CORPORATE GOVERNANCE ON SUSTAINABILITY IN THE EU

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Abstract.

As part of the European Union's transition to a climate-neutral and green economy in line with the European Green Deal, the directions of action considered are related to the improvement of corporate governance practices to better integrate risk management and mitigation processes of human rights and environmental risks and impacts, including those stemming from value chains, into corporate strategies; the avoidance of fragmentation of due diligence requirements in the single market and creation of legal certainty for businesses and stakeholders as regards expected behaviour and liability; the increment of corporate accountability for adverse impacts, and insurance of the coherence for companies regarding obligations under existing and proposed EU initiatives on responsible business conduct.

This paper analyses the measures proposed at the EU level in order to achieve sustainability objectives by focusing on the business processes of the companies.

Keywords: *sustainable development, companies, corporate governance, environmental risks, business conduc.*

JEL Classification: *M48, O16, Q01.*

Regarding environmental, social and human rights related risks, impacts, measures (including due diligence) and policies, at EU level, sustainable corporate governance has been mainly fostered indirectly by imposing reporting requirements in the *Directive 2014/95 /EU - Non-Financial Reporting Directive*[2] *(NFRD)* on a significant number of companies.

The objectives pursued by the NFRD were to increase the transparency of certain companies, and to increase the relevance, consistency, and comparability of the non-financial information disclosed, by strengthening and clarifying the existing requirements; to increase diversity in the boards of companies through enhanced transparency in order to facilitate an effective oversight of the management and robust governance of the company and to increase the company's accountability and performance, and the efficiency of the Single Market.

In this regard, large undertakings which are public-interest entities exceeding on their balance sheet dates the criterion of the average number of 500 employees during the financial year shall include in the management report a non-financial statement containing information to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity, relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters, including:

a) a brief description of the undertaking's business model;

b) a description of the policies pursued by the undertaking in relation to those matters, including due diligence processes implemented;

c) the outcome of those policies;

d) the principal risks related to those matters linked to the undertaking's operations including, where relevant and proportionate, its business relationships, products or services which are likely to cause adverse impacts in those areas, and how the undertaking manages those risks;

e) non-financial key performance indicators relevant to the particular business.

These requirements are in force since the financial year started on 1 January 2017 or during the calendar year 2017.

On 23rd February 2022, the Commission published a *Proposal for a Corporate Sustainability Reporting Directive (CSRD)*, revising the NFRD, that will extend the scope of the companies covered to all large and all listed companies, require the audit (assurance) of reported

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[2] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups

information and strengthen the standardisation of reported information by empowering the Commission to adopt sustainability reporting standards. This Directive will complement the current NFRD and its proposed amendments *(Proposal for CSRD)* by adding a substantive corporate duty for some companies to perform due diligence to identify, prevent, mitigate and account for external harm resulting from adverse human rights and environmental impacts in the company's own operations, its subsidiaries and in the value chain.

Of particular relevance of the *Proposal on CSRD* is that it mandates disclosure of plans of an undertaking to ensure that its business model and strategy 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. The two initiatives are closely interrelated and will lead to synergies.

First, a proper information collection for reporting purposes under the proposed CSRD requires setting up processes, which is closely related to identifying adverse impacts in accordance with the due diligence duty set up by the Directive. Second, the CSRD will cover the last step of the due diligence duty, namely the reporting stage, for companies that are also covered by the CSRD. Third, the Directive will set obligations for companies to have in place the plan ensuring that the business model and strategy 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 on which the CSRD requires to report. Thus, the Directive will lead to companies' reporting being more complete and effective. Therefore, complementarity will increase effectiveness of both measures and drive corporate behavioural change for those companies.

The new due diligence rules will apply to the following companies and sectors:

A. EU companies:

- Group 1: all EU limited liability companies of substantial size and economic power (with 500+ employees and EUR 150 million+ in net turnover worldwide).

- Group 2: Other limited liability companies operating in defined high impact sectors, which do not meet both Group 1 thresholds, but have more than 250 employees and a net turnover of EUR 40 million worldwide and more. For these companies, rules will start to apply 2 years later than for group 1.

B. Non-EU companies active in the EU with turnover threshold aligned with Group 1 and 2, generated in the EU.

For defining the scope of application in relation to non-EU companies *the described turnover criterion* should be chosen as it creates a territorial connection between the third-country companies and the Union territory. Turnover is a proxy for the effects that the activities of those companies could have on the internal market. In accordance with international law, such effects justify the application of Union law to third-country companies. To ensure identification of the relevant turnover of companies concerned, the methods for calculating net turnover for non-EU companies as laid down in Directive (EU) 2013/34[1] as amended by Directive (EU) 2021/2101[2] should be used.

The definition of turnover foreseen by the Directive 2013/34/EU has already established the methods for calculating net turnover for non-Union companies, as turnover and revenue definitions are similar in international accounting frameworks too.

The Directive applies to the company's own operations, their subsidiaries and their value chains (direct and indirect established business relationships). In order to comply with the corporate due diligence duty, companies need to: *integrate due diligence into policies; identify actual or potential adverse human rights and environmental impacts; prevent or*

[1] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC

[2] Directive (EU) 2021/2101 of the European Parliament and of the Council of 24 November 2021 amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches

mitigate potential impacts; bring to an end or minimise actual impacts; establish and maintain a complaints procedure; monitor the effectiveness of the due diligence policy and measures; and publicly communicate on due diligence.

For the purposes of due diligence, companies are entitled to share resources and information within their respective groups of companies and with other legal entities in compliance with applicable competition law.

► Companies shall *integrate due diligence into all their corporate policies* and have in place a due diligence policy. The due diligence policy shall contain all of the following:

a) a description of the company's approach, including in the long term, to due diligence;

b) a code of conduct describing rules and principles to be followed by the company's employees and subsidiaries;

c) a description of the processes put in place to implement due diligence, including the measures taken to verify compliance with the code of conduct and to extend its application to established business relationships.

The companies shall update their due diligence policy annually.

► Companies take appropiate measures *to identify actual and potential adverse human rights impacts and adverse environmental impacts* arising from their own operations or those of their subsidiaries and, where related to their value chains, from their established business relationships.

In order to allow for a comprehensive identification of adverse impacts, such identification should be based on quantitative and qualitative information. For instance, as regards adverse environmental impacts, the company should obtain information about baseline conditions at higher risk sites or facilities in value chains. Identification of adverse impacts should include assessing the human rights, and environmental context in a dynamic way and in regular intervals: prior to a new activity or relationship, prior to major decisions or changes in the operation; in response to or anticipation of changes in the operating environment; and periodically, at least every 12 months, throughout the life of an activity or relationship. Regulated financial undertakings providing loan, credit, or other financial services should identify the adverse impacts only at the inception of the contract. When identifying adverse impacts, companies should also identify and assess the impact of a business relationship's business model and strategies, including trading, procurement and pricing practices. Where the company cannot prevent, bring to an end or minimize all its adverse impacts at the same time, it should be able to prioritize its action, provided it takes the measures reasonably available to the company, taking into account the specific circumstances.

► In order to ensure that prevention and mitigation of potential adverse impacts is effective, companies should prioritize engagement with business relationships in the value chain, instead of terminating the business relationship, as a last resort action after attempting at preventing and mitigating adverse potential impacts without success.

For cases where potential adverse impacts could not be addressed by the described prevention or mitigation measures, companies shall to refrain from entering into new or extending existing relations with the partner in question and, where the law governing their relations so entitles them to, to either temporarily suspend commercial relationships with the partner in question, while pursuing prevention and minimisation efforts, if there is reasonable expectation that these efforts are to succeed in the short-term; or to terminate the business relationship with respect to the activities concerned if the potential adverse impact is severe. In order to allow companies to fulfil that obligation, Member States should provide for the availability of an option to terminate the business relationship in contracts governed by their laws. It is possible that prevention of adverse impacts at the level of indirect business relationships requires collaboration with another company, for example a company which has a direct contractual relationship with the supplier. In some instances, such collaboration could be the only realistic way of preventing adverse impacts, in particular, where the indirect business relationship

is not ready to enter into a contract with the company. In these instances, the company should collaborate with the entity which can most effectively prevent or mitigate adverse impacts at the level of the indirect business relationship while respecting competition law.

As regards direct and indirect business relationships, industry cooperation, industry schemes and multi-stakeholder initiatives can help create additional leverage to identify, mitigate, and prevent adverse impacts. Therefore it should be possible for companies to rely on such initiatives to support the implementation of their due diligence obligations laid down in the Directive to the extent that such schemes and initiatives are appropriate to support the fulfilment of those obligations. Companies could assess, at their own initiative, the alignment of these schemes and initiatives with the obligations under the Directive. In order to ensure full information on such initiatives, the Directive also refer to the possibility for the Commission and the Member States to facilitate the dissemination of information on such schemes or initiatives and their outcomes. The Commission, in collaboration with Member States, may issue guidance for assessing the fitness of industry schemes and multi-stakeholder initiatives.

► Also, the Directive establishes the obligation for Member States to ensure that companies take appropriate measures *to bring to an end actual adverse human rights and environmental impacts* that they had or could have identified. Where an adverse impact that has occurred at the level of established direct or indirect established business relationships cannot be brought to an end, Member States should ensure that companies minimise the extent of the impact.

Under the due diligence obligations set out by the Directive, if a company identifies actual human rights or environmental adverse impacts, it should take appropriate measures to bring those to an end. It can be expected that a company is able to bring to an end actual adverse impacts in their own operations and in subsidiaries. However, it should be clarified that, as regards established business relationships, where adverse impacts cannot be brought to an end, companies should minimise the extent of such impacts. Minimisation of the extent of adverse impacts should require an outcome that is the closest possible to bringing the adverse impact to an end. To provide companies with legal clarity and certainty, the Directive define which actions companies should be required to take for bringing actual human rights and environmental adverse impacts to an end and minimisation of their extent, where relevant depending on the circumstances.

So as to comply with the obligation of bringing to an end and minimising the extent of actual adverse impacts under the Directive, companies should be required to take the following actions, where relevant. They should neutralise the adverse impact or minimise its extent, with an action proportionate to the significance and scale of the adverse impact and to the contribution of the company's conduct to the adverse impact. Where necessary due to the fact that the adverse impact cannot be immediately brought to an end, companies should develop and implement a corrective action plan with reasonable and clearly defined timelines for action and qualitative and quantitative indicators for measuring improvement. Companies should also seek to obtain contractual assurances from a direct business partner with whom they have an established business relationship that they will ensure compliance with the company's code of conduct and, as necessary, a prevention action plan, including by seeking corresponding contractual assurances from its partners, to the extent that their activities are part of the company's value chain.

The contractual assurances should be accompanied by the appropriate measures to verify compliance. Finally, companies should also make investments aiming at ceasing or minimising the extent of adverse impact, provide targeted and proportionate support for an SMEs with which they have an established business relationship and collaborate with other entities, including, where relevant, to increase the company's ability to bring the adverse impact to an end.

► Companies should provide the possibility for persons and organisations to submit *complaints* directly to them in case of legitimate concerns regarding actual or potential human rights and environmental adverse impacts.

Organisations who could submit such complaints should include trade unions and other workers' representatives representing individuals working in the value chain concerned and civil society organisations active in the areas related to the value chain concerned where they have knowledge about a potential or actual adverse impact. Companies should establish a procedure for dealing with those complaints and inform workers, trade unions and other workers' representatives, where relevant, about such processes. Recourse to the complaints and remediation mechanism should not prevent the complainant from having recourse to judicial remedies.

In accordance with international standards, complaints should be entitled to request from the company appropriate follow-up on the complaint and to meet with the company's representatives at an appropriate level to discuss potential or actual severe adverse impacts that are the subject matter of the complaint. This access should not lead to unreasonable solicitations of companies.

► Under the Directive, companies should monitor the implementation and effectiveness of their due diligence measures. They should carry out periodic assessments of their own operations, those of their subsidiaries and, where related to the value chains of the company, those of their established business relationships, to monitor the effectiveness of the identification, prevention, minimisation, bringing to an end and mitigation of human rights and environmental adverse impacts. Such assessments should verify that adverse impacts are properly identified, due diligence measures are implemented and adverse impacts have actually been prevented or brought to an end. In order to ensure that such assessments are up-to-date, they should be carried out at least every 12 months and be revised in-between if there are reasonable grounds to believe that significant new risks of adverse impact could have arisen.

► Member States shall ensure that companies that are not subject to reporting requirements under Articles 19a and 29a of Directive 2013/34/EU report on the matters covered by the Directive by publishing on their website an annual statement in a language customary in the sphere of international business. The statement shall be published by 30 April each year, covering the previous calendar year.

Like in the existing international standards set by the United Nations Guiding Principles on Business and Human Rights and the OECD framework, it forms part of the due diligence requirement to communicate externally relevant information on due diligence policies, processes and activities conducted to identify and address actual or potential adverse impacts, including the findings and outcomes of those activities. The proposal to amend Directive 2013/34/EU as regards corporate sustainability reporting sets out relevant reporting obligations for the companies covered by the Directive. In order to avoid duplicating reporting obligations, the Directive not introduce any new reporting obligations in addition to those under Directive 2013/34/EU for the companies covered by that Directive as well as the reporting standards that should be developed under it.

But, as regards companies that are within the scope of the Directive, but do not fall under Directive 2013/34/EU, in order to comply with their obligation of communicating as part of the due diligence under this Directive, they should publish on their website an annual statement in a language customary in the sphere of international business, as we mentioned previously.

All these seven measures that companies need to take, in order to comply with the corporate due diligence duty, will contribute to more effective protection of human rights included in international conventions and will help to avoid adverse environmental impacts contrary to key environmental conventions.

Companies in scope will need to take appropriate measures (‘obligation of means'), in light of the severity and likelihood of different impacts, the measures available to the company in the specific circumstances, and the need to set priorities.

Also, national administrative authorities appointed by Member States will be responsible for supervising these new rules and may impose fines in case of non-compliance. In addition, victims will have the opportunity to take legal action for damages that could have been avoided with appropriate due diligence measures.

To ensure that due diligence becomes part of the whole functioning of companies, directors of companies need to be involved. This is why the Directive also introduces directors' duties to set up and oversee the implementation of due diligence and to integrate it into the corporate strategy. In addition, when fulfilling their duty to act in the best interest of the company, directors must take into account the human rights, climate change and environmental consequences of their decisions. Where companies' directors enjoy variable remuneration, they will be incentivised to contribute to combating climate change by reference to the corporate plan.

Small and medium enterprises (SMEs) are not directly in the scope of the Directive.

In order to support all companies, including SMEs, that may be indirectly affected, the Directive also includes, accompanying measures which include the development of individually or jointly dedicated websites, platforms or portals and potential financial support for SMEs.

The Directive will also underpin the Sustainable Finance Disclosure Regulation (SFDR) that has recently entered into force and applies to financial market participants (such as investment fund and portfolio managers, insurance undertakings selling insurance-based investment products and undertakings providing various pension products) and financial advisers. Under the SFDR, these undertakings are required to publish, among others, a statement on their due diligence policies with respect to principal adverse impacts of their investment decisions on sustainability factors on a comply or explain basis. At the same time, for companies with more than 500 employees the publication of such a statement is mandatory, and the Commission is empowered to adopt regulatory technical standards on the sustainability indicators in relation to the various types of adverse impacts1.

Similarly, this Directive will complement the recent Taxonomy Regulation, a transparency tool that facilitates decisions on investment and helps tackle greenwashing by providing a categorisation of environmentally sustainable investments in economic activities that also meet a minimum social safeguard2 .

The reporting covers also minimum safeguards established in Article 18 of the Taxonomy Regulation that refer to procedures companies should implement to ensure the alignment with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organization on Fundamental Principles and Rights at Work and the International Bill of Human Rights when carrying out an economic activity categorized as “sustainable”. Like NFRD and the *Proposal for CSRD,* the Taxonomy Regulation does not impose substantive duties on companies other than public reporting requirements, and investors can use such information when allocating capital to companies. By requiring companies to identify their adverse risks in all their operations and value chains, this Directive may help in providing more detailed information to the investors. It therefore complements the Taxonomy Regulation as it has the potential to

[1] La 4 februarie 2021, cele trei autorități europene de supraveghere au transmis Comisiei raportul lor final (disponibil la adresa https://www.esma.europa.eu/press-news/esma-news/three-european-supervisory-authorities-publish-final-report-and-draft-rts), inclusiv proiectele de standarde tehnice de reglementare în ceea ce privește prezentarea informațiilor în temeiul SFDR

[2] Taxonomia va fi dezvoltată treptat. Toate investițiile eligibile din punctul de vedere al taxonomiei fac obiectul unor garanții sociale minime

further help investors to allocate capital to responsible and sustainable companies. Moreover, the Taxonomy Regulation (as providing a common language for sustainable economic activities for investment purposes) can serve as a guiding tool for companies to attract sustainable financing for their corrective action plans and roadmaps.

In conclusion, all these measures proposed aim to ensure that the Union, including both the private and public sectors, acts on the international scene in full respect of its international commitments in terms of protecting human rights and fostering sustainable development, as well as international trade rules.

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2. Communication from the Commission on the European Green Deal, COM/2019/640 final;

3. Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups;

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