THE DANISH INSTITUTE FOR HUMAN RIGHTS

LEGISLATING FOR IMPACT

ANALYSIS OF THE PROPOSED EU CORPORATE SUSTAINABILITY DUE DILIGENCE DIRECTIVE

March 2022

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1 EXECUTIVE SUMMARY

The Corporate Sustainability Due Diligence Directive (the proposal) requires large companies to identify and address their negative human rights and environmental impacts in line with key international frameworks including the UN Guiding Principles on Business and Human Rights[1] (UNGPs) and OECD Guidelines for Multinational Enterprises[2] (OECD Guidelines) and associated due diligence guidance. It is welcome that the proposal has drawn heavily from these frameworks in its design.

The proposal contains a number of ambitious aspects, as it covers impacts across the full value chain, includes provisions on enforcement and civil liability and has the potential to have a significant positive impact for people and planet. However, the restricted number of companies in scope and provisions limiting the extent of the due diligence obligation including by suggesting reliance on contractual means to exercise this due diligence and other deviations from the international frameworks mentioned above risk undermining its effectiveness as well as the legal certainty it sets out to create.

Limited personal scope: the UNGPs make plain that all companies have a responsibility to respect human rights, regardless of their size or circumstances, which can be discharged in part by conducting human rights due diligence. Unfortunately, the scope of the proposal is not so broad, taking the approach that due diligence obligations will apply only to larger companies with the expectation that they will support their smaller business partners to conduct business responsibly. Ultimately, only an estimated 13,000 EU and 4,000 non-EU companies will be required to comply, representing around 1% of EU companies. This is a departure not only from the UNGPs, but emerging practice. In recent years there has been increased focus on encouraging and supporting SMEs to undertake their own due diligence in a proportionate way, rather than the 'trickle down' approach set out in the law. It is not clear that the provisions in the law requiring larger companies to provide support are sufficient to encourage SMEs to meaningfully engage in their own due diligence.

Material scope: The material scope of the proposal covers a range of human rights and environmental impacts specified in annexes to the proposal. The presentation of rights in the annex does not follow conventional ways of organising human rights, e.g. by civil and political and economic, social and cultural rights or potentially affected groups (workers, communities, end users/consumers). In addition, some rights are framed in novel ways, which are not entirely aligned with international human rights instruments which might open avenues for interpretation of what is included and not in the rights listed. Further, the proposal defines an 'adverse human right' to mean 'an adverse impact on protected persons resulting from the violation of one of the rights or prohibitions' in the annexes. Introducing the concept of 'violation' risks inadvertently raising the threshold for when an impact would be covered by the proposal and thereby should be part of a company's due diligence obligation.

Extent of the due diligence obligation:

- It is welcome that the proposal applies to impacts across the full value chain of companies in scope, meaning that companies will not only need to exercise due diligence over their own operations or their supply chain, but also need to address impacts which occur in relation to the use of their goods and services, sometimes referred as the 'downstream' part of a business.
- However, there are limitations on the scope of due diligence that create uncertainty and risk hindering a real value chain approach: the proposal limits the scope of due diligence that a company is required to undertake to its own operations; subsidiaries; and business partners in an 'established business relationship'. The definition of 'established business relationship' is not found in the international standards the proposal is based on and remains unclear, leading to uncertainty around what kinds of relationships will meet this threshold, and how far the due diligence duty extends. There are risks, both of creating a perverse incentive for companies to remain at arms-length with their business partners rather than engaging with them to improve human rights and environmental performance and that companies will fail to address severe impacts in the value chain which are not in connection with an established business relationship.

Reliance on Contract and verification: there are features of the proposal that risk reducing due diligence to 'checkbox compliance'. Companies are encouraged to seek contractual assurances from their business partners that they will act responsibly in accordance with a code of conduct, and put in place means to verify that their partners are living up to these requirements. However, this carries a risk that a company will 'farm out' its management of human rights and environmental risks by passing responsibility to its partners through a contract clause, and then engaging a third party certification firm to verify compliance. Codes of conduct and certification are tools that have been used for some time including to manage human rights impacts. Unfortunately, although widely used, they have not been particularly effective in avoiding human rights harm. While the proposal does try to encourage a broader range of responses to human rights impacts, contractual terms and third-party assurance are central, including providing a potential means to avoid liability where a harm occurs. Today, companies with a more mature approach to engaging with their human rights impacts have adopted a range of strategies to address root causes of human rights abuses and work more collaboratively with their business partners. However, it is the larger companies that the law captures that are more likely to have matured beyond reliance on codes of conduct and certification. This could mean that the law perversely encourages a step back from best practice as well as weakens current efforts to move beyond audit regimes to address systemic impacts.

Oversight: The proposal outlines an oversight structure requiring Member States to designate Supervisory Authorities including clear rules on their independence, resourcing and powers, including the power to investigate, inspect, order cessation of infringements, impose pecuniary sanctions and adopt measures to avoid irreparable harm. The proposal establishes a mechanism for any person to refer a 'substantiated concern' to the authority for assessment. Care must be taken to ensure the primary responsibility for monitoring compliance rests with the Supervisory Authority, and that an undue burden is not placed on civil society and other actors to monitor compliance through use of the substantiated concerns reporting mechanism.

Remedy and civil liability:

- The proposal also includes a way for companies to be liable for harms caused by their failure to conduct adequate human rights due diligence, although it comes with a form of defence based on contractual assurances. The civil liability mechanism in the proposal is a welcome addition to facilitate access to effective remedy, but there is a lack of clarity around the use of contractual assurances as a means of avoiding liability. Moreover, by using the language of 'violation of one of the rights and prohibitions as enshrined in the international conventions as listed in Annexes to the Directive' the proposal potentially creates a very high threshold, as it remains an open question whether there will be a need for a national court to establish a violation of international law in order for a claim to succeed.
- The UNGPs expect companies to provide for or cooperate in remediation of any adverse human rights impacts where they have caused or contributed to a human rights harm, including through company grievance mechanisms. The law touches on this briefly, anticipating that a company may be required to give financial compensation where a negative human rights or environmental impact occurs. However, it does not wholly meet the expectations of the UNGPs, which envisage a larger role for companies with respect to remedy, including a requirement to provide for or cooperate in broader range of remedies than simple financial compensation, taking into account the needs of those affected.

Directors' responsibilities: The proposal includes clarification of the responsibilities of company directors in implementing and overseeing due diligence and incorporating sustainability considerations into their decisions and the broader company strategy. This is a welcome clarification as, in order to be effective, a mandatory environmental and human rights due diligence measure must not only be operationalised throughout the organisation, but also be accompanied by a level of management and board oversight over human rights and sustainability impacts, risks and strategies.

Communication: The proposal does not include new disclosure obligations, rather it largely defers the reporting obligations to the Corporate Sustainability Reporting Directive (CSRD). Care must be taken to ensure that the CSRD disclosure requirements are adequate to meet the expectations of the UNGPs and the proposal.

Whilst, in principle the proposal has solid anchorage in key international frameworks, in practice it contains a number of deviations from these standards. Such deviations need to be assessed not just in terms of how well they work from a hard law perspective or their ability to create legal certainty for companies, but also for their likelihood in driving respect for human rights by business. The analysis which follows identifies a number of key issues that require clarification or strengthening in order to ensure that the law creates a push for improved practices rather than a return to past ones, and achieves its aim of fostering real efforts by companies to avoid and address human rights and environmental impacts.

2 INTRODUCTION

To ensure that recovery after COVID-19 is just and equitable, that human rights abuses connected to unsustainable business practices are tackled and that the urgent issues of climate change and environmental degradation are adequately addressed, there is a need to refocus on sustainable development and the principles set out in the 2030 Agenda, in which respect for human rights is deeply embedded. The European Union has taken laudable steps to address these issues through the Green Deal and the Corporate Sustainability Due Diligence Directive (the proposal), each of which set an ambitious goal of transforming corporate behaviour and encouraging a sustainable future. The fundamental principles set out in the UN Guiding Principles on Business and Human Rights (UNGPs) and OECD Guidelines for Multinational Enterprises (OECD Guidelines) remain critical touchstones for the development of such regulatory solutions.

Translating the expectations of soft law instruments into hard law obligations is challenging for any legislature. Legal certainty is needed in order for a law to be consistently applied, adhered to and enforced. However, this must be done with a view to the overall objective of the proposal, namely to secure a just transition to sustainability in a manner consistent with the Union's core values of respect for human dignity, freedom, democracy, equality, rule of law and respect for human rights.

There are a number of aspects of the regulation which, in seeking to create legal certainty, may undermine this objective and instead create further ambiguities. Examples of this can be found in the use of the 'established business relationship' concept to delimit the scope of due diligence rather than taking a risk based approach, a heavy reliance on the tools of contractual assurance, cascading and verification, and in the approach to defining the material scope of adverse human rights impacts.

The co-legislators should not lose sight of the fact that we now have over a decade of practice of companies applying human rights due diligence as it is understood in the UNGPs and OECD Guidelines. It is the larger companies falling within scope of the proposal who are more likely to have developed more innovative practices to identify and address their human rights impacts, drawing from methodologies such as promoting the use of human rights impact assessments, empowering trade unions and civil society, making investments in management or production processes and creating business models which better respect human rights, encouraging long term collaboration and capacity building with partners and collective responses including working at the sectoral level. Care must be taken to ensure that the requirements of the proposal support these practices and do not perversely encourage a step back.
This briefing analyses the proposal to both inform public debate and support policy development and is of relevance to policy makers, as well as civil society in the EU and outside of the EU.

The briefing examines foundational aspects such as personal and material scope, how the proposal treats business relationships and the scope of due diligence across the value chain, use of contractual assurances as well as enforcement and liability. It

then goes on to consider each element of the due diligence obligation, from policy commitments and governance to identification, addressing actual or potential impacts, monitoring, communication and access to remedy. For each issue and element, the briefing asks and examines:

1. What does the proposal say?
2. Does it have the potential to effectively address corporate human rights impacts?
3. How can it be strengthened?

This briefing focuses on how the proposal deals with human rights impacts specifically. It does not consider the environmental aspects in isolation, but does so recognising the interconnections between environmental impacts and the enjoyment of human rights.

3 ANALYSIS OF THE PROPOSAL

3.1 FOUNDATIONAL ASPECTS

This section considers foundational aspects of the proposal, including personal and material scope, how the proposal treats business relationships and the scope of due diligence across the value chain, use of contractual assurances and enforcement and liability.

The approach the proposal takes is to impose hard law obligations on larger companies, with the expectation that this will lead to improved human rights performance of smaller companies not captured by the law through their business relationships.

The proposal relies heavily on the use of contractual assurances to secure compliance with obligations concerning respect for human rights and responsible business conduct set out in a code of conduct, but as discussed in detail below, it is not clear that the proposal has created the right balance of incentives for companies to go beyond the use of contract and certification and meaningfully engage with the process of due diligence as it is envisaged in the UNGPs.

There are a number of uncertainties around key concepts used in the proposal, such as 'established commercial relationship' which will impact on the scope of the due diligence obligation and require clear guidance.

3.1.1 Personal Scope

a) What does the proposal say?

The proposal applies to:

- Large EU companies (500 employees and net worldwide turnover of EUR150m) (Art 1(1)(a)) including financial companies
- Medium EU companies (250 employees and net worldwide turnover EUR40m) in 'high impact sectors' (Art 2(1)(b))
- Large non-EU companies (turnover EUR150m in the EU) (Art 2(2)(a))
- Medium non-EU companies (turnover EUR40m in the EU) and in a 'high impact sector' (Art 2(2)(b))

The proposal takes an expansive definition of 'employee' for the purposes of these calculations, including part time and temporary workers (Art 1(3)).

The proposal defines 'company' by reference to the Accounting Directive[3] or by reference to a comparable law of a third country, but lacks a clear reference to state owned enterprises. Relatedly, the proposal does not consider due diligence in public procurement. The definition also includes a 'regulated financial undertaking' regardless of its legal form (Art 3(a)).

The designation of certain sectors as 'high impact' is based largely on the approach of the OECD and includes certain sectors currently covered by OECD sectoral guidance[4] (recitals [22]), being:

a) Textiles and leather manufacture and wholesale trade of textiles, clothing and footwear;
b) Agriculture, forestry, fisheries, manufacture of food products and wholesale trade of agricultural materials; and
c) Extractives (see Art 2(1)(b)).

However, the financial sector is excluded from the high-impact category despite being the subject of OECD guidance. The special status of the financial sector in the proposal is considered further in section 3.1.4 below.

b) Does it have the potential to effectively address corporate human rights impacts?

The reduced personal scope of the proposal is a departure not only from the UNGPs, which make plain that all companies have a responsibility to respect human rights, regardless of their size or circumstances, but also from emerging practice.

In recent years there has been increased focus on encouraging and supporting SMEs to undertake their own due diligence in a proportionate way, rather than the 'trickle down' approach set out in the law.[5] Under the UNGPs, the exercise of due diligence is to be done in a way that is proportionate, bearing in mind the size and circumstances of the particular business. This means that although SMEs are also obliged to undertake their own due diligence, it is not expected to be of the same nature or scale as that of a large multinational. It is not clear that the provisions in the law requiring larger companies to provide support are sufficient to encourage SMEs to meaningfully engage in their own due diligence. As a result, there is a risk that the proposal might unintentionally incentivise a step back from the good practices developed more recently around the independent responsibilities of SMEs to carry out HRDD.

The Explanatory Memorandum accompanying the proposal states that it is expected that 13,000 EU and 4,000 third country companies will be captured by the proposal. However, SMEs are specifically excluded even while the Explanatory Memorandum acknowledges that SMEs overall account for 99% of all companies in the Union. The proposal anticipates that they will nonetheless be impacted through their business relationships with the large and medium companies required to comply with the DD obligations in the proposal, who will pass on demands. The proposal therefore requires companies captured to provide support to SMEs 'where the viability of the SME would be jeopardised', but is unclear on what this means in practice and therefore what the threshold for the provision of assistance may be.

This is indicative of the general approach of the proposal, whereby stricter obligations are imposed on larger companies who are perceived to have sufficient resources to comply, with the expectation that they will bring other smaller companies along through their business relationships. The proposal requires support to be given to SMEs in these circumstances, for companies within the personal scope of the proposal to bear the costs of any such verification (Art 7(4) and 8(5)) and anticipates that Member States will provide other forms of support to SMEs, including information portals, and financial assistance (Art 14).

However, it is not clear that sufficient incentives have been included to drive the desired engagement and encourage SMEs to undertake due diligence in the proportionate manner envisaged by the UNGPs, particularly due to the lack of clarity around when 'the viability of the SME would be jeopardised' and thereby trigger assistance. Lastly, the framing of 'high impact sectors' by reference to sectors on which the OECD has prepared guidance excludes other sectors which equally have a high risk exposure, such as chemicals, energy, dual use technology or private security.

c) How can it be strengthened?

The personal scope of the proposal has clearly been a sticking point in the various review rounds by the Regulatory Scrutiny Board (RSB), and appears from the Explanatory Memorandum to be a reduced personal scope from what was initially proposed as a compromise position.

Further, it is notable that the proposed Corporate Sustainability Reporting Directive[6] has a different personal scope than this proposal, applying to large and listed companies, creating a missed opportunity for alignment. Extending the application of the due diligence proposal to large companies, listed SMEs and high-risk SMEs would align with the approach of the European Parliament in its proposed Directive adopted in March 2021.[7]

Further, given the central logic of the proposal that obligations should apply to larger companies who then encourage responsible business conduct of smaller companies through their business relationships, the circumstances in which SMEs are to receive support from their business partners should be the subject of clearer guidance. Attention should be paid to whether the proposal creates the right balance of incentives to encourage SMEs to engage in their own due diligence with support from business partners and the Member States.

RECOMMENDATIONS

- Expand the personal scope of the proposal to align with that proposed in the CSRD, ie large companies and listed SMEs to ensure regulatory alignment
- Over time include high-risk SMEs in line with the European Parliament's proposed Directive
- Ensure that sufficient incentives are given to larger companies to engage with SME partners

3.1.2 Material Scope

a) What does the proposal say?

The material scope of the proposal covers a range of human rights and environmental impacts specified in annexes to the proposal. With respect to human rights, the proposal requires due diligence to be conducted with respect to 'adverse human rights impact on protected persons resulting from the violation of one of the rights and prohibitions as enshrined in the international conventions as listed in Annexes to the Directive'.

THE ANNEX EXPLICITLY LISTS THE FOLLOWING RIGHTS:

- right to dispose of a land's natural resources and to not be deprived of means of subsistence
- right to life and security
- prohibition of torture, cruel, inhuman or degrading treatment
- right to liberty and security
- prohibition of arbitrary or unlawful interference with a person's privacy, family, home or correspondence and attacks on their reputation
- freedom of thought, conscience and religion
- right to enjoy just and favourable conditions of work including a fair wage, a decent living, safe and healthy working conditions and reasonable limitation of working hours
- prohibition to restrict workers' access to adequate housing, if the workforce is housed in accommodation provided by the company, and to restrict workers' access to adequate food, clothing, and water and sanitation in the work place
- Children's rights (specifying numerous specific rights)
- prohibition of the employment of a child under the age at which compulsory schooling is completed and, in any case, is not less than 15 years, except where the law of the place of employment so provides
- prohibition of child labour (specifying different aspects thereof)
- prohibition of forced labour, including debt bondage and forced labour
- prohibition of all forms of slavery
- prohibition of human trafficking
- right to freedom of association, assembly, the rights to organise and collective bargaining including trade union rights and the right to strike
- prohibition of unequal treatment in employment including equal pay for equal work
- prohibition of withholding an adequate living wage
- prohibition of causing any measurable environmental degradation
- prohibition to unlawfully evict or take land, forests and waters
- indigenous peoples' right to the lands, territories and resources which they have traditionally owned, occupied or otherwise used or acquired

The annex specifies that violations of rights not specifically listed in the annex, but included in the international human rights agreements referenced 'which directly impairs a legal interest protected in those agreements, provided that the company concerned could have reasonably established the risk of such impairment and any appropriate measures to be taken in order to comply with the obligations referred to in Article 4 of this Directive taking into account all relevant circumstances of their operations, such as the sector and operational context'.

b) Does it have the potential to effectively address corporate human rights impacts?

The UNGPs state that business activities can impact virtually the full scope of human rights and for that reason, businesses should be assessing impacts on the full spectrum of rights contained in the International Bill of Human Rights (IBHR) (consisting of the Universal Declaration of Human Rights and the main instruments through which it has been codified: the International Covenant on Civil and Political Rights and the International Covenant on Economic, Social and Cultural Rights), coupled with the

principles concerning fundamental rights in the eight ILO core conventions as set out in the Declaration on Fundamental Principles and Rights at Work.

While the annex at first glance appears relatively comprehensive in its human rights coverage it is not entirely clear how the list of rights was developed. The presentation of rights in the annex does not follow conventional ways of organising human rights, e.g. by civil and political and economic, social and cultural rights or potentially affected groups (workers, communities, end users/consumers). In addition, some rights are framed in novel ways, which are not entirely aligned with international human rights instruments or the conventional representation of these, which might open avenues for interpretation of what is included and not in the rights listed. For example, whereas the list includes unequal treatment in employment, it does not include a broad recognition of the right to non-discrimination, including as it might be relevant outside of employment, e.g. in the context of consumers or end-users. Similarly, while the presentation recognises the right to adequate housing, food etc in the context of workers, it does not include this right as it relates to other groups e.g. consumers or housing tenants subject to negative impacts associated with businesses or financial institutions.

Further, there are a number of limitations where violations of rights not specifically listed in Annex 1 but which are enshrined in one of the instruments listed in Annex 2 are concerned. The approach of listing rights in one annex and creating a limited 'catch all' by referring to the relevant human rights instruments in another creates ambiguities which may inadvertently narrow the scope of human rights being considered by companies. Further, there are key European human rights instruments that are not referred to, including the European Convention on Human Rights and the EU Charter of Fundamental Rights.

The proposal defines an 'adverse human right' to mean 'an adverse impact on protected persons resulting from the violation of one of the rights or prohibitions' in the annexes. Notably the UNGPs and OECD Guidelines do not use the term 'violation' of rights, but rather frames adverse impacts as any action or omission that removes or reduces the ability of an individual to enjoy his or her human rights. Introducing the concept of 'violation' risks inadvertently raising the threshold for when an impact would be covered by the proposal and thereby should be part of a company's due diligence obligation. Further, it is not clear whether, in the context of civil liability, a court would be required to make a determination that there has been a violation in order for a claimant to succeed. Such approach could significantly reduce the scope of the due diligence obligation and civil liability mechanism (see further section 3.1.7 below).

In addition, the proposal Art 3(c) stresses 'one of the rights' when in practice impacts on people by business often involve several human rights and when as a matter of principle human rights are indivisible and interdependent (as specified in the Vienna Declaration). Human rights due diligence should be a holistic exercise of understanding the different ways in which business activities impact people's rights rather than an exercise of looking at specific rights in an isolated manner.

c) How can it be strengthened?

The proposal could be strengthened to align its definition of adverse impacts with that of UNGPs and OECD Guidelines, include a clearer presentation of rights as included in the IBHR and ILO core conventions and making clear that the obligations extend to the full spectrum of rights therein without any limitations and refrain from using 'one right' approach and better cross-reference the European human rights framework.

RECOMMENDATIONS:

- Consider referring to the relevant international human rights instruments (per the approach in Annex 2) rather than taking the approach of enumerating individual rights (as set out in Annex 1). If enumerating specific rights, then do so in a manner consistent with human rights instruments and exhaustive in terms of covering impacts on rights across the value chain
- Include reference to missing international human rights conventions as well as European human rights instruments, including the European Convention on Human Rights and the EU Charter of Fundamental Rights
- Clarify the language in the proposal to make clear that businesses may impact on one or more rights, in line with the principle whereby no right can be achieved without the implementation of other rights.

3.1.3 Business Relationships

a) What does the proposal say?

The proposal requires companies within scope to take appropriate measures to identify and address actual or potential human rights and environmental impacts in their own operations, in their subsidiaries and at the level of 'established business relationship'. This is defined to mean 'a business relationship, whether direct or indirect, which is, or which is expected to be lasting, in view of its intensity or duration and which does not represent a negligible or merely ancillary part of the value chain' (Art 3(f)).

The concept of 'established business relationship' is deployed in various ways in the proposal, in relation to the publication of a policy which describes due diligence processes including with respect to established business relationships (Art 5); and the due diligence process itself, at the identification stage where companies are required to identify actual or potential impacts arising from their own operations, those of their subsidiaries or from their established business relationships (Art 6(1)).

In the proposal, 'business relationship' means a relationship with a contractor, subcontractor or any other legal entities ('partner'):

1. with whom the company has a commercial agreement or to whom the company provides financing, insurance or reinsurance (first prong), or
2. that performs business operations related to the products or services of the company for or on behalf of the company (second prong).

The two prongs of the definition seem to concern commercial relationships with suppliers (first prong) and with those in the downstream (second prong), although these distinctions are not wholly clear, and it is arguable that the second prong could also be applicable to relationships in the upstream, and vice versa.

The recitals to the proposal go on to state that 'if the direct business relationship of a company is established, then all linked indirect business relationships should also be considered as established regarding that company.' ([20])

b) Does it have the potential to effectively address corporate human rights impacts?

While the introduction of the concept of an 'established business relationship' appears to be a means to introduce certainty to companies with respect to the scope of their due diligence obligation, given the ambiguities outlined above this is far from being the case.

The definition of 'established business relationship' is not found in the international standards the proposal is based on. Rather, the UNGPs and the OECD Guidelines expect that companies will take a risk-based approach to their due diligence, undertaking an assessment of their operations and business relationships which is guided by severity of risk rather than closeness of the business relationship. This approach ensures that severe human rights impacts which are often more likely to be deeper in the value chain, are identified and addressed. The definitions of 'established business relationship' and 'business relationship' and how they are to be interpreted together are unclear, leading to uncertainty around what kinds of relationships will meet this threshold, and how far the due diligence duty extends.

By limiting the scope of due diligence by reference to 'established business relationships' companies may overlook severe risks which might be most important and urgent to address. This represents not only a departure from the principles of the UNGPs, but also from best practice. Companies at a higher level of maturity when it comes to responsible business conduct are developing means of undertaking due diligence beyond tier 1 of the supply chain as well as deeper into the downstream value chain (ie, due diligence conducted with respect to impacts that occur once a product or service leaves the company). As noted below in section 3.1.5, some of the larger companies captured by the proposal are more likely to have developed approaches to addressing human rights impacts beyond those arising from established relationships, in line with OECD Guidelines and UNGPs. By departing from best practice the proposal may create perverse incentives for leading companies to do less than what international frameworks expect.

The notion of 'established business relationship' is critical to the approach of the proposal. However, it is not wholly clear from the definitions of 'established business relationship' and 'business relationship' precisely what kinds of relationships are captured and so how far the due diligence obligation extends with respect to business relationships. Assessing whether a business relationship is 'lasting' by reference to intensity or duration and being more than 'negligible or merely ancillary' is not a straightforward exercise.

Accordingly, it is possible to interpret the scope of the obligation beyond own operations and subsidiaries broadly, capturing the value chain, or more narrowly to restrict the scope to only those with whom there is a long term contractual or other sufficiently established relationship. The broad interpretation is supported by the indication in the recitals that 'if a direct business relationship of a company is established, then all linked indirect business relationships should also be considered as established'. On its face, this could be interpreted to mean the partner with whom there is an established business relationship and all other business relationships linked thereto indicating a relatively broad scope of due diligence, but this is not made sufficiently clear in the relevant article. The breadth depends significantly on how the concept of 'linkage' is to be interpreted.

It is also noteworthy that the proposed complaint mechanism (see sections 3.2.2 and 3.2.6 below) accessible to affected persons and other stakeholders including trade unions and CSOs is creating another avenue to extend the scope of value chain due diligence obligation beyond established business relationships. However, this shifts the burden on civil society and other organisations to identify a company's impacts across the value chain, which is out of step with the UNGPs. These actors may not have the resources to monitor a company's full value chain impacts, or access to the same level of information about them available to the company. Further, in contexts where there are constraints on the civic space and restrictions on trade unions, the capacity to monitor company activities may be weak.

Lastly, a similar concept of 'established commercial relationship' is found in the French due diligence law which has been in force since 2017.[8] The ambiguities around that approach have been noted by various commentators[9]. This could create a perverse incentive for companies to remain at arms-length with their business partners and resorting to short term contracts rather than engaging with them including via longer term commitments to improve their leverage and thereby the human rights and environmental performance.

c) How can it be strengthened?

The concept of 'established business relationship' is used to delimit the scope of the due diligence obligation, by reference to the closeness of a business relationship rather than by severity of risk to rightsholders. As noted above, this concept is not found in any of the international frameworks on which the proposal is based.

Clear guidance is required if companies are to properly understand the scope of the required due diligence. Such guidance should aim to take an expansive view of the scope of due diligence in order to align as closely as possible with the risk-based approach to due diligence set out in the UNGPs. A narrow scope may unduly limit the extent of the due diligence obligation and undermine the effectiveness of the proposal. In addition, although engagement with stakeholders is critical, it is the company who should be primarily responsible for identifying its impacts across the value chain, rather than placing the responsibility on civil society and other actors to identify and alert a company to an impact that occurs outside an established business relationship via a complaints mechanism.

RECOMMENDATIONS:

- Align the approach to value chain due diligence with the UNGPs based on severity of impacts rather than the nature of the business relationship
- Ensure that clear guidance is given to companies so that the scope of due diligence is properly understood

3.1.4 Financial Sector

a) What does the Proposal say?

The proposal defines 'companies' to include 'regulated financial undertakings' such as credit institutions, investment companies, funds. However, when compared with the approach to real economy companies, the proposal takes a more narrow approach to the financial sector with regards to both the scope of entities included and the due diligence obligation.

With regard to personal scope, the proposal uses the same methodology to include financial companies as for real economy companies, but contrary to real economy companies that can be included by meeting two sets of criteria, it includes only very large financial undertakings under the first criteria (article 2(1)(a)).

With regard to the due diligence obligation of financial undertakings, the proposal confines it to the pre-contractual stages only and specifies that only large first tier clients and subsidiaries of relevance to the contract should be in scope for due diligence. In other words, the proposal departs from the value chain approach when it comes to the financial sector by both limiting the scope to clients only (leaving out suppliers for instance) and by further limiting the clients in scope to be large clients only and by excluding the value chains of these clients.

b) Does it have the potential to effectively address corporate human rights impacts?

It is positive that the proposal includes financial sector companies. However, whereas the proposal overall targets only a small portion of companies (see section 3.1.1), the approach taken to covering the financial sector is even more confined, which gives rise to concern about the reach and impact of the approach when contrasted with the financial sector at large. Further, the proposal does not substantiate that the same turnover thresholds for real economy companies and financial institutions can be used. In addition, the limitations put on the due diligence obligations of those that are covered by the proposal further weaken its potential effectiveness and is at risk of undermining or incentivising a step back in practices of large financial institutions. Notably, mature ESG practices among investors go beyond transactional due diligence at the pre-investment stage to also assess and act on risks as they appear in the ownership phase. Moreover, the proposal seems to speak to active investment only, which is a missed opportunity given a general rise in passive investment, in which investors mostly rely on active ownership measures (e.g. company dialogue/ engagement, proposing shareholder resolutions, proxy voting). Finally, limiting risk assessment to the contract inception stage is out of step with UNGPs but also with the OECD Responsible business conduct for institutional investors[10] .

Finally, beyond the recognition of finance related existing regulation in the recitals, the proposal does not clarify or capitalise on the synergies with article 18 on minimum safeguards in the taxonomy regulation and the requirements around principal adverse impact disclosures stemming from the Sustainable Finance Disclosure Regulation (SFDR). Taxonomy alignment by investors and meaningful reporting under the SFDR involves alignment by these actors with the UNGPs and OECD Guidelines. For example, some of the mandatory principal adverse indicators included in SFDR technical standards cannot meaningfully be reported on without due diligence by investors after contract signature. Further, the degree to which the proposal aligns with the UNGPs and the OECD Guidelines directly impacts whether it can be used to determine whether companies covered by the environmental taxonomy comply with the minimum safeguards specified in art 18 of the taxonomy regulation. Creating due diligence duties slightly out of step with these frameworks risks both harming effectiveness and doing covered entities a disservice, rather than creating mutually reinforcing pieces of regulation.

c) How can it be strengthened?

The proposal can be strengthened by aligning the personal scope as well as the due diligence obligation of financial undertakings with that of real economy companies at a minimum, as well as by ensuring strict policy coherence between the proposal, the SFDR and taxonomy instruments when it comes to human rights related requirements of both financial and corporate undertakings.

RECOMMENDATIONS:

- Specify financial sector coverage directly in article 2 for clarity.
- Expand the personal scope to include more financial institutions, ideally by developing inclusion criteria specifically aimed at the financial sector or as a minimum by including financial institutions under article 2(1)(b).
- Align the due diligence obligations of financial institutions with that of real economy companies in line with UNGPs and OECD Guidelines
- Further develop and specify regulatory coherence and interlinkages between CSDD, SFDR and Taxonomy regulation as it applies to financial institutions including directly in the proposal text.

3.1.5 Contractual Assurances

a) What does the proposal say?

The use of contractual assurances is central to the approach of the proposal. It provides that companies should 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.

Contractual assurances are used in various ways throughout the proposal, for example:

- They are a suggested means of ensuring compliance with prevention or corrective action plans where indirect partners are involved in an adverse impact (Art 7(3) and Art 8(4)); and
- They are one means of limiting or avoiding liability under the civil liability mechanism, where combined with appropriate means of verifying compliance (Art 22(2)).

While the recitals in the proposal specify that businesses should prioritise engagement with business partners over termination (see [36]), the proposal also specifies that Member States shall be required to establish contractual rights of termination in cases of severe impacts.

Given the centrality of contract law to the approach of the proposal, it also contemplates that the Commission will develop guidance on model contract clauses (Art 12).

b) Does it have the potential to effectively address corporate human rights impacts?

The UNGPs emphasise that companies are required to cease, prevent, mitigate and/or remediate actual or potential impacts which they cause or to which they contribute, and use and seek to increase their leverage in order to address impacts to which they are directly linked through a business relationship.

While leverage could include securing contractual obligations to engage in responsible business conduct or comply with the terms of a code of conduct, the UNGPs state that each business is responsible for its own due diligence and generally expect companies to undertake due diligence themselves, rather than deferring obligations to business partners.

Contract plays a central role in the proposal, particularly in respect of actions that a company should take to address actual or potential impacts in Articles 7 and 8 (discussed below in section 3.2.3). The heavy reliance on contractual assurances carries a danger of checkbox compliance, as companies could simply include a model clause in their contracts and then secure the services of a third party verification provider rather than meaningfully engage with the process of due diligence and develop contextual approaches to avoid and address human rights impacts.

The proposal goes so far as to suggest that a business could seek to conclude contractual arrangements with a partner with whom they have an indirect relationship in order to afford the company a clearer right to secure compliance with a code of conduct. There are real questions around how practical this approach would be and what incentives an indirect business partner would have to enter into formal contractual relations in circumstances where the exercise of leverage was not sufficient to secure compliance.

Codes of conduct and certification are tools that have been used for some time to manage human rights impacts. Unfortunately, although widely used, they have not been particularly effective in avoiding human rights harm.[11] While the proposal does try to encourage a broader range of responses to human rights impacts, contractual terms

and third-party assurance are central, including providing a potential means to avoid liability where a harm occurs.

Companies with a more mature approach to engaging with their human rights impacts have adopted a range of strategies to address the root causes of adverse human rights impacts and work more collaboratively with their business partners. These include the use of human rights impact assessments, empowering trade unions and civil society, making investments in management or production processes and creating business models which better respect human rights, encouraging long term collaboration and capacity building with partners and working at the sectoral level. However, it is amongst the larger companies that the law captures that mature approaches to human rights due diligence beyond reliance on codes of conduct and certification are found. This could mean that the law perversely encourages a step back from best practice.
The recitals to the proposal make clear that termination is to be an option of last resort and that the preferred approach is engagement with a partner to improve performance. However, the proposal also anticipates the development of new termination rights, entitling a company to terminate a business relationship if potential adverse impacts are severe and to require companies to temporarily suspend relations with partners while pursuing prevention and minimisation efforts where it may be reasonably expected that they will succeed in the short term. However, the creation of new more robust termination rights in cases of severe impacts and obligations for a company to step away while preventative efforts are undertaken, carry the possibility that companies will refrain from engaging with their business partners. This undermines the central logic of the proposal in applying obligations only to the largest companies in the hope that they will engage with their business partners in particular SMEs to improve human rights performance.

c) How can it be strengthened?

Further consideration needs to be given to whether the provisions in the proposal strike the right balance, both in incentivising engagement even in challenging circumstances, and in driving companies to engage with the full range of tools available to identify and address human rights impacts, not only those which are 'low hanging fruit', such as the introduction of contract clauses and third party verification, which are more likely to lead to checkbox compliance. The proposal should seek to incentivise companies to develop a range of practices such as those noted above.

RECOMMENDATIONS:

- Ensure that sufficient incentives have been given to encourage companies to meaningfully engage with the full range of tools available to identify and address human rights impacts, not only those which are 'low hanging fruit', such as the introduction of contract clauses and third party verification

3.1.6 Supervisory Authority

a) What does the proposal say?

The proposal requires Member states to designate one or more supervisory authorities to oversee compliance with due diligence obligations in the proposal (Art 17). Member States are required to guarantee the independence of such supervisory authorities, and ensure that they and all persons working for them, exercise their powers impartially and transparently. This includes auditors or experts working on their behalf (Art 17(8)).

The supervisory authorities are required to have adequate powers and resources, including:

- the power to request information and carry out investigations related to compliance with the obligations in the proposal (Art 18(1));
- ordering the cessation of infringements, abstention from repetition of infringing conduct and where appropriate, remedial action proportionate to the infringement (Art 18(5)(a));
- imposing pecuniary sanctions (Art 18(5)(b)) based on turnover (Art 20); and
- adopting interim measures to avoid the risk of severe and irreparable harm (Art 18(5)(c)).

If a supervisory authority identifies a failure to comply it shall grant a company an appropriate period of time to take remedial action (Art 18(4)). This does not preclude the imposition of administrative sanctions or the triggering of civil liability.

Where sanctions are imposed, account is to be taken of a company's efforts to comply with remedial action required of them and any investments, targeted support given or collaboration with other entities to address adverse impacts in the value chain (Art 20(2)).

Any natural or legal person is to be entitled to submit substantiated concerns to a supervisory authority where they have reason to believe that a company is failing to comply with the provisions of the proposal (Art 19(1)). Supervisory authorities are to assess the substantiated concern (Art 19(3)) and inform the person who referred it of the outcome of the assessment (Art 19(4)) who are to be granted rights of review (Art 19(5)).

This system of national supervisory authorities is to be supported by a European Network of Supervisory Authorities to facilitate cooperation and alignment of regulatory, investigative, sanctioning and supervisory practices (Art 21(1)).

b) Does it have the potential to effectively address corporate human rights impacts?

It is positive that the proposal has recognised the clear need for the designation of an adequately empowered and resourced supervisory authorities as well as the need for a coordinated European approach. It is equally welcome that this supervisory regime includes a mechanism for any person to submit a concern. Further this supervisory regime is supported by a civil liability mechanism, considered below in section 3.1.7
It is beneficial that the proposal specifies a broad range of administrative powers which the supervisory authority is to have, including the power to investigate, inspect, order

cessation of infringements, impose pecuniary sanctions, adopt measures to prevent irreparable harms and a mechanism to assess substantiated concerns referred to it by a range of stakeholders.

c) How can it be strengthened?

While it is positive that any natural or legal person is to be entitled to submit substantiated concerns to a supervisory authority, care must be taken to ensure that this does not place too great a burden on CSOs or other actors to monitor compliance. Supervisory Authorities should be primarily responsible for monitoring compliance and investigating non-compliance with the terms of the proposal.

As independent state bodies with a mandate to promote and protect human rights including in the context of business activities, National Human Rights Institutions (NHRIs) could have a role to play in discharging some of the functions of a Supervisory Authority, such as capacity building, support or monitoring, or where the NHRI does not perform a function of the Supervisory Authority, assessing the performance of a Supervisory Authority.

RECOMMENDATIONS:

- Ensure that an undue burden is not placed on civil society and other actors to monitor compliance with the proposal and that a correct balance is stuck between a Supervisory Authority's own investigations and use of the substantiated concerns reporting mechanism
- Consider what role NHRIs could play in either discharging functions of a Supervisory Authority or monitoring the performance of a Supervisory Authority

3.1.7 Civil Liability

a) What does the proposal say?

In addition to the administrative supervisory framework, the proposal also creates a novel pathway to civil liability for harms occasioned as a result of due diligence failures. Article 22(1) specifies that a company will be liable if it failed to comply with the due diligence obligations in Articles 7 and 8, and as a result an adverse impact that should have been identified, prevented, mitigated, brought to an end or minimised through appropriate measures occurred and led to damage. Adverse human rights impact is defined in the proposal to mean an impact resulting from a violation of one of the rights or prohibitions specified in an annex, all of which are defined by reference to international human rights instruments. It is however unclear whether this then requires a domestic court to make a determination that there has been a violation of international human rights law in order for liability to attach.

A quasi-defence is available in cases involving indirect partners with whom they have an established business relationship. Where a company has put in place contractual obligations requiring compliance with a code of conduct and has put procedures

in place to monitor compliance with that obligation, it may avoid liability if it was reasonable to expect that the actions taking (including verification) would be adequate (Art 22(2)).

This civil liability mechanism is stated to be 'without prejudice' both to the liability of any subsidiaries or direct or indirect business partners; and to other civil liability mechanisms in national laws which provide for liability in situations not covered or providing for stricter liability than the mechanism set out in the proposal. The proposal, therefore, provides a minimum set of circumstances in which a company should be liable for human rights or environmental harms occasioned as a result of due diligence failures which may be supplemented by tortious or other mechanisms in national laws. By Article 1(2) nothing in the proposal shall be grounds for reducing the level of protection of human rights or the environment provided for at the time of adoption. The proposal is deliberately silent on the question of who should be responsible for proving that the company's actions were 'reasonably adequate' in the circumstances, thus deferring this important question of the onus of proof to the Member States. Finally, the proposal envisages that the liability mechanism provided for in national law through the transposition of the terms of the proposal be of mandatory overriding application, even where the applicable law is not the law of a Member State (Art 22(5)).

b) Does it have the potential to effectively address corporate human rights impacts?

Articles 7 and 8 make plain that actions taken to prevent, mitigate and cease an actual or potential impact are to be taken in respect not only in relation to impacts that were identified through the application of appropriate measures in the identification process set down in Article 6, but also those which should have been identified. This approach to liability has a broad scope, potentially giving rise to liability for any harm which should have been foreseen, but was not adequately addressed via the due diligence process without an apparent causation requirement.

The approach taken differs as between harms occasioned in own operations and subsidiaries on the one hand, and those arising from business relations on the other. Essentially, as the Explanatory Memorandum explains, the intention is that companies should not be liable for failing to prevent or cease harm at the level of 'indirect business relationships' if it used contractual cascading and assurance and put in place processes to monitor compliance with those contractual assurances unless it was unreasonable to expect that the actions taken (including with respect to verifying compliance) would be inadequate. Much will turn on whether it was reasonable to expect that contractual cascading would be effective.

Further, the 'established commercial relationship' limitation on the scope of value chain due diligence (discussed above in section 3.1.3) will have an impact on the civil liability provision. If the scope of due diligence is interpreted narrowly, then a company will only be required to exercise due diligence with respect to impacts that were or should have been identified and addressed in accordance with this narrow scope. This could place a significant limitation on the civil liability mechanism and limit its ability to provide access to effective remedy.

Lastly, breaches of international law are not generally recognised as a cause of actionable harm in a civil claim under domestic law. If the actionable harm in the law requires an assessment of whether there has been a breach of international human rights law or whether there has been a 'violation', then this presents challenging issues for a domestic court to determine and may create an unduly high threshold for claimants to meet in order for a claim to succeed.

c) How can it be strengthened?

The scope of due diligence required under the proposal will have a flow on effect to the scope of liability. Consistent with the UNGPs and OECD Guidelines, the scope of due diligence should be cast as broadly as possible based on severity of risk to rightsholders, rather than the nature and proximity of a business relationship. Given the limited effectiveness of an approach to preventing human rights harms based on the use of codes of conduct and certification, the proposal should reconsider placing such approaches at the centre of its approach to liability. It may be preferable to take an approach which adopts limitations on liability drawn from ordinary tort principles, such as foreseeability, remoteness and reasonableness.[12]

Clarification is needed on the question of whether domestic courts are to be required to make a determination that there has been a violation of international law. If that is the case, guidance and judicial capacity building are essential in order to ensure that the provisions in the proposal are consistently applied and that the liability mechanism effectively facilitates access to remedy.

Lastly, the proposal could consider introducing an overarching duty to respect human rights and the environment in the value chain to supplement the due diligence requirements, as has been proposed by some, including the Dutch government in their recent non-paper.[13] This would assist the proposal to better align with the expectations of the UNGPs and create another option for a liability mechanism based on a failure to discharge the duty.

RECOMMENDATIONS

- Clarify the scope of the due diligence requirement to ensure that it is as broad as possible based on severity of risk to rightsholders, rather than the nature and proximity of a business relationship
- Consider an approach which adopts limitations on liability drawn from ordinary tort principles, such as foreseeability, causation and reasonableness rather than avoiding liability by use of codes of conduct and certification
- Ensure that the definition of adverse human rights impact by reference to a 'violation' of international law does not unduly create too high a threshold for a claimant to succeed
- Consider introducing an overarching duty to respect human rights and the environment in the value chain to supplement the due diligence requirements

3.2 DUE DILIGENCE PRINCIPLES

The due diligence obligation is established in Article 4, which requires Member States to ensure that companies carry our due diligence as specified in Articles 5-11 by:

a. integrating due diligence into their policies in accordance with Article 5;
b. identifying actual or potential adverse impacts in accordance with Article 6;
c. preventing and mitigating potential adverse impacts, and bringing actual adverse impacts to an end and minimising their extent in accordance with Articles 7 and 8;
d. establishing and maintaining a complaints procedure in accordance with Article 9;
e. monitoring the effectiveness of their due diligence policy and measures in accordance with Article 10;
f. publicly communicating on due diligence in accordance with Article 11.

Importantly, the due diligence obligation applies to the value chain, rather than being limited to the supply chain. 'Value chain' is defined to mean activities related to the production of goods or the provision of services by a company, including the development of the product or the service and the use and disposal of the product as well as the related activities of upstream and downstream established business relationships of the company. As noted above, the definition of business relationship is broad enough to include relationships across the value chain. By taking a full value chain approach the proposal explicitly contains an important recognition that businesses can have impacts not only with respect to their supply chain and the production of their goods and services, but also with respect to the downstream ie, impacts that occur once a product or service leaves the company.

The Explanatory Memorandum makes plain that companies are not expected to guarantee that adverse impacts will never occur or will be stopped in all circumstances. The due diligence obligation is expressed to be an 'obligation of means' discharged through process-based requirements undertaken to a particular standard of reasonableness, rather than an expectation that companies to achieve particular outcomes with respect to their human rights or environmental performance. An explicit requirement that companies make a policy commitment to respecting human rights is absent, as is an overarching duty to respect human rights, as has been proposed by some, including the Dutch government in their recent non-paper.[14] Taken holistically, the approach to due diligence set out in the proposal broadly aligns with that in the UNGPs and OECD Guidelines. However, as the observations set out below show there are a number of important departures, including some of a more fundamental nature. The ability of this approach to due diligence to have a broader impact rests on the idea that larger companies will bring along their smaller business partners. To that end there are a number of means by which larger companies might be obliged to assist their smaller business partners, but each of these is to be exercised only 'when relevant' affording a degree of discretion to companies as to whether and how they engage with their smaller business partners on human rights issues.

3.2.1 Policy Commitment and Governance

a) What does the proposal say?

Companies are required to have a due diligence policy made up of three elements:
1. description of the approach to due diligence;
2. a code of conduct applicable to employees and subsidiaries; and
3. a description of processes put in place to implement due diligence and ensure compliance with the code of conduct and extend its application to established business relationships (Art 5).

In addition the proposal clarifies certain obligations of directors, including with respect to the oversight of due diligence. Article 25 sets out a directors' duty of care which states that directors shall take into account the consequences of their decisions for sustainability matters including human rights, climate change and the environment in discharging their duty to act in the best interests of the company. Article 26 places responsibility for putting in place and overseeing the due diligence policy and due diligence process on directors with due input from relevant stakeholders and CSOs. It also requires that directors report to the board in respect of due diligence and take steps to adapt corporate strategy to take into account the impacts identified and addressed in accordance with the due diligence process set out in the proposal.

b) Does it have the potential to effectively address corporate human rights impacts?

The policy requirements outlined in this article are a departure from the expectations of the UNGPs, which state that businesses should have in place a policy commitment to meet their responsibility to respect human rights.

The replacement of a requirement that companies articulate their commitment to respect human rights in a policy statement with a requirement of a 'due diligence policy' is indicative of the approach of the proposal to imposing an 'obligation of means' through process based requirements. Such an approach does not fully embrace the spirit of the UNGPs which require a clear acknowledgement of the responsibility to respect human rights, which may be discharged, in part, through the exercise of due diligence. The UNGPs purposely include several requirements for the policy commitment that are not reflected in the proposal. Notably that a policy commitment is approved at the highest level of the organisation, relies on human rights expertise and that it is publicly communicated. That there is no requirement for a company to publish this policy framework further misses an opportunity to promote transparency and accountability.

Another feature missing from this approach is the need to involve stakeholders in the development of the due diligence policy.

In order to be effective, a mandatory environmental and human rights due diligence measure must not only be operationalised throughout the organisation, but also be accompanied by a level of management and board oversight over human rights and sustainability impacts, risks and strategies. It is positive that the proposal has taken steps to clarify the responsibilities of directors in this regard and make environmental and human rights due diligence a matter of strategic priority.

c) How can this be strengthened?

The proposal should require that companies make a policy commitment to respect human rights in line with the expectations of the UNGPs. Further, it should require that the due diligence policy should be made public and that stakeholders be involved in its development. In addition, guidance should be given to companies in developing the due diligence policy, particularly with respect to development of the code of conduct to ensure a consistent approach.

RECOMMENDATIONS

- Require companies to make a policy commitment to respect human rights in line with the expectations of the UNGPs
- Require that the due diligence policy should be made public and that stakeholders be involved in its development
- Give appropriate guidance to ensure a consistent approach to due diligence policy development

3.2.2 Identifying Impacts

a) What does the proposal say?

Companies are to be required to take 'appropriate measures' to identify actual and potential impacts arising from their own operations, those of their subsidiaries or those in an established business relationship (Art 6(1)). This should be based on qualitative and quantitative information, as relevant, including information received through complaints mechanisms and through consultations with relevant stakeholders (Art 6(4)).

'Appropriate measures' means a measure that is capable of achieving the objectives of due diligence, commensurate with the degree of severity and the likelihood of the adverse impact, and reasonably available to the company, taking into account the circumstances of the specific case, including characteristics of the economic sector and of the specific business relationship and the company's influence thereof, and the need to ensure prioritisation of action (Art 3(q)).

A 'severe adverse impact' is defined as an adverse environmental impact or an adverse human rights impact that is especially significant by its nature, or affects a large number of persons or a large area of the environment, or which is irreversible, or is particularly difficult to remedy as a result of the measures necessary to restore the situation prevailing prior to the impact (Art 3(l)).

Companies shall be entitled to make use of 'appropriate resources' in identifying impacts, including information gathered through complaints mechanisms. Further, companies should 'where relevant' carry out consultation with potentially affected groups including workers and other stakeholders (Art 6(4)). Medium sized companies in high risk sectors are only required to identify severe adverse impacts relevant to the respective sector (Art 6(2)).

b) Does it have the potential to effectively address corporate human rights impacts?

The proposal requires companies to take 'appropriate measures' to identify impacts including through reliance on 'appropriate sources'. What is appropriate in both respects is context dependent. The proposal enumerates a number of limiting considerations relevant to the determination of what an 'appropriate measure' may be, including: the circumstances of the case, such as the sectoral characteristics, the characteristic of the business relationship, degree of influence; the need to ensure prioritisation; as well as severity and likelihood. The definition of 'appropriate measures', therefore, evokes a number of different concepts in the UNGPs, not all of which are considered relevant to the identification of impacts under that framework. For example, although the UNGPs uses principles of leverage, which is broadly analogous to 'influence' in the definition, it is not a relevant consideration in identifying impacts, rather it is a concept used to assess what action a company should take where it is directly linked to a relevant impact. As such it places an undue limitation on the scope of the identification exercise.

This may be a result of the definition of 'appropriate measures' being used not only in relation to the identification of impacts in Article 6, but also to the steps that should be taken to address impacts in Articles 7 and 8. However, by using this omnibus concept in relation to the various stages of due diligence, it narrows the scope of actions a company ought to take in a manner out of step with the expectations of the UNGPs.

The requirement to consult with stakeholders in order to identify impacts is weak, requiring only that such consultations be undertaken 'where relevant', providing a degree of discretion to companies to elect when to engage in such consultation. The approach in the UNGPs,[15] by contrast, emphasises the centrality of rightsholder engagement to the identification of actual and potential impacts.

Further, the proposal only requires medium sized companies in high risk sectors to identify and address their severe impacts 'relevant to the respective sector', rather than the broad risk-based approach to due diligence expected by the UNGPs. However, human rights risks do not stem only from sector affiliation, but also from geographical locations or entity or activity level specificities. It is probable that companies will be expected to take cues from specific risks highlighted in sectoral OECD guidance, given the centrality of the OECD's sectoral approach to the designation of high impact sectors in the proposal. This approach creates the risk that medium sized companies will fail to adequately address the full range of their human rights impacts including those that may not flow from sector affiliation.

c) How can this be strengthened?

Appropriate guidance should be given to companies to ensure a consistent interpretation of 'appropriate measures' and that the concept is not unduly limiting when used in the context of the identification of impacts.

Further, the requirements to consult with stakeholders should be strengthened and considered a core rather than discretionary element of the identification process.

Finally, the proposal should require medium sized companies in high risk sectors to undertake the same broad based approach to due diligence expected of larger companies consistent with the expectations of the UNGPs.

RECOMMENDATIONS

- Provide companies with appropriate guidance on the meaning of 'appropriate measures' to ensure that it is not unduly limiting when used in the context of the identification of impacts
- Strengthen the requirements to consult with stakeholders and in particular with rightsholders
- Require medium sized companies in high risk sectors to undertake a broad-based approach to due diligence not limited to tackling specific sector risks

3.2.3 Addressing Actual or Potential Impacts

a) What does the proposal say?

The proposal specifies different approaches to taking action to address impacts depending on whether the impact is a 'potential' impact to be prevented (Art 7) or an 'actual' impact which needs to be minimised or brought to an end. The approaches are generally aligned, with some additional obligations in the case of an actual impact. Companies are to be required to take appropriate measures to prevent or mitigate potential adverse impacts that have been or should have been identified (Art 7(1)), bring to an end actual impacts (Art 8(1)) and minimise an impact where it cannot be brought to an end (Art 8(2)). This includes, where relevant:

a. Neutralising or minimising the extent of the impact, including by payment of damages or financial compensation (Art 8(3)(a));
b. Developing and implementing a prevention or corrective action plan (Arts 7(2)(a) and 8(3)(b));
c. Seeking contractual assurances from a business partner in a direct business relationship to ensure compliance with the code of conduct, and cascading those obligations (Arts 7(2)(b) and 8(3)(c));
d. Making necessary investments (eg management or production processes) (Arts 7(2)(c) and 8(3)(d));
e. Providing support to SMEs with whom the company has an established business relationship where compliance with the code of conduct would jeopardise the viability of the SME (Arts 7(2)(d) and 8(3)(e)); and
f. Collaborate with other entities to increase the company's ability to bring the impact to an end (Arts 7(2)(e) and 8(3)(f)).

The company may seek to conclude contractual arrangements with indirect partners in order to secure compliance with the code of conduct (Arts 7(3) and 8(4)). Any contractual assurances are required to be accompanied by appropriate measures to verify compliance (Arts 7(4) and 8(5)). Where this concerns SMEs, the company is required to bear the costs of verification.

There is an additional obligation where potential impacts cannot be prevented or adequately mitigated restraining the company from entering into new or extending relations with the partner in question (Arts 7(5) and 8(6)). This includes, where the law permits, suspending relations or terminating the relationship.

As noted above, supervisory authorities are to take into account a company's efforts to comply with remedial action required of them and any investments, targeted support given or collaboration with other entities to address adverse impacts in the value chain when considering sanctions for non-compliance (Art 20(2)).

b) Does it have the potential to effectively address corporate human rights impacts?

Again, companies are required to take 'appropriate measures' to prevent potential adverse impacts. Critically, the proposal requires companies to take action where impacts have or should have been identified. By including impacts that should have been identified, the proposal includes an important check on the adequacy of due diligence which could potentially operate as an important protection against checkbox compliance.

One means of taking action is the development and implementation of preventative and corrective action plans, which is positive. However, it must be noted that not all human rights impacts can be brought to compliance levels immediately including as they may be systemic to an industry or a particular geographical context. In such instances, effective due diligence involves more nuanced approaches to creating change and addressing systemic impacts, which should be encouraged by the proposal.

In addition, Article 8 introduces requirements to neutralise or minimise the extent of an actual impact, including by payment of damages or financial compensation. The language of 'neutralising', 'bringing actual impacts to an end' or 'minimising their extent' are not found in the UNGPs. Rather, the UNGPs speak of 'ceasing', 'preventing' and 'mitigating' impacts (Commentary GP19). This creates the possibility of conceptual confusion as it is not clear whether the concepts are completely analogous and if not, what the distinction may be.

c) How can this be strengthened?

By requiring that actions be taken 'where relevant' the proposal affords a degree of discretion to companies to adapt their due diligence to their particular circumstances. While a degree of flexibility is indeed desirable, it is not clear that the proposal has struck the right balance between requiring companies to engage in actions more likely to lead to checkbox compliance, such as the reliance on contractual assurances (Art 7(2)(b)), and encouraging companies to go beyond such measures by, for example, investing in management and production processes or infrastructure (Art 7(2)(c)), collaborating with other entities (Art 7(2)(e)) or supporting smaller business partners (Art 7(2)(d)).

Requiring supervisory authorities to take into account investments, collaboration and support when considering administrative sanctions is one means by which the proposal seeks to address this, but it is again unclear whether the right balance has been struck.

RECOMMENDATIONS

- Ensure that sufficient incentives have been given to encourage companies to go beyond contractual assurances and third-party verification and engage with the full range of actions to address their impacts
- Align terminology with that of the UNGPs and OECD Guidelines or clarify differences

3.2.4 Monitoring Impacts

a) What does the proposal say?

Companies are to be required to carry out periodic assessments to gauge the effectiveness of their due diligence at least annually and more frequently whenever there are reasonable grounds to believe there are significant new risks. This should be based on appropriate qualitative and quantitative indicators. The outcome of the monitoring process should be used to update the due diligence policy.

b) Does it have the potential to effectively address corporate human rights impacts?

Company assessments of their due diligence are to be conducted annually or 'whenever there are reasonable grounds to believe that significant new risks of the occurrence of those adverse impacts may arise', and be used to update the due diligence policy which is in keeping with the ongoing nature of the process of due diligence as set out in the UNGPs. It is positive that this requirement has been included.

c) How can this be strengthened?

While the requirement to conduct periodic assessments is welcome, it should be clarified that the assessment should also be used to inform the development of actions to address actual or potential impacts more generally, including the revision of preventative or corrective action plans.

The proposal should emphasise the need to consult with stakeholders when undertaking assessments, as well as the need to use the findings from assessments to not only inform the due diligence policy, but also to update due diligence processes, including the development of action plans.

RECOMMENDATIONS

- Strengthen the requirements to consult with stakeholders when undertaking periodic assessments
- Clarify the need to use the findings from assessments to not only inform the due diligence policy, but also to update due diligence processes, including the development of action plans

3.2.5 Communicating on Impacts

a) What does the proposal say?

The proposal does not include any new disclosure requirements, given that there is no requirement to disclose the policy framework required by Article 5. Rather, the proposal defers the reporting obligations to the Corporate Sustainability Reporting Directive (CSRD), except in the case of companies not required to report under that directive, in which case they will be required to prepare an annual statement published on their website the content of which will be specified in delegated acts.

b) Does it have the potential to effectively address corporate human rights impacts?

Given that the CSRD proposal was published substantially before the due diligence proposal, particular care needs to be taken to ensure that the form of disclosures required are adequate to meet the expectation that companies will communicate externally about how they address their human rights impacts set out in the UNGPs (GP21). Further, the draft CSRD disclosure standards have a wider scope than that of the CSDD, e.g. covering both negative and positive impacts as well as double materiality reporting, including around risks to businesses. As a result, there will likely be a need to specify which disclosure requirements of the CSRD are those that discharge the CSDD obligations and which serve a different purpose. This will also be key for demonstrating alignment with article 18 of the taxonomy regulation.

The proposal anticipates that there will be a further subset of companies required to comply with the proposal but not report under the CSRD, creating a parallel reporting regime for companies in that subset. If the reporting obligations of such companies are not aligned with the requirements of the CSRD, the proposal risks jeopardising one of the stated aims of the proposal, namely the creation of a level playing ground. Finally, it is not made clear how covered financial institutions that may be covered by SFDR reporting requirements interrelate with the CSDD reporting requirements.

c) How can this be strengthened?

Care must be taken to ensure that the CSRD disclosure requirements are adequate to meet the expectations of the UNGPs and the proposal.

RECOMMENDATIONS:

- Ensure that the CSRD proposal disclosure requirements are fit for purpose, and meet the expectations of the UNGPs as well as the needs of this proposal as well as article 18 of the taxonomy regulation
- Align reporting requirements of companies not directly covered by CSRD with the CSRD as much as possible
- Clarify reporting obligations for financial institutions

3.2.6 Participation in Remediation

a) What does the proposal say?

In addition to the civil liability provisions (Art 22), the prospect of remediation is addressed in part in Article 8, which anticipates that a company may be required to pay damages or financial compensation to affected persons or communities.

Further, companies are to be required to set up complaints handling mechanisms (Art 9(1)) accessible to affected persons and other stakeholders including trade unions and CSOs (Art 9(2)). There needs to be a procedure to assess complaints and where a complaint is well founded, it is deemed to be identified in accordance with Article 6 (Art 9(3)). Those submitting complaints shall be entitled to request follow up and to meet with company representatives (Art 9(4)).

b) Does it have the potential to effectively address corporate human rights impacts?

While explicit recognition that financial compensation may be required in certain circumstances is welcome, it is a rather more limited approach to the expectation to engage in remediation expected in the UNGPs. Forms of remediation may be broader than purely financial compensation. Further, the UNGPs expect that companies will provide for or cooperate in remediation of any adverse human rights impacts they cause or to which they contribute (GP22). This expectation is alluded to by the possibility that compensation may be required, but does not fully capture the spirit of the UNGPs.

The requirement that companies establish a complaints mechanism which is open to a broad range of stakeholders is welcome. However, notably, the mechanism is expressed to be a complaint mechanism, rather than a grievance mechanism, departing from the expectations of the UNGPs and absent the effectiveness criteria specified therein. Further, although the complaint mechanism should accommodate requests for follow up, the proposed mechanism is weak and falls far short of the expectations of the UNGPs. Lastly, the complaint mechanism could be a valuable means of facilitating the discharge of other due diligence obligations, but the proposal misses opportunities to do so. The proposal does link the establishment of a well-founded complaint to the identification process in Article 6, but does not create links between the complaint mechanism and the actions taken to address actual or potential impacts in Articles 7 and 8. It is a particularly glaring omission that the complaint mechanism is silent with respect to remedy and fails to make a link between the process and the recognition Article 8(2)(a) that in certain circumstances financial compensation may be required. The complaint mechanism could be a valuable means of facilitating such compensation.

c) How can this be strengthened?

The proposal should take a broader view of a company's obligations with respect to providing and/or cooperating in remediation consistent with the UNGPs. In addition, the complaint mechanism should be better aligned.

RECOMMENDATIONS:

- Ensure that the proposal takes a broad view of a company's obligations with respect to providing for or cooperating in remediation of adverse human rights impacts
- Better align the complaint mechanism with the effectiveness criteria including in UNGPs and create sufficient interlinkages with other processes in the proposal, such as those concerning identification of impacts and actions to address them

ENDNOTES

1 UN Office of the High Commissioner for Human Rights, 'Guiding Principles on Business and Human Rights: Implementing the 'Protect, Respect and Remedy' Framework' (HR/PUB/11/04), 2011
2 OECD Guidelines for Multinational Enterprises (OECD 2011).
3 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 Text with EEA relevance
4 OECD Due Diligence Guidelines
5 See for example, guidance from the European Commission: My Business and Human Rights: A Guide to Human Rights for Small and Medium-Sized Enterprises, (2012) and OHCHR Challenges and opportunities: Small and medium-sized enterprises (SMEs) and human rights, (2017)
6 Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting COM/2021/189 final
7 European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountabilityv (2020/2129(INL))
8 LOI n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre, amending the French Commercial Code, art L 225-102-4 including the concept of « relation commerciale établie »
9 See for example, analysis from Sherpa which identifies ambiguities around the concept and advocates for a broad interpretation to capture all suppliers and subcontractors of a company and its subsidiaries regardless of their position in the value chain beyond direct or Tier 1 relationships: Sherpa, Vigilance Plans reference Guidance (2019)
10 OECD (2017), Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises
11 See for example a recent report from the Business and Human Rights Resource Centre Beyond Social Auditing: Recommendations for Mandating Effective Due Diligence (2021)
12 See further, Gabrielle Holly and Claire Methven O'Brien Human rights due diligence laws: Recommendations – Briefing on civil liability for due diligence failures, Danish Institute for Human Rights (2021)
13 Mandatory due diligence: Building blocks for effective and ambitious European due diligence legislation (2021)
14 Mandatory due diligence: Building blocks for effective and ambitious European due diligence legislation (2021)
15 The UNGPs state that the process that a business establishes to identify impacts should 'involve meaningful consultation with potentially affected groups and other stakeholders' emphasising that this is a core rather than discretionary element (GP 18).


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