Association for Financial Markets in Europe

Corporate Sustainability Due Diligence Directive

AFME position paper

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Introduction

AFME supports the policy objectives of enhancing due diligence on human rights and environmental impacts provided by the proposed directive on Corporate Sustainability Due Diligence (CSDDD). However, it is necessary to ensure that the proposal takes a proportionate, risk-based approach and provides a clear, practical and legally certain framework. It should also be better aligned with the relevant international normative standards i.e. the UN Guiding Principles on Business and Human Rights and the OECD Guidelines. In particular, where the proposal goes beyond these existing standards (e.g. contract termination), it should be proportionate.

A number of areas need clarification, in particular with respect to the application to financial institutions and financial services e.g. clarifying the scope of the due diligence obligation. It is important to provide legal certainty, particularly in light of the responsibility of directors and the potential liability introduced by the directive.

We welcome the appreciation in the proposal that it is necessary to carefully consider the application of the due diligence requirements to financial services firms given the very large number of counterparties that they have. Financial institutions have many thousands of counterparties and are already subject to numerous regulatory requirements, including with respect to managing environmental, social and governance risks. It is therefore essential to ensure a proportionate, risk-based and workable approach to due diligence, in particular for client relationships of financial institutions.

While we welcome the policy intent regarding the definition of value chain for financial institutions as outlined in Recital 19, we believe that it is necessary to further clarify the financial services in scope and that it should, with respect to financial services business, apply only to relevant clients receiving lending, credit, financing, insurance or reinsurance services.

The implications and impact of the proposal for companies' international businesses and supply chains should be carefully considered. While we welcome that the proposed annex is based on international standards, we note that the extensive requirements in the proposal go further than some other international jurisdictions, in particular in developing economies, potentially impacting the international competitiveness of EU companies. In this respect it is important to ensure that the requirements take a proportionate, risk-based and workable approach for EU firms with international businesses and non-EU firms with EU businesses. Moreover, it is essential that the requirements do not create a systematic barrier to international trade, whether to non-EU companies doing business in the EU or for EU companies with respect to their international businesses and supply chains.

We would also note that many of the referenced international agreements for environmental and human rights have been signed and/or ratified by many jurisdictions. Following a risk-based approach, where a counterparty is located in a jurisdiction that has ratified these agreements, provided that the counterparty warrants that it complies with relevant laws and statutes, this should be considered adequate for due diligence purposes unless there is clear evidence that the counterparty is in breach with the applicable conventions.

It is also important to ensure consistent application of the requirements throughout the EU to ensure a level playing field.

Overall, we do not consider that the approach in the proposal to directors' duties is proportionate. We consider that further consideration is required as the proposal introduces very broadly worded changes to directors' duties which would give rise to liability and potential litigation risk, but at the same time give rise to significant uncertainty as to how these should be applied in practice.

We expand below upon our priorities to:

1. Ensure a clear, practical and legally certain due diligence obligation;
2. Clarify the scope of the due diligence requirements for financial services firms;
3. Provide a proportionate territorial scope and international coordination; and
4. Ensure a proportionate approach to directors' responsibilities.

Scope of the due diligence obligation for financial institutions

We welcome the recognition in the proposal of the need to include specific provisions to define the scope of the due diligence obligation for financial services provided by regulated financial undertakings. It is essential that a proportionate, risk-based and clear approach is taken for regulated financial undertakings in light of the regulatory requirements to which they are already subject and the very large number of counterparties.

We strongly support the need to distinguish between supply chains with respect to the operations of a financial undertaking and the provision of financial services to clients of financial institutions. We support the Commission's proposed policy intent to limit the personal scope of the value chain to the direct clients of financial institutions. However, there are a number of areas where further clarification of the proposal is required. These include:

Definition of value chain: we support the policy intent to limit the value chain with respect to financial services to the clients receiving financial services and to exclude SMEs and retail clients (as referred to in Recital 19). However, we propose the following changes and clarifications:

The due diligence value chain with respect to regulated financial undertakings' clients should be limited to clients receiving loan, credit, financing, insurance or reinsurance services. We believe that this is the focus in the proposed definition in Article 3(g). However, banks provide a broad range of financial services which do not always cover financing activity and it should be clarified that other types of financial services, for instance, safekeeping services such as custody, or trading or payments activities, are excluded from the scope of the value chain. In contrast to lending, trading and payments activities are frequently of short duration and are of a different nature to financing of businesses where there is a longer-term relationship and the financing may be used to fund the client's business. This is an important distinction which should be reflected in the directive.

It is also unclear how the extension of the obligation to activities of other companies belonging to the same group "whose activities are linked to the contract in question" should be applied. Banks may not know the identity of all affiliates of a borrower, for example for general purpose loans which are not dedicated to funding specific activities of the client. We therefore propose that this should be clarified to include only counterparties named in the relevant contract.

The exclusion of "SMEs receiving loan, credit, financing, insurance or reinsurance" is insufficient to cover the breadth of financial services that are provided to SMEs, for example payments services. This would be addressed through the clarified scope of the value chain as we propose above, but if this is not amended, the exclusion of SMEs should be replaced with a general exclusion of SMEs from the value chain of regulated financial undertakings. It should also be similarly clarified that retail clients are fully excluded.

There is a lack of clarity around thresholds in terms of value of contracts subject to due diligence, which could lead to all clients and suppliers being required to be subject to the same due diligence procedures. The CSDDD proposal appears to focus on wholesale clients, but there is a lack of clarity around the application to retail clients. While the proposal excludes its direct application to retail clients of financial institutions or clients below the thresholds, these often constitute the customer base or the value chain of larger non-financial groups subject to the CSDDD requirements, and will consequently be affected by the proposals. Therefore, it should be clarified that SMEs and private individuals including any business or other client relationship with them is out of scope of the directive.

Due diligence for financial services clients: we also welcome the intent behind article 6(3) to provide that, with respect to financial services, the identification of actual and potential adverse impacts should be carried out only before providing "credit, loan or other financial services". However, it is important to clarify how this provision should operate in practice and as discussed above we propose that the scope of the due diligence requirement should be limited to loans, credit, financing, insurance or reinsurance services and not broader categories of financial services. It should be considered how this obligation can be made workable in practice, for example whether due diligence may be conducted as part of on-boarding processes for relevant clients, supplemented as necessary and subject to an annual update.

We would note that the extent of due diligence requirements in the text are unclear and would require extensive guidance from the Commission and Member States. Financial institutions typically conduct due diligence through a risk-based approach which is tailored to the counterparty, industry or activity being financed. For example there are differences between lending for general purposes and financing for specific projects which need to be recognised.

Scope of application and international coordination

It is important to carefully consider the implications and impact of the proposal for companies' international businesses and supply chains. While we welcome that the proposed annex is based on international standards, we note that the extensive requirements in the proposal go further than some other international jurisdictions, in particular in developing economies, potentially impacting the international competitiveness of EU companies and introducing substantial additional obligations for non-EU companies within the scope of the directive. It is important to ensure that the requirements take a proportionate, risk-based and workable approach for EU firms with international businesses and non-EU firms with EU businesses. Moreover, the CSDDD requirements should not create a systematic barrier to international trade, whether to non-EU companies doing business in the EU, or for EU companies with respect to their international businesses and supply chains.

The proposed scope is likely to cover not only large international EU financial institutions at consolidated level but also non-EU financial institutions with cross-border business and/or branches in the EU, requiring both EU and non-EU international financial institutions to comply with the EU CSDDD requirements throughout their global businesses. These global businesses are likely to be subject to different jurisdictional requirements and the proposal as it stands would cover business with no nexus to the EU, for example loans from a non-EU bank to a non-EU company or a Chinese company selling goods or services to a customer in China. Such extraterritorial application raises concerns for non-EU members and is also likely to give rise to enforcement challenges. To address this while maintaining a level playing field between banks headquartered in the EU and those headquartered outside the EU, we propose that the scope should be limited to business with a nexus to the EU. We are considering further how this principle should be applied in practice for financial institutions and would welcome the opportunity to discuss this with the co-legislators.

We also encourage the EU to coordinate with other international jurisdictions to ensure a consistent and coherent approach to achieving the policy objectives in the CSDDD proposal.

When competing for financing business in non-EU regions (particularly emerging markets), EU firms and non-EU firms with an EU footprint above the revenue threshold will be subject to requirements that would be likely to render them uncompetitive compared with large regional banks. This effect would also be amplified if the scope of the due diligence requirement for banks is not clearly limited to financing and insurance services as discussed above. If measures are not coordinated internationally, banks operating in the EU could be rendered less competitive outside the EU against local/regional competitors which are not subject to CSDDD obligations, resulting in financial market fragmentation and an un-level playing field for firms active in the EU. Similar considerations and concerns are likely to apply to companies in other economic sectors.

Practicalities of the due diligence obligation for financial institutions

Group application of due diligence policy and processes: As due diligence policies are frequently set at group level, it is important that the requirements for companies to integrate due diligence into their corporate policies and to put in place a due diligence policy are sufficiently flexible to accommodate a group-level approach to due diligence processes and a group-wide due diligence policy. As currently drafted, article 5 requires each company to put in place a separate policy and update it annually. It should be clarified that companies could do so or be included in a due diligence policy as part of a corporate group. This will allow companies to ensure that they take a consistent approach across the group.

In addition, article 5 establishes that "Member States shall ensure that companies integrate due diligence into all the corporate policies and have in place a due diligence policy". We consider that the obligation to set a specific due diligence policy should be left to the discretion of the company´s internal management and organisation, which should evaluate whether its existing policies already cover the requirements of the CSDDD. Further, it does not make sense to require integrating due diligence in "all" corporate policies. There will most likely be numerous policies that are unrelated to the subject of the directive. It should be clarified that it should be integrated into all *relevant* policies.

We have concerns regarding the practical application of the envisaged actions to prevent potential adverse impacts under article 7. Even assuming that the clarifications on the scope of the due diligence requirement proposed above are made, seeking contractual assurances throughout a bank's value chain together with the proposed requirement for verification measures imposes a tremendous burden and leads to a high risk of litigation.

We query how this is envisaged to work in practice, as it is unlikely to be feasible for all of a bank's corporate clients to contractually agree to comply with the bank's code of conduct and for the bank to comply with each of theirs, particularly given that codes of conduct will be updated annually. This will be particularly challenging for large international financial institutions that will be subject to the CSDD across their global businesses.

This would result in banks and companies across industries being contractually required to comply with a multitude of codes of conduct, potentially hundreds of them. Each code would have to be analysed, the company's internal policies and procedures benchmarked against the requirements of each code, adjusted if necessary and a compliance system would have to be introduced to monitor compliance. This would not only be extremely costly, it would be practically impossible to implement for companies with many business partners and global operations.

To address this concern, we propose that the Commission should be mandated to establish principles that they expect to be followed through a level 2 measure, for example through developing a template code of conduct, similar to the model policy provided in Annex II to the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas. An alternative approach could be to let the institution assess whether the client has processes in place to ensure compliance with international conventions and limit the application of banks' code of conduct to situations where no such process is in place.

It is unclear what measures are required to verify compliance of contractual assurances and further guidance on the expectations for verification should be provided. It is important that verification requirements are proportionate. Implementing measures to verify compliance of contractual assurances is likely to be very challenging to achieve. Furthermore, independent third party verification can be highly costly.

When it comes to identifying actual and potential adverse impacts, article 6(4) is disproportionately wide as it lays down a practically unlimited obligation to consult potentially affected groups, possibly on a global basis. It should be sufficient to limit the consultation obligation to situations where an actual complaint within the meaning of article 9 or substantiated concern within the meaning of Article 19 has been submitted.

The general scope of actions required to be taken to prevent potential adverse impacts and to bring actual adverse impacts to an end, set out in article 7(2) and article 8(3) respectively, provides for a number of different actions "where relevant". It is unclear when these actions will be "relevant" and therefore required. There is also uncertainty over what is meant by "making necessary investments" or "of collaboration with other entities" and what actions are expected to be taken under these provisions. Given the consequences that can derive from potentially not having made the necessary investments, it is important that the proposal clarifies what is considered as "necessary investments".

It is important to note that failure to comply with these unclear requirements will result in civil liability and/or sanctions for the bank and also a breach of the proposed director responsibility under article 26. Given the vagueness and uncertainty of the requirements this should be reconsidered. Civil liability does not appear to be the appropriate remedy; sanctions that may be imposed by authorities should be limited to clear and severe breaches, taking into account the required discretion for companies to implement the requirements of the directive with respect to the specificities of their business model and industry.

The OECD in its paper "Due Diligence for Responsible Corporate Lending and Securities Underwriting"[1] identifies that banks may be causing, contributing or being linked to adverse impacts. However, financial institutions are primarily exposed to adverse impacts through being linked to those adverse impacts through their business relationships. Even in those circumstances, once a financial institution has provided financing, the ability to prevent or rectify human rights or environmental degradation is limited and any requirements should be proportionate to the types of facilities contemplated. Any forced cessation of relationships, particularly for projects which have not reached completion, create risk of substantial losses on the bank's

[1] http://mneguidelines.oecd.org/due-diligence-for-responsible-corporate-lending-and-securities-underwriting.pdf

financial exposure beyond those contemplated by the original credit assessment. The proposed approach is also inconsistent with the UNGPs and the OECD Guidelines that provide that the enterprise should consider ending the relationship, taking into account credible assessments of potential adverse human rights impacts of doing so, but do not make such termination mandatory. We therefore consider that the requirement to terminate contracts is disproportionate.

Furthermore, and as highlighted in AFME's response to the Corporate Governance consultation, the requirements on financial institutions to be able to identify, prevent, mitigate and bring actual and potential adverse impacts to an end are extremely onerous, if not impossible. Banks are able to identify adverse impacts once occurred, but they would be unable to always foresee those potential adverse impacts, mitigate or bring a stop to them. Furthermore, it is necessary to balance different interests including the potential consequences for a borrower if a bank stops financing them. The need to balance such interests should be clearly reflected in the text.

Complaints procedure and civil liability regime

The directive includes an obligation for entities to establish procedures that, inter alia, allow for complaints regarding actual and potential adverse impacts in relation to their business, their subsidiaries and their supply chains to be adequately addressed (Art 9). The legal standing to log a complaint seems to be very broad (encompassing potentially affected persons, trade unions and other workers' representatives, and civil organisations), which could have the collateral effect of encouraging complaints. We therefore view the scope of persons to make a complaint as too broad and should not extend, for example, to NGOs but should be limited to stakeholders that are directly affected. Furthermore, it is not sufficiently clear what is meant by "adequate" treatment. It may lead to an over judicialization of corporates' activities.

We also consider that entitling the complainant to meet with appropriate representatives with the company is unduly onerous, in particular where activists conduct sustained campaigns to try to halt business activities or in circumstances where claims are without merit.

Furthermore, it is unclear how far liability is intended to extend. The only exemption provided for is the one contemplated under article 22.2. If the adverse impact arises as a consequence of a bank's affiliate's or partner's operations, would the bank need to pay for damages first and then claim those damages from the affiliate or partner? A particular concern for involving banks in the chain of liability is the relative size of bank balance sheets versus those of the actual offender. As banks would typically have greater collective resources for payout of claims than the actual offender, there would be incentive for plaintiffs to draw banks into litigation as the potential rewards would be greater. We object to this "deep pocket" approach and request that any company should only be liable for its own breaches of the directive – which would also take into account the fact that a company, notably a bank, does not have control over the behaviour of its business partners, even if such business partner is contractually bound by appropriate compliance obligations.

Transition plans

It is important to consider the application to banks of the proposed obligation under Article 15 for companies to adopt a plan to ensure that the business model and strategy of the company are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 C. Significant work is already underway on transition plans for the financial services sector and it is essential to ensure that this obligation is compatible with other legal and regulatory requirements, both in the EU and internationally, for example in the context of the upcoming CSRD and upcoming transition plan requirements in other jurisdictions.

Directors' responsibility and remuneration

We do not consider that the proportionality of the proposed duty of care obligation has been demonstrated, which we note that during the drafting process has been a concern held by the Commission's Regulatory Scrutiny Board. In addition, we do not consider that, given the proposed civil liability articles, article 25 is required in any form and propose that it is deleted. Regulation of the directors' duty of care in this Directive as envisaged, where, for example "sustainability matters" or "short, medium and long term" are not defined, brings not just liability but also the risk of litigation. As such it would bring great legal uncertainty for EU companies and therefore should be deleted. Furthermore, the definition of directors' duty of care has not been harmonized at EU level and Member States have different legal frameworks.

If the proposal regarding directors' duty of care is retained, we would raise the following specific concerns.

It should be clearly delineated. For example rather than referencing "sustainability matters" it could reference sustainability-related obligations under the applicable law of the European Union or the relevant Member State. It should also be clarified how the expansion of the duty of care should interact with existing fiduciary duties, for example what weighting should be given and how directors should balance the expanded duty with other duties.

In light of the wide definition of "director" in article 3(o) it should be clarified that the primary responsibility to comply with the requirements of the directive is for the company and directors can only be responsible within the scope of their functional responsibilities (that may be it managerial or supervisory in nature) as they are defined under the relevant corporate governance rules – that may be different in each member state and also depend on the specific legal form of the company. In particular, it should not interfere with the principle of the collective decision-making of the board in some jurisdictions. It should be clarified that both the scope of duties and responsibilities and the impact on remuneration are subject to the peculiarities, particularly roles, functions and responsibilities as specified under the relevant national corporate governance regime.

In addition, the current proposal does not address how possible conflicts in the proposal are to be reconciled, for example, how the proposed termination obligations should interact with directors' duties/the duty of care (e.g. withdrawing from a lucrative material contract in line with Article 8, which could impact a company's balance sheet).

With respect to the proposed responsibility of directors for putting in place and overseeing the due diligence actions under article 26, we consider that this action is undertaken by appropriate senior management.

In addition, the Directive (Articles 5 and 26) provides that undertakings shall consider the contributions of interest groups and civil organizations for the implementation and annual updating of the specific due diligence policy required by the Directive, it shall include a code of conduct and a description of the processes for implementing it. It is not clear how such contributions are to be obtained or what the obligation to take them into account requires in practice. We believe that this provision should be limited to the stakeholders deemed relevant by the firm. As regard the consideration of input from stakeholders and civil society organisations (article 26) as well as the impact of sustainability matters on the directors' duty of care, it should be clarified that directors are and remain obliged to act in the best interests of the company. They must not put aside or subordinate the interests of the company in light of sustainability considerations, but should only be obliged to take into consideration sustainability matters when defining in their managerial discretion and business judgement the best interest of the company.

Concerning article 26(2), we acknowledge that this Directive would bring obligations to companies to prevent and bring to an end adverse impacts, as well as concerning procedures on complaints. However, these future legal mandatory provisions should not be confused with the necessary leeway that companies must have in defining and executing their corporate strategy, within the boundaries of the applicable regulation. This Directive should not mandate an adaptation of the corporate strategy to its provisions, and therefore article 26.2 should be deleted.

Regarding remuneration matters detailed in article 15(3), the ability for shareholders to influence a company's remuneration policy is already fully addressed by Directive 2017/828. Therefore, we consider the inclusion of the issue of remuneration in this Directive unnecessary.

In any case, we do not believe that article 15(3) should be applied to the entities named in article 2(2), consistent with the non-application of the requirements for directors to third country entities in the remainder of the directive.

Implementation timeline

The proposed implementation timeline appears ambitious and we propose that an additional year should be provided between the transposition of the directive into national legislation and the application of the new requirements.

In conclusion, we hope that the co-legislators reflect upon these aspects of the proposal to ensure a proportionate, risk-based, clear and workable framework for financial services firms.

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