European Value Chain Legislation Marches On

European Commission Adopts Corporate Sustainability Due Diligence Directive That Will Impact Many U.S. Companies

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Directive on Corporate Sustainability Due Diligence (CSDD)

On February 23, 2022, the European Commission adopted a Proposal for a Directive on Corporate Sustainability Due Diligence (CSDD) that addresses **social** and **environmental** concerns, including **global warming**. If, as expected, the proposed directive is enacted by the European Parliament and the European Council, it will require all 27 member states of the EU to enact laws consistent with the directive. When that happens, global commerce as we have known it for centuries will enter a new era.

CSDD goes beyond the supply chain to deal with a company's "value chain", which it defines very expansively to mean activities related to the development, production and providing of goods and services, the use and disposal of products, and the related activities of upstream and downstream businesses.

As presently drafted, CSDD will **directly** or **indirectly affect** a large number of companies around the world, including American companies.

Why is this development relevant for American organizations? On March 21, 2022, the Securities & Exchange Commission (SEC) issued a major proposal on climate change disclosure entitled *The Enhancement and Standardization of Climate-Related Disclosures for Investors*. The simultaneous emergence of the European and American disclosure proposals is representative of a continuing global wave of reporting requirements.

It is thus helpful for every American organization that is subject to SEC regulation, and not just American organizations that have direct interests in Europe, to be aware of the European proposals. The European market is generally a little more advanced than the U.S. in climate disclosure development, and thus it serves as a helpful barometer of change here. In other words, by understanding European trends in this sector, we can better understand and anticipate disclosure trends in the U.S.

The European law will **directly** apply to companies within its "scope", so-called "In-Scope" companies, which are defined in terms of country of incorporation, revenues, headcount and industry sectors in which they operate. There are four categories, as shown in the table below.

Table of In-Scope Companies		
Category[1]		
EU Companies		
EU-L	Large	Employ more than 500 employees and generate net worldwide turnover of at least 150 million euros
EU-M	Moderate Size	Employ 250 to 499 employees and generate net worldwide turnover of at least 40 million euros, provided that 50% or more of the net worldwide turnover is generated in specified industries sectors, such as clothing, forestry and mining (hereinafter referred to as "Specified Industries"
Non-EU Companies		
Non-EU-L	Large	Generate net turnover of at least 150 million euros in the EU
Non-EU-M	Moderate Size	Generate net turnover of at least 40 million to 150 million euros in the EU, provided that 50% or more of the net worldwide turnover is generated in Specified Industries

If companies are not In-Scope, they will not be directly regulated by CSDD. However, the law will **indirectly** affect them if they are in the value chain of an In-Scope company, because the In-Scope company will be forced to bring them into its compliance regime.

CSDD establishes the following requirements for In-Scope firms:

1. **Due Diligence Activities.** Firms must conduct due diligence activities that assess human rights and environmental adverse impacts in their internal operations, in the internal operations of their subsidiaries, and in their value chains.

2. Corporate Policies. Firms must adopt due diligence policies that contain: (a) descriptions of approaches to due diligence, (b) codes of conduct for employees and subsidiaries, and (c) descriptions of processes for implementing due diligence activities. These due diligence policies must be updated annually.

3. Adverse Impacts. Firms must take appropriate measures to identify actual or potential adverse human rights and environmental impacts arising from their internal operations, from the internal operations of their subsidiaries, and from business relationships in their value chains.

Organizations must also take appropriate measures to prevent potential adverse impacts or to adequately mitigate them if prevention is impossible. They will be expected to cease actual adverse impacts in their internal operations and in the internal operations of their subsidiaries. In addition, they are expected to minimize actual adverse impacts in the operations of companies with which they have business relationships. Such minimization activities may include:

- developing and implementing preventive or corrective action plans;

[1] The terms Large, Moderate Size, EU-L, EU-M, Non-EU-L, Non-EU-M and Specified Industries are used here for the convenience of the reader. They do not appear in the draft Directive.

- seeking contractual assurances that external entities in their value chains will comply with their codes of conduct and preventive action plans;
- paying damages to affected persons and financial compensation to affected communities;
- investing in management and production processes and infrastructures;
- providing targeted and proportional support for small and medium sized enterprises with which the company has established business relationships;
- establishing a complaints procedure for affected persons, including representatives of value chain workers and social organizations;
- monitoring the effectiveness of due diligence policies and adverse impact activities every 12 months or whenever new risks arise, making appropriate revisions when necessary.

4. Climate Change. EU-L and Non-EU-L companies will be required to develop plans for ensuring that their business strategies will be compatible with governmental efforts to limit global warming to 1.5° Celsius. These plans must **i**dentify the extent to which climate change is a risk for, or an impact of, their operations. If climate change is identified as a principal risk, the plans must address emission reduction objectives, and must incorporate them in the variable remuneration of "directors" in regard to their contributions to the long-term interests of their firms. This is a significant encroachment on the corporate governance rights of Non-EU-L companies to determine their executive compensation plans.

5. Directors' Duties. Directors of EU companies, both EU-L and EU-M companies, will be required to address **t**he consequences of their decisions on human rights, climate change, and other sustainability considerations. Note that third-country company directors will not be so obligated. Note also that, as drafted, CSDD defines "director" very broadly to include senior managers who would not be deemed directors under American law.

Enforcement

How will the Directive be enforced? All member states of the European Union will designate supervisory authorities to ensure compliance. Firms that are based in the United States and other non-European locales will designate authorized representatives within the European Union for communication purposes.

Sanctions of a "dissuasive, proportionate and effective" nature will be applied and published by supervisory authorities. Companies applying for public support will certify that no such sanctions have been imposed on them.

Firms will also face civil liability lawsuits for damages that arise from adverse impacts that could have been identified, prevented, mitigated, ceased, or minimized through appropriate measures. However, firms will not be liable for adverse impacts that are attributable to indirect business partners if cascading contractual assurances were obtained from direct business partners, unless it was unreasonable for the firms to expect that these actions could be effective.

Status of the Proposal

The Directive is currently a proposal and does not yet have legislative effect. It will be considered by the European Parliament and Council as part of the EU's legislative process, with the go-ahead ("entry into force" of the Directive) expected this or next year. If adopted, all member states will have two years to "transpose" the Directive into their national laws. Thus, there will be 27 separate national laws, each presumably consistent with the Directive.

In-Scope EU-L and Non-EU-L firms (the large ones) will be required to be in compliance within two after the Directive "enters into force", but the smaller EU-M and Non-EU-M companies will enjoy an additional two-year period to come into compliance. That means that the large firms will probably have to be in compliance as soon as 2024 or as late as 2025, and the smaller firms as soon as 2026 or as late as 2027.

The compliance burdens will be substantial, to put it mildly. The window of time for companies *and their value chain partners* to become compliant will not be generous. The time to begin the process is now.

Impact on Business Activities within the United States

Although the direct legal impact of the Directive will not be experienced for several years, there are progressive forces at work that are driving companies to choose voluntarily to operate in compliance with ESG considerations. The global automobile industry, for instance, has embraced the development of electric battery technology even though traditional gasoline engines are currently more cost effective and much more practical for long distance driving activities. Likewise, many firms have adopted diversity initiatives at the board level and throughout their organizations in the absence of formal legal mandates. And most firms now issue sustainability (ESG) reports and other Corporate Social Responsibility information without being compelled by technical regulatory requirements to do so.

There are two key requirements in the CSDD proposal that will likely impact the development of ESG policies and procedures in the United States. One is the requirement of due diligence activities, which is relevant to the practice of internal controls in the United States. The other is the requirement of managing adverse impacts, which is relevant to the practice of enterprise risk management to American firms.

Both of these conceptual requirements are codified by COSO, the joint initiative of the American Accounting Association, the American Institute of CPAs, Financial Executives International, the Institute of Management Accountants, and the Institute of Internal Auditors in the United States. The initiative promulgates standards, frameworks, and other guidance for practitioners in the fields of internal control, risk management, governance and fraud deterrence.

Firms utilize these standards to develop their systems of internal control. Thus, public accounting firms likewise utilize them for their assurance activities on the control systems of publicly traded firms. COSO does not recommend or require the utilization of any particular regulatory or legislative standard. Instead, its contents are written in a manner that enables the inclusion of appropriate legal requirements on a firm-by-firm basis. Thus, companies endeavor to integrate

each new global legislative requirement and each new COSO framework into their management accounting and control systems in a holistic manner.

In other words, each new COSO and regulatory promulgation tends to drive the development of the entire ecosystem of control. New European regulations that are relevant to American firms will thus impact the implementation of COSO guidance in the United States.

Furthermore, all American firms that exist within the value chains of European suppliers, vendors, customers, and other stakeholders may need to begin developing management accounting systems that are consistent with each stakeholder. It may take years to develop systems of measurement and assurance that comply with the eventual regulatory adoption of the Directive.

Many firms, for instance, have declared carbon emission "neutrality" and "net zero" target dates in the 2030s to give themselves a full decade to define, develop, and implement such environmental reporting systems. Likewise, it has already taken a decade or more for many firms to develop systems to certify that their products are "organic" or "free of forced labor" or "raised with sustainable farming practices."

In addition, even the most advanced multi-national organizations in the United States are developing new policies and procedures to utilize ESG reporting standards that are likewise works in progress. ExxonMobil, for instance, relies heavily on the standards of the Global Reporting Initiative (GRI) to define the metrics in its annual Sustainability Reports. The GRI, however, first issued a set of standards for the Oil and Gas Sector last year; it does not even take effect for reporting purposes until next year.

On the other hand, Chevron does not rely on the GRI standards for its annual Sustainability Report. Instead, it relies on the standards of the Sustainability Accounting Standards Board (SASB). Exxon, in contrast, does not rely on the SASB in its reporting systems.

Over time, the energy industry and other economic sectors will converge on common sets of guidelines. In the meantime, firms will continue to be responsible for reviewing all relevant standards and all proposed and actual regulatory requirements in order to develop effective management systems.

Thus, as standards of management accounting, non-financial reporting, internal control, and enterprise risk management continue to develop in mutually impactful ways, regulatory developments like the CSDD Proposal will continue to influence the development of U.S. requirements and practices.

If this Proposal advances into enactment as expected, many American firms will need to spend years preparing to meet their new legal responsibilities. And even though the Proposal may never become law, its principles and practices have already entered the debates regarding the ecosystem of ESG mandates.

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