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REGULATORY SCRUTINY BOARD OPINION

Proposal for a Directive of the European Parliament and of the Council on Sustainable Corporate Due Diligence and amending Directive (EU) 2019/1937

COM(2022) 71
SWD(2022) 39
SWD(2022) 42-43

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EUROPEAN COMMISSION
Regulatory Scrutiny Board

Brussels,
RSB

Opinion

Title: **Impact assessment / Sustainable Corporate Governance**

Overall 2nd opinion: NEGATIVE

(A) Policy context

The EU corporate governance framework combines EU rules, national rules and soft law. International bodies, EU, Member States and private actors have made efforts to support the mainstreaming of sustainable governance practices in companies. This initiative aims to codify such practices as legal obligations in the EU corporate governance framework. It is closely linked to a series of ongoing sustainability initiatives, including on sustainable finance (i.e. the taxonomy and the Sustainability Reporting Directive).

(B) Summary of findings

The Board notes the significant revision of the report in response to the Board's opinion. However, the Board maintains its negative opinion, because the revised report still contains the following significant shortcomings:

(1) The problem description remains vague and does not demonstrate the scale and likely evolution of the problems the initiative aims to tackle. It does not provide convincing evidence that EU businesses, in particular SMEs, do not already sufficiently reflect sustainability aspects or do not have sufficient incentives to do so.

(2) The presented policy options remain too limited in scope. Key policy choices are not identified nor fully assessed.

(3) The impacts are not assessed in a sufficiently complete, balanced and neutral way. Uncertainty related to the realisation of benefits is not sufficiently reflected.

(4) The report does not sufficiently demonstrate the proportionality of the preferred option.

This opinion concerns a draft impact assessment which may differ from the final version.

Commission européenne, B-1049 Bruxelles - Belgium. Office: BERL 08/010. E-mail: regulatory-scrutiny-board@ec.europa.eu

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<u>(C) What to improve</u>

Problem definition

(1) The report continues to provide little specific evidence on the scale and evolution of the **environmental and sustainability problems** directly linked to the apparent absence or insufficient use of corporate sustainability management practices by EU companies to be tackled by this initiative. While the assessment of benefits provides ample evidence on the competitive, financial and reputational advantages that companies achieve by applying corporate sustainability practices, the report should identify, and substantiate with evidence, the obstacles that may prevent companies from pursuing sustainable corporate management practices. It needs to demonstrate more convincingly why the market and competitive dynamics together with the further evolution of companies' corporate strategies and risk management systems are considered insufficient. Moreover, it needs to substantiate better the assumed causal link between using corporate sustainability tools and their practical effect in tackling the problems.

(2) The report should present a sufficiently developed and more balanced dynamic **baseline scenario** that integrates (i) the increasing trend of take up of corporate sustainability practices, (ii) the large number of related measures already adopted and parallel regulatory measures being developed (including sectoral and sustainable product due diligence), (iii) the comprehensive package of measures to promote sustainability under the Green Deal and (iv) the developments expected in third countries with sustainability sub-standards resulting from own commitments as well as substantial EU and international trade and development support measures.

Options

(3) The report is not clear about why it is necessary to regulate **directors' duties on top of due diligence requirements**. It should better explain and assess the value- added of regulating directors' duties, considering that the due diligence option already requires risk management and engagement with stakeholders' interests. It should justify why stand-alone options covering directors' duties or due diligence requirements only were not identified and subsequently compared with the combination options.

(4) As regards enforcement, the report discards mandatory due diligence policy options that do not include a **civil liability regime** without providing evidence of their apparent lack of effectiveness. Given that stakeholders consider administrative supervision as the preferred option (and this seems a solution also introduced at Member State levels), the report should better assess and compare all feasible enforcement options, including a stand-alone administrative supervision option. The report should also include more detail on the functioning, efficiency and effectiveness of the envisaged sanction regimes (e.g. withdrawal of products from the market, exclusion from public procurement), in particular with respect to non-complying third country undertakings. It should be clearer on the feasibility and impacts of possible overriding mandatory provisions as regards applicable law and assess any unintended consequences.

(5) The options **extending the scope into medium-sized companies** should better account for the results of the new SME study, which shows both a significant uptake already in exposed sectors as well as an important trickle-down effect through the value chain of measures adopted for large companies. The report should better justify and substantiate with evidence why certain medium-sized companies operating in '**high-impact' sectors** should be included in the personal scope. It should present

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clear and objective criteria that would be used in determining such sectors. To the extent that specifying the selection design comes with policy choices (including on the legislative technique to be used, as implementing legislation is mentioned in the annex), these should be assessed and compared in terms of costs and benefits. The report needs to be clearer on the envisaged **phasing in** of the requirements for medium-sized companies. It should also be more specific on the safeguards it would include to prevent that large companies impose unjustified compliance burden on SMEs in their value chain. If this comes with policy choices, it should present and analyse alternatives.

(6) To ensure greater **regulatory coherence,** the report should consider aligning the personal scope better with the scope of parallel initiatives, such as the Corporate Sustainability Reporting Directive. It should also discuss more thoroughly how coherence will be ensured with the parallel sectoral and product due diligence initiatives and whether these could become (partially) superfluous.

(7) The report should be more precise which selected **international environmental conventions** should be included in the material scope of the due diligence obligations and why. It should ensure that it does not unduly extend specific EU commitments (e.g. from the Climate Law) to third countries.

(8) Regarding the **inclusion of companies without an EU establishment,** the report should specify and justify what the 'adequate turnover' threshold should be (the annex mentions EUR 350 million) or assess alternative options in case the Commission enjoys discretion on this. It should make an effort to estimate how many foreign companies would be affected respectively, as this is important to assess the proportionality of the measures in terms of overall benefits and costs. It should clarify whether all worldwide activities of foreign companies would be subject to the due diligence duty or only activities with a clear (turnover) link to the EU. Similarly, for companies established in the EU, the report should clarify whether all their global activities under control would be covered (e.g. products produced in China and sold exclusively in the US).

(9) The description of the directors' duties should clarify how directors need to **incorporate conflicting interests of stakeholders** and sustainability aspects. It should clarify whether or not there is a long-term interest of the company that could supersede particular interests of stakeholders or beneficiaries or particular sustainability considerations.

(10) The report should justify and substantiate with evidence the **need for a mandatory science based target** for climate change mitigation (and potentially also for bio-diversity) as part of the corporate strategy of very large companies. It should clarify which gap in climate mitigation legislation it would fill. It should explain how these targets would be established and function and how independent validation would be ensured. It should justify why the requirement for science-based targets is linked to the size of a company and not to the scale of emissions it is responsible for. The report should explain why science based target setting is part of directors' duties and not due diligence, which already requires companies to mitigate adverse effects.

(11) The report should better explain the precise **role of public authorities** in checking the corporate strategy and the scientific targets. It should also better explain which national authority would be best placed to act with respect to non-compliance of third-country undertakings. It should also explain how effective coordination among national authorities would be ensured, for instance launching ex-officio procedures or imposing sanctions and what role a 'mechanism of EU cooperation/coordination'

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would play.

Impacts

(12) The report should be more balanced and complete in terms of presenting potential impacts concerning **competition, innovation, agility and litigation risks**. While stricter sustainability requirements may spur innovation, there is also a risk that due diligence will make companies less dynamic and agile – and more dependent on a set of fixed providers, in particular in highly concentrated sectors, with only a very limited number of suppliers. The report should assess to what extent the measures envisaged will make it more difficult for certain industry sectors to diversify their suppliers and to improve the resilience of their supply chain. It should assess impacts on competition that may arise from potential increased vertical integration by businesses as well as from the exchange of commercially sensitive information resulting from joint company value chain due diligence efforts. It should assess more thoroughly whether the potentially increased risk of (unsuccessful) litigation could also make EU companies less dynamic and agile.

(13) The report should better account for potential negative **impacts in third countries**, notably in developing countries, by being more realistic on risks and costs and the contribution of potential soft mitigation measures. It should better assess the risk of 'sustainability leakage'. If EU companies will ultimately have to withdraw from certain suppliers due to sustainability issues, third-country companies (if out of the personal scope) could take over these suppliers and thereby gain a competitive advantage and supply chain control, while leaving no improvement in overall human rights and environmental performance.

(14) Based on a clarification of the personal scope, the report should assess more thoroughly the impacts of the options on the global level playing field and **competitiveness of EU companies**, in particular for SMEs in scope. While a large number of EU SMEs active in 'high impact' sectors would be covered (e.g. turnover higher than EUR 8 million), this is not the case for their 'SME competitors' established in (neighbouring) third countries (as they are very unlikely to be above the indicated much higher EU turnover threshold of EUR 350 million). The report needs to assess the potential competitive disadvantage for the affected EU SMEs. Similarly, as directors' duties obligations would apply only to EU established companies, the report should assess more thoroughly the impacts on their competitiveness, including the risk that EU companies may relocate their headquarters to (neighbouring) third countries.

(15) The report should assess how the proposed EU corporate sustainability governance rules would fit with the different **national corporate governance models** existing in the EU, given the national focus of company law.

Comparison of options and proportionality

(16) While the report provides greater clarity on the substantial costs of the initiative, it still does not sufficiently reflect the high uncertainty that the estimated benefits will actually materialise on a scale to outweigh the costs. The report should therefore further improve the **proportionality assessment** of the (preferred) option(s) by reconsidering the arguments for the inclusion of medium-sized EU companies operating in high impact sectors and the broad scope of mandatory measures.

(17) The **comparison of options** in terms of effectiveness should analyse the expected achievement of the specific objectives identified in the objectives section.

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Consultation and methodology

(18) The report should present more systematically the **views of different stakeholder categories.** It should find a better balance between supportive and critical views expressed. The views of SMEs should be singled out to support the discussion on scope and options.

(19) The report would benefit from a more precise summary of the final **preferred option**, including in terms of the variation in scope across elements.

(D) Conclusion

The Board's opinion is in principle final. The DG should seek political guidance on whether, and under which conditions, this initiative may proceed further.

Full title	Impact assessment / Sustainable Corporate Governance
Reference number	PLAN/2019/5404
Submitted to RSB on	8 November 2021
Date of RSB meeting	Written procedure

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Title: Impact assessment / Sustainable Corporate Governance

Overall opinion: NEGATIVE

(A) Policy context

The EU corporate governance framework combines EU and national rules and soft law. International bodies, EU, Member States and private actors have made efforts to support the mainstreaming of sustainable governance practices in companies. This initiative aims to integrate such practices more firmly in the EU corporate governance framework. It is closely linked to a series of ongoing sustainability initiatives, including on sustainable finance (i.e. the taxonomy and the Sustainability Reporting Directive).

(B) Summary of findings

The Board notes the additional information provided in advance of the meeting and commitments to make changes to the report.

However, the Board gives a negative opinion, because the report contains the following significant shortcomings:

(1) The problem description is vague and does not demonstrate the magnitude and likely evolution of the problem. It does not provide clear evidence that EU business (including SMEs) do not sufficiently address sustainability opportunities, risks and impacts.

(2) The policy options are too limited and do not adequately reflect the available policy choices in terms of company and sector scope, content of measures and range of delivery instruments. The added value and likely effectiveness of several of the measures are unclear.

(3) The assessment of proportionality is insufficient. Costs and benefits are not sufficiently presented.

(4) The report does not sufficiently integrate differentiated stakeholder views.

(C) What to improve

(1) The problem definition sets out a very broad and intangible problem. The claimed insufficient sustainability practices in companies concerns a wide range of climate, environmental, human rights, social and health related issues and their internal and external

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impacts. The report should clarify what problem this initiative aims to tackle and why it is not sufficiently covered by existing or planned sectoral and horizontal legislation or private sector initiatives. The report should clarify if the problem concerns insufficient sustainable governance in the interest of the company, or companies breaching sustainability and human rights standards. It should describe the magnitude of the problem and how it will evolve, taking into account expected market and societal dynamics. It should clearly establish why the problem cannot be tackled appropriately at the level of Member States.

(2) The report is not clear about why existing sustainability strategies and corporate management practices are considered as insufficient or what in practice companies would have to do to have adequate sustainability governance practices in place. It should substantiate with clear evidence that EU business (including SMEs) do not sufficiently address sustainability opportunities, risks and impacts via their corporate management systems.

(3) The report argues that the problems pertain to more or less all companies independent of their size (all above 20 employees) or sector. What is the risk that SMEs are engaged in unsustainable practices? What is the evidence that companies (particularly SMEs) in all sectors will have the market power to generate real change on the ground through processes of due diligence and directors' duties?

(4) The policy options are too limited and do not sufficiently reflect the available policy choices. Given the sensitive nature of corporate governance, the radical change of approach from existing practise, the uncertainty in terms of effectiveness and efficiency, and potential subsidiarity issues, the policy options should offer a broader and more nuanced range of options allowing for more diverse policy packages, with measures including different levels of ambition, scope and legal obligations. Soft law instruments should be assessed in a more nuanced and balanced way, and be considered in possible combination with selected hard law elements. The need for transitional measures, including experimental or adaptive approaches should be considered.

(5) Overall, the options should provide more clarity on the content, added value and effectiveness of elements included such as due diligence, target setting at company level, directors' nominations or the role of competent authorities. The report should also clearly set out the added value of a very broad horizontal due diligence regime compared to sectoral approaches focusing on clearly identified shortcomings.

(6) The report should clarify how third country businesses would be covered by the initiative and how effective enforcement would be ensured in view of global level-playing-field concerns. It should clarify what standards would apply to third country companies in the value chain and how these would be aligned with international agreements, such as the Paris Agreement.

(7) A more consistent intervention logic should be established, based on a clearer problem definition, specific objectives expressed in SMARTer terms and a clearer link to a wider range of policy options. Costs, benefits, trade-offs, and proportionality of options should be brought out more clearly.

(8) The report should include a more nuanced assessment of impacts on companies, notably SMEs, innovation and competitiveness. It should assess how this initiative impacts on the fundamental rights to conduct a business and on property and ownership rights. Moreover, the report needs to clearly distinguish between having certain practices (e.g. due diligence obligations, sustainability targets) in place and the extent to which they are effective in reaching sustainability or human rights objectives, and having a real world impact on climate, environment and social issues. It should also convincingly show that

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these effects could not be reached by other legislation or voluntary corporate initiatives under the baseline.

(9) Given the uncertainty that the expected benefits will actually materialise and the substantial costs resulting from a broad set of measures that would be imposed on up to 2 million companies, the proportionality of the options needs to be significantly better argued. In particular, the inclusion of SMEs in the scope requires a more critical proportionality reflection. Subsidiarity issues also require more attention, given that many SMEs operate largely within national borders and given the national focus of company law. The comparison of options should provide a more convincing assessment of effectiveness, efficiency, coherence and proportionality.

(10) The report should present the diverse stakeholder views better. This should be done in the main text (notably in the problem section and when discussing options and impacts) but also in annex 2, while more seriously addressing the criticism raised by stakeholders and academics. More generally, the report should be revised to present the evidence in a more balanced and neutral way.

Some more technical comments have been sent directly to the author DG.

<u>(D) Conclusion</u>

The DG must revise the report in accordance with the Board's findings and resubmit it for a final RSB opinion.

Full title	Sustainable corporate governance
Reference number	PLAN/2019/5404
Submitted to RSB on	9 April 2021
Date of RSB meeting	5 May 2021

Electronically signed on 26/11/2021 11:41 (UTC+01) in accordance with article 11 of Commission Decision C(2020) 4482

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