakeholders, trade unions and civil society organizations working in relevant fields can access. But it sets only limited requirements for the effectiveness of such mechanisms, despite significant existing guidance from OHCHR and the OECD on the role of grievance mechanisms under the UN Guiding Principles and OECD GL. Nor does it convey the importance of such mechanisms – including the role played by trade unions – at all tiers of the value chain, which is a missed opportunity. **A complaints mechanism is also a purely reactive way to hear from stakeholders; while important, it needs to be complemented by clearer expectations regarding proactive engagement by covered companies.**

Crucially, the current draft does not pay sufficient attention to the risks faced by affected stakeholders that raise concerns where those individuals are not covered by the EU Whistleblower Directive (under Article 23), particularly human rights and environmental defenders located outside the EU. This is another reason to include the existing, broadly accepted criteria on the effectiveness of the design and safety of complaints procedures at all levels of the company's operations and in its value chain.

The second way in which the draft Directive should strengthen a focus on the affected stakeholders that are at the heart of due diligence is in relation to remedy. It is positive that the draft recognizes the responsibility of covered companies to take action to address impacts that they themselves have caused or contributed to.[18] Remedy in such situations is a central expectation in both the UN Guiding Principles and OECD Guidelines, and it is the 6th step of the OECD due diligence process. Yet the term 'remedy' does not feature in the draft Directive's provisions, which speak instead of 'neutralizing the adverse impact'. In our view, this is not just a language issue.

The draft gives only one example of a way to 'neutralize' impacts, which is through the provision of financial compensation. While compensation can be a critical component of remedy, the objective of remedy from a human rights perspective is to put the affected person back in the position they were in before the harm or as close to it as possible. This could also involve other steps such as an apology, support for mental or physical health needs, reinstatement to a position, sanctioning of those responsible and commitments to prevent future harm – but this can only be determined by consulting with directly affected stakeholders themselves. The same kinds of approaches should be part of the range of options available to affected stakeholders through formal enforcement of a breach (via civil liability or administrative sanctioning). The draft would benefit from aligning more closely with the concept and definitions of remedy in the international standards in this respect.

Finally, it is very positive that the draft puts forward a clear framework of enforcement measures involving both civil liability and administrative supervision. With regard to the latter, the draft highlights a number of features, including the need for administrative bodies to have true independence with staff that are free from conflicts of interest; to have appropriate powers to investigate and sanction companies (and for such sanctions to be dissuasive in nature based on turnover); and to ensure that there is judicial review of the authority's decisions. The draft also proposes a European network of authorities – although it is not clear what role this would play beyond coordinating cross-border cases, for example in ensuring coherence of interpretation of the standard of conduct across Member States. [19]

With regard to civil liability, it is positive that the draft recognizes its importance in enabling access to remedy in specific cases, with a due diligence defense (and not a safe harbor). However, the appropriateness of this defense depends on the extent to which due diligence is equated with the use of contractual clauses, social audits and corrective action plans, or whether it is given its broader meaning in line with international standards, as explained above. Moreover, NGOs and trade unions have rightly highlighted the need for the Directive to require Member States to address legal and practical barriers to accessing judicial remedy, as highlighted in the UN Guiding Principles themselves (GP 25), in OHCHR's Accountability and Remedy Project, and in a range of expert studies in the EU context, including by the European Fundamental Rights Agency. This would help make the prospect of remedy real and advance the Directive's own aims in this regard.

4. THE SCOPE OF COMPANIES COVERED BY THE DUTY

The draft Directive defines the scope of companies covered by the duty to do due diligence to include all 'very large' companies as well as 'large' companies in only three sectors (textiles, agriculture and extraction of minerals). No SMEs are covered. This risks limiting the Directive's potential to create a truly level playing field – a central factor motivating many companies that support regulation at EU level. While recognizing that there may be good reasons to stagger the imposition and/or implementation of new legal duties across different types of companies over time, the current draft does not provide consistent risk-based rationales for why certain companies are in and others are out of the initial scope.

The due diligence obligation in the draft Directive applies only to 'very large' and a limited number of 'large' EU limited liability companies (around 13,000 companies in total).[20] It is certainly positive that, at least in this regard, non-EU companies in these categories are also covered (around 4,000 in total). For 'large' companies,[21] only companies in three high-risk sectors are included in the scope of the duty - textiles, agriculture and extraction of minerals. The stated rationale for limiting the application to companies in these sectors is that they are covered by existing OECD sector-specific guidance. Yet the Directive expressly excludes large companies in the financial sector, which has also been the subject of extensive OECD sectoral guidance.

The expectations in the international standards apply to all companies since all may potentially be connected to severe risks. To make this manageable, both the UN Guiding Principles and OECD Guidelines expect companies to adopt due diligence processes that are appropriately adapted to their size, operating contexts and – importantly – to their risk profile. While it is understandable that there may be a need to limit the scope of companies covered under new legislation (or at least to stagger its implementation in relation to certain companies), this needs to be done in a way that is clearly based on the nature of the human rights and environmental risks that covered companies could be connected to. If it is not risk-based, then it has the potential to undermine the establishment of a true level playing field, which is a central factor motivating many companies that support mandatory due diligence at EU level. [22]

It appears that the various rationales for the very limited 'personal scope' of covered companies in the draft Directive were developed primarily in response to the Regulatory Scrutiny Board's negative findings, which have still not been made public.[23] Trade unions and NGOs have already highlighted a number of other sectors that are clearly high-risk and where there are various initiatives underway to provide guidance or develop shared approaches to addressing human rights and environmental risks, including transport, electronics and construction.[24] **The existence of authoritative guidance may be a basis for staggering implementation across sectors that lack such guidance, but that is distinct from using it as a basis to scope out those sectors entirely.**

The Directive also excludes all SMEs from its scope, regardless of whether they are in a higher-risk sector or not, primarily on the basis of concerns about the financial and administrative burden on them in setting up due diligence systems.[25] Yet it recognizes that, in practice, many are likely to feel the effects of the Directive anyway, particularly given its heavy reliance on contractual terms as the primary way for covered companies to require risk management by their business partners. SMEs may therefore find themselves on the receiving end of prescriptive due diligence requirements rather than being afforded the latitude to develop their own approaches to due diligence, which their inclusion in the scope of the Directive would have allowed for.

The Directive emphasizes the need for support, including financial and capacity-building support, to SMEs within the value chains of covered companies from both those companies and from Member States. Yet if the Directive is going to require support to SMEs then it would seem feasible to include at least some SMEs within the scope of the duty, in line with the Parliament's recommendation on this point.[26] At a minimum, the rationale for excluding all SMEs does not seem to apply in the same way to financial sector companies, as we discuss next.

5. DUE DILIGENCE IN THE FINANCIAL SECTOR

The draft Directive creates several exceptions for the financial sector which do not align with the UN Guiding Principles or OECD Guidelines and are also out of step with existing practice in the sector. For example, by restricting due diligence by financial sector companies to the pre-contractual phase of relationships and to the activities of large corporate clients, the draft ignores the fact that such companies are already showing the feasibility and benefits of directing their due diligence efforts towards the most severe sustainability risks – based on their clients' sectors, operating contexts and value chains – and using leverage to tackle them throughout the duration of the relationship. The Directive should avoid undermining the important role and responsibility of the financial sector in addressing human rights risks based on the international standards, and the catalytic effect this can have for other sectors, as we have seen in the case of climate risks.

The draft Directive treats the financial sector differently from other sectors in at least three key ways. First, regarding the scope of covered companies, it is unclear why all financial sector entities apart from 'very large' ones are excluded from the scope of the duty to do due diligence. The existence of OECD sector guidance is the stated rationale for only including large companies in certain high-risk sectors in the scope of the duty; yet as the explanatory memorandum itself notes, the OECD has issued extensive guidance for institutional investors, banks and other financial institutions. Inadequate resourcing is the stated rationale for excluding SMEs; yet that can hardly hold true for medium-size or even small financial sector companies like private equity and venture capital firms, which can also be connected to severe risks. It is also not clear whether, even within the realm of the 'very large' financial sector companies that are covered by the duty, the definition of 'value chain' in Article 3(g) would include the full range of capital market activities that are relevant to long-term value creation, including the activities of investors who participate in secondary market transactions (for example, institutional investors or the investment arms of international banks that manage portfolios of public equities and debt).

The second way in which financial sector companies are treated differently is that their due diligence obligations are limited to the pre-contractual phase of relationships. This adopts a short-term perspective of some capital providers that is misaligned with the longer-term horizon necessary to sustainable value creation and which is enabled by sustainability due diligence. It is at odds with, and risks disincentivizing, strategies for ongoing due diligence in line with the UNGPs and OECD Guidelines that are in fact already being undertaken by financial institutions. Growing good practice in the sector involves these institutions creating contractual and commercial levers for ongoing identification and mitigation of impacts with which their client or investee companies are involved through, for example: decisions to structure (e.g. tranche) the duration of financial relationships in ways that create more opportunities for leverage; loan covenants allowing investors to conduct human rights due diligence and/or to access data or findings from such processes; and the embedding of regular and systematic identification and tracking of human rights and environmental risks in front line client management processes.[27] All of this helps to drive greater corporate accountability for adverse impacts, and has the potential even to enhance access to remedy for affected stakeholders.

Third, the draft Directive limits financial sector companies' due diligence to the activities of their large corporate clients (and other companies in their corporate group), and excludes risks arising in those clients' own value chains. This is not consistent with explicit guidance on the financial sector from the OECD, OHCHR and UN PRI, nor with growing practice in the sector. For example, in the Netherlands, under the Dutch Banking Sector Agreement, banks are working individually and collectively to tackle the most severe sustainability risks deep in their clients' supply chains, including relating to palm oil, coffee production, and the extraction of diamonds and various minerals and metals. This approach is also reflected in emerging practice among financial institutions seeking to use their leverage in the solar power value chain to address severe forced labor impacts upstream from their immediate clients. It is vital that the Directive avoid incentivizing these companies to focus their resources on large, lower-risk clients at the expense of smaller clients in higher-risk sectors or operating contexts, or discouraging them from innovative uses of their leverage that try to address more severe harms further up the value chain.

In conclusion, we hope that these reflections can be a useful input into the legislative debate as the Commission's proposal is taken up by the European Parliament and the Council. We look forward to engaging in and continuing to contribute to the debate, alongside other interested stakeholders.

EU Commission's Proposal for a Corporate Sustainability Due Diligence Directive, Shift's Analysis
Shift, New York. March 2022

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ABOUT SHIFT

Shift is the leading center of expertise on the UN Guiding Principles on Business and Human Rights. Shift's global team of experts works across all continents and sectors to challenge assumptions, push boundaries, and redefine corporate practice, in order to build a world where business gets done with respect for people's dignity.

Shift was established following the 2011 unanimous endorsement of the Guiding Principles by the UN Human Rights Council, which marked the successful conclusion of the mandate of the Special Representative of the UN Secretary-General for Business and Human Rights, Professor John Ruggie. Shift's founders were part of Professor Ruggie's core advisory team that helped develop the Guiding Principles.

Shift is a non-profit, mission driven organization headquartered in New York City.

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ENDNOTES

1 Available at https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1145 (hereinafter, Corporate Sustainability Due Diligence Directive).

2 Corporate Sustainability Due Diligence Directive, Recitals at (14).

3 The UN Guiding Principles on Business and Human Rights (UN Guiding Principles) are the authoritative global standard on how to prevent and address business-related human rights harms. They expect states to adopt a smart mix of measures, mandatory and voluntary, national and international, to drive meaningful change in business behavior. The OECD Guidelines for Multinational Enterprises (OECD Guidelines) are aligned with the UN Guiding Principles and cover a broader range of topics in addition to human rights, including the environment, and are supported by general and sector-specific guidance. The ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy reinforces these expectations, specifically in relation to due diligence regarding labor rights.

4 Corporate Sustainability Due Diligence Directive, p 3.

5 Ibid, Recital (17), emphasis added.

6 Ibid, Article 3(f).

7 Ibid, Article 3(e), emphasis added.

8 At the same time, if a relationship can be characterized as established, then all of the 'indirect' relationships attached to that 'established business relationship' are within scope for the covered company's due diligence. It also appears that then all impacts occurring in relation to the activities of those 'indirect' relationships would be within scope, whether or not there is a link to the covered company's operations, products or services. This again would diverge from international standards.

9 This is discussed in Ruggie's 2008 report presenting the "Protect, Respect and Remedy" Framework to the UN Human Rights Council, available at https://digitallibrary.un.org/record/625292?ln=en, at paras 65-72.

10 See https://www.europarl.europa.eu/doceo/document/TA-9-2021-0073_EN.pdf, particularly Articles 1, 3, 18 and 19.

11 See Shift and OHCHR, Enforcement of Mandatory Due Diligence: Key Design Considerations for Administrative Supervision, October 2021, available at https://shiftproject.org/resource/enforcement-mhrdd-design/ (pp7-8).

12 See Corporate Sustainability Due Diligence Directive, Articles 7(3) and 7(4). Trying to put a contract in place with an entity several tiers up the supply chain that a company does not otherwise have a relationship with in order to 'force compliance' with the company's supplier code is unlikely to be effective in trying to tackle a situation of forced labor, for example.

13 Ibid, Article 22(2).

14 Early evidence was provided in 2007-09 in a series of well-known studies by Professor Richard Locke and colleagues, see for example, https://eprints.lse.ac.uk/59405/1/Qin_etal_Does-monitoring-improve-labor-standards_2007.pdf, and https://journals.sagepub.com/doi/10.1177/0032329209338922. More recent evidence can be found in academic studies (such as http://speri.dept.shef.ac.uk/wp-content/uploads/2018/11/Global-Brief-1-Ethical-Audits-and-the-Supply-Chains-of-Global-Corporations.pdf), studies by NGOs (such as https://cleanclothes.org/file-repository/figleaf-for-fashion-brief.pdf/view) and in initiatives seeking to tackle the contribution of buyers' own purchasing practices to working conditions in the supply chain (such as https://betterbuying.org/). See also the perspectives collected at https://www.business-humanrights.org/en/big-issues/labour-rights/beyond-social-auditing/.

15 Corporate Sustainability Due Diligence Directive, Recital (32).

16 One effort that has sought to address this is the American Bar Association's Model Contract Clauses Project which propose mutual obligations on the buyer and supplier in seeking to ensure better human rights outcomes: https://www.americanbar.org/groups/human_rights/business-human-rights-initiative/contractual-clauses-project/.

17 See further https://shiftproject.org/resource/signals-draft1/ and more generally https://shiftproject.org/resource/lg-indicators/about-lgis/.

18 Corporate Sustainability Due Diligence Directive, Article 8(3)(a).

19 Many of these points are raised in the proposals of the European Parliament, note 10 above. See also note 11 above (Shift and OHCHR).

20 See European Commission fact sheet, available at https://ec.europa.eu/commission/presscorner/detail/en/fs_22_1147.

21 Defined as those with more than 250 but less than 500 employees and an annual turnover between EUR 40-150 million for EU companies, and just on the basis of EU turnover for non-EU companies. In both cases, at least 50% of net turnover (in the case of non-EU companies that means net worldwide turnover) must have been generated in one of the three listed sectors.

22 See, for example, https://www.business-humanrights.org/en/latest-news/eu-mandatory-due-diligence/

https://media.business-humanrights.org/media/documents/EU_Business_Statement_February2022.pdf.

23 Corporate Sustainability Due Diligence Directive, Explanatory memorandum, p 21.

24 The Commission has previously commissioned guidance on due diligence addressing three other sectors that were assessed as high-risk on human rights grounds (oil and gas, ICT and employment and recruitment agencies): available at https://ec.europa.eu/anti-trafficking/european-commission-sector-guides-implementing-un-guiding-principles-business-and-human-rights_en.

25 Corporate Sustainability Due Diligence Directive, Explanatory memorandum, p 14.

26 See note 10 above, Article 2.

27 See further https://shiftproject.org/resource/using-leverage-to-drive-better-outcomes-for-people/.