EU ESG Regulations in the Spotlight

A sweep of ESG-related measures are in the legislative pipeline for companies. As a ground-breaking proposal for a Corporate Sustainability Due Diligence Directive enters a crucial negotiation stage at EU level, Matheson analyses the latest developments.

ESG themes remain firmly in the spotlight with the progress of far-reaching corporate sustainability proposals[1] through the EU legislative process. While the EU's primary policy focus in this area has been on corporate reporting, the proposed new measures look beyond what companies say about their ESG performance and at what they actually do. The emergence of cracks between the various views of the EU co-legislators suggests that the path to getting the measures onto the statute books may not be as straightforward as initially appeared.

The Corporate Sustainability Due Diligence Directive (CS3D) would see a substantive duty on large companies to identify and address adverse human rights and environmental impacts of their operations, subsidiaries and "value chains". Certain classes of in-scope companies would have to draw up plans to meet the objectives of the Paris Climate Agreement. As currently framed, the requirements could also impact entities with which an in-scope company has a corporate relationship.

Legislative Path

The February 2022 European Commission (Commission) proposal for CS3D follows on from the Corporate Sustainability Reporting Directive (CSRD). The latter came into force on 5 January 2023 and transposition measures are currently being formulated across Member States in advance of the deadline of 6 July 2024. Reporting standards are being developed at EU level. CS3D and CSRD are closely linked. They, along with other significant legislation in this space, stem from the ambitious legislative targets set by the Commission to underpin the European Green Deal[2] committing the EU to climate neutrality by 2050.

CS3D is to be adopted through the ordinary legislative procedure, meaning that the European Parliament and Council, as co-legislators, will have to adopt the same final text.

In December 2022, following extensive negotiation, the Council agreed its General Approach[3] for negotiations with the Parliament. The General Approach recommends some significant changes to the Commission's proposal (the chief ones being outlined below). The Council must now wait for the Parliament to reach its own agreed position (expected in June 2023) before the two institutions begin negotiations.

Early signals from the Parliament are that core aspects of the Council's compromise text will be rejected. Currently, it seems that there are significant policy gaps to be bridged between the parties.

1 https://commission.europa.eu/business-economy-euro/doing-business-eu/corporate-sustainability-due-diligence_en

2 https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal_en

3 https://data.consilium.europa.eu/doc/document/ST-15024-2022-REV-1/en/pdf

UNDER THE COMMISSION PROPOSAL, IN-SCOPE COMPANIES WOULD BE SUBJECT TO DETAILED DUE DILIGENCE, MONITORING, REMEDIAL AND PUBLIC DISCLOSURE OBLIGATIONS.

In-scope Entities

In determining which companies will fall under CS3D, for EU companies, the criteria are based on the number of employees and the net worldwide turnover. For non-EU entities, you look at net turnover generated in the EU. Under the Commission proposal, these are the qualifying thresholds:

Group 1 companies	All EU limited liability companies with 500+ employees and €150 million+ in net turnover worldwide in the last financial year *Council seeks thresholds met for past two financial years	Approximately 9,400 companies
Group 2 companies	Other EU limited liability companies operating (to the extent of 50% of turnover generated) in defined high impact sectors such as textiles, agriculture and mineral extraction, which do not meet both Group 1 thresholds, but have 250+ employees and a net turnover of €40 million+ worldwide in the last financial year. * Council proposes two year delay in application *Parliament may wish to see the energy, construction, financial services and technology sectors added to list	Approximately 3,400 companies
Non-EU companies active in the EU	Turnover thresholds generated in the EU aligned with Groups 1 and 2	Approximately 3,400 companies

The Council advocates a delayed and phased-in approach with CS3D applying first to “very large companies” (with more than 1000 employees and €300 million net worldwide turnover or, for non-EU companies, €300 million net turnover generated in the EU), three years from the entry into force of CS3D. Indications are that Parliament, in contrast, may seek lower thresholds and reduced timelines, bringing more companies in scope, sooner.

The Commission’s proposal envisages financial services as being within the scope of the Directive. In a major policy divergence, the Council recommends that each Member State decides whether to include financial services within the definition of “chain of activities” when transposing the CS3D. This approach has come under fire for undermining a core function of EU Directives in creating a harmonised approach across Member States (including by Irish delegates).

New Duties

Under the Commission proposal, in-scope companies would be subject to detailed due diligence, monitoring, remedial and public disclosure obligations. The human rights issues and environmental impacts encompassed by the due diligence duty are contained in an annex to the Directive and relate broadly to measures under international human rights and environmental conventions.

The Commission proposal involves a full life-cycle concept, applying to the company’s operations, and those of its subsidiaries and “value chains” (being direct and indirect established business relationships). The Council proposes a narrower concept relating to a company’s “chain of activities”. This means a company’s “upstream and in a limited manner also downstream business partners”, including distribution, and expressly excludes the use of a company’s products by its consumers. The Council’s text

emphasises a risk-based approach and proposes rules on the prioritisation of the adverse impacts to ensure that carrying out due diligence obligations is feasible for companies.

There are indications that the Parliament favours a "whole value chain approach", suggesting a serious divergence in views on this issue.

Climate Change Targets

Under the Commission proposal, a Group 1 company (and equivalent non-EU companies) must adopt a plan 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 under the Paris Climate Agreement.

The Council wants to see a proposal to link directors' remuneration to setting climate plans dropped.

Garret Farrelly, Chair of Matheson ESG Advisory Group

Directors' Duties

The Commission seeks to expand directors' duties at national level and would see them assume a range of duties related to the implementation of CS3D's requirements. It would require directors, in fulfilling their duty to act in the best interest of the company, to take into account the consequences of their decisions for sustainability matters, including, where applicable, human rights, climate change and environmental consequences, including in the short, medium and long term.

The Council wishes to see these requirements dropped.

Enforcement

Member States will designate a national authority to supervise and impose effective, proportionate and dissuasive sanctions, including fines and compliance orders.

A civil liability redress mechanism must, under the Commission proposal, be established at national level to ensure that victims are compensated for a company's breach of CS3D. The Council seeks a narrowing of the civil liability component, tied to concepts of intent or negligence on the company's part. The Parliament, however, will seemingly take a tougher stance, favouring strict liability, and widening potential liability to include parent companies.

Timelines

Once adopted, Member States will have two years to transpose the CS3D into national law. In Ireland, this will involve changes to the current company law regime.

Matheson View

Matheson continues to closely monitor EU policy deliberations on CS3D and advises companies to keep up to date with this fast-evolving area. Despite the divergent views concerning CS3D among the EU co-legislators, the EU remains at the forefront of ESG regulation.

Information correct as of 28th May 2023.