IIGCC
The Institutional Investors Group on Climate Change

31 May 2022

<u>IIGCC Position Paper: EU Corporate Sustainability Due Diligence Directive</u>

The Institutional Investors Group on Climate Change (IIGCC) is the leading European membership body enabling the European investment community in driving significant and real progress by 2030 towards a net zero and resilient future. IIGCC's 360+ members, representing €51 trillion AUM, are in a position to catalyse real-world change through their capital allocation decisions, stewardship and engagement with companies and the wider market, as well as through their policy advocacy.

IIGCC welcomes the European Commission's proposal for an EU Corporate Sustainability Due Diligence Directive ('the Directive'). Integrating sustainability considerations into corporate due diligence practices across the value chain is essential for identifying, mitigating and addressing the adverse impacts of companies' activities on the climate and environment. We also support efforts to encourage company directors to consider climate-related factors and the net zero transition when fulfilling their duties to act in the best interests of the company and wider stakeholders.

However, the proposed measures risk missing a vital opportunity to uphold the objectives of the European Green Deal, and foster approaches to climate risks and opportunities that prioritise long-term perspectives over short-term considerations. As such, IIGCC encourages the European Council and Parliament to review the following considerations during the ongoing negotiations:

- The need for clarity on how the Directive will apply to investors, including in relation to entity- and product-level due diligence requirements, mitigating adverse impacts, value chain due diligence and the development of transition plans.
- Regarding the application of the Directive to corporates, we encourage the Council and Parliament to review the scope and ensure that companies operating in the highest-emitting sectors are subject to transition plan disclosure requirements. As a priority, investors need more detail on the precise nature of how these companies will align their business models with the goals of the Paris Agreement, in order to allocate capital towards a 1.5°C future.[1]
- The Directive must be consistent with wider EU sustainable finance and real economy initiatives, including the proposed Corporate Sustainability Reporting Directive, the Sustainable Finance Disclosure Regulation and sectoral policies under the EU Green Deal, to support a coherent regulatory framework.

We welcome your consideration of these concerns. Through our work with both our membership base and corporates, IIGCC has developed a deep understanding of the circular and interdependent relationship between investors and investees and is therefore well placed to provide input on the proposals. We stand ready to engage with the Council and the Parliament to ensure the Directive establishes a robust framework for sustainability due diligence and upholds the objectives of the European Green Deal and the Paris Agreement.

[1] This is particularly important for companies in-scope of the Directive, but which are not in-scope of the Corporate Sustainability Reporting Directive, where more detailed transition plan disclosures will need to be made under the sustainability reporting standards to be developed by the European Financial Reporting Advisory Group.

1. **Clarity on application of the Directive to investors**

IIGCC stresses the need for more clarity on how the Directive will apply to investors specifically. For example, per Article 3 of the proposals, asset managers are scoped-in at entity-level (e.g. AIFMs; UCITs ManCos), but also at product-level (e.g. AIFs and UCITS). The inclusion of investment products within the scope of the Directive represents a noticeable deviation from the rest of the text, which imposes obligations on other firms at entity-level only. Investors are already making entity- and product-level disclosures on sustainability due diligence under the Sustainable Finance Disclosure Regulation (SFDR), including the identification and mitigation of principal adverse impacts. The Directive states that it will 'underpin' due diligence requirements under SFDR, but no further detail on how it will underpin these requirements is provided. To avoid imposing duplicative and burdensome obligations on investors, it will be important to clarify how the Directive complements existing requirements that investors must meet under SFDR. For example, where investors are already submitting relevant information in line with SFDR, provisions could be introduced which would allow them to cross-reference these disclosures under this Directive. More broadly, requirements to identify, mitigate and address adverse impacts should be strengthened to avoid a situation whereby in-scope entities can solely rely on policies and contractual assurances to meet their obligations under the Directive, while investors are subject to more stringent do not significant harm requirements under SFDR.

The proposal defines the concept of a 'value chain' for the financial sector as activities of clients receiving a loan, credit, other financial and other companies belonging to the same group whose activities are linked to the contract in question. However, it is not clear how this concept relates to asset managers, and more specifically the nature of the due diligence investors will need to conduct across the value chain. To ensure clarity and uphold consistency with the SFDR, we recommend that value chain due diligence requirements for investors should relate specifically to the relationship with investees (per the OECD Guidelines for Multinational Enterprises sector-specific guidance for institutional investors).

We would also welcome additional detail on how the requirement to terminate business relationships as a last-resort action, where principal adverse impacts are severe, will apply to investors. Where corrective action plans have failed, this could imply a need for divestment, including from carbon-intensive companies whose activities may currently be having an adverse impact on the climate, but which have credible plans in place to transition to net zero. While selective divestment can be necessary as a last resort, IIGCC sees the value in strategies to hold high-impact assets and use engagement and stewardship actions to drive real world emissions reductions.

2. **Align the scope of the Directive with the Corporate Sustainability Reporting Directive (CSRD), and scope in companies operating in carbon-intensive sectors**

The proposed scope of the Directive will capture approximately 13,000 EU companies and 4,000 non-EU companies, with no small and medium sized enterprises (SMEs) subject to the requirements. While it is important for due diligence requirements to be proportionate, and to avoid imposing an undue burden on reporting entities, the current proposals would exclude around 99% of European companies from the scope of the Directive. In addition, the definition of high-risk sectors does not include the sectors which have the greatest negative impact on the climate, and whose transition is most essential to achieving the goals of both the Paris Agreement and the EU's own climate and energy targets.

Climate change presents material financial risks and opportunities to all companies, irrespective of size. The limited scope of the Directive, alongside the exclusion of carbon-intensive sectors from the list of high-risk sectors, would significantly reduce the impact of the proposals. Given the interdependency between the Directive and the forthcoming CSRD, IIGCC recommends that the scope should be amended to uphold consistency with the original proposed scope of the CSRD (which covers an estimated 49,000 companies, including listed SMEs). We also recommend that the list of high-risk sectors is broadened out to account for, and bring into scope, companies operating in carbon-intensive sectors. This should include companies operating within the material sectors identified by the Paris Aligned Investment Initiative's Net Zero Investment Framework (NZIF), namely those in NACE code categories A-H and J-L.

3. **More specificity on requirements to adopt transition plans, including for companies in high-risk sectors, and holding company directors accountable for their delivery**

IIGCC supports proposals to require companies to adopt plans setting out how their business model and strategy is aligned with a 1.5°C pathway. However, more detail is needed to ensure such plans are credible and science-based. The current proposals under Article 15 are not sufficiently holistic, focusing primarily on the need to assess whether climate change is a risk for, or impact of, the company's operations. Investors also need to be able to assess how companies' business models and strategies are aligning with the goals of the Paris Agreement. We therefore recommend that companies develop plans that incorporate the indicators established under the Climate Action 100+ Net Zero Company Benchmark ('the CA100+ Benchmark'). This will increase transparency over the actions investees are undertaking to align their business models and strategies with a net zero future.

It will be important to establish a clear connection between proposals to adopt transition plans and the proposed requirements to bolster directors' duty of care and due diligence. At present, the obligation to adopt transition plans under Article 15 does not include any requirements for board-level oversight of transition plans and emissions reduction objectives. We therefore propose that the Commission explicitly links the requirements to adopt transition plans and set emissions reduction targets with the obligations relating to directors' duty of care (Article 25) and due diligence oversight (Article 26).

Under the current proposals, companies captured by the Directive on the basis that they operate in a high-risk sector (and meet the relevant turnover and employee thresholds) are not required to adopt transition plans. Given that it is precisely these companies whose transition is most vital to ensuring we reach net zero, IIGCC would urge the Parliament and the Council to amend the proposals to require high-risk companies (including carbon-intensive companies) to adopt transition plans. We suggest that in-scope companies covered by sectors in NACE code categories A-H and J-L should also be required to adopt transition plans, alongside the companies referred to in Article 2(1), point (a), and Article 2(2), point (a), of the proposals.

The proposals only require in-scope companies to set emissions reduction objectives as part of their transition plans where climate change has been identified as a principal risk for, or a principal impact of, the company's activities. This leaves considerable room for companies to self-determine whether climate change is a principal risk for their business strategy and operations. Where in-scope companies have been identified as operating in high-risk sectors - and particularly carbon-intensive sectors – IIGCC recommends the introduction of mandatory emissions reduction objectives. Moreover, the high-level nature of the requirement means it is not entirely clear what 'emissions reduction objectives' entail in practice. For the Directive to truly contribute to combating climate change, 'emissions reduction objectives' should include robust science-based targets, on a clearly defined scope of emissions, covering the short-, medium- and long-term. This would align the Directive more closely with the proposals to disclose science-based targets set out in CSRD.

IIGCC also emphasises the need to differentiate between the type of transition plans to be adopted by investors, and those to be adopted by corporates to support the current and forward-looking alignment of their holdings. Where investors are in scope of the requirement to adopt transition plans, IIGCC proposes that these plans should integrate the recommendations developed through the Investor Agenda's Expectations for Investor Climate Action Plans, which set out key elements of what could be considered 'transition plans' for investors at all levels of ambition, with a view to ultimately setting a net zero target.

Finally, detailed guidance on what a 'good' transition plan looks like will be helpful to support in-scope companies in adopting and implementing these plans in practice (particularly where they operate in carbon-intensive sectors). The Commission could consider adopting a similar approach to that taken by the UK's Transition Plan Taskforce, which aims to develop guidance and templates setting out both generic and sector-specific transition plan disclosures and metrics.

4. Clearer requirements to link variable remuneration to the achievement of climate-related objectives, including transition plans

At present, the proposals require directors to take transition plans into account when setting variable remuneration only where variable remuneration is already linked to sustainability factors. Linking variable remuneration to tangible sustainability KPIs (including science-based emissions reduction targets) is integral to fostering long-term perspectives and sustainable value creation. IIGCC therefore recommends that the requirements relating to variable remuneration are strengthened, and mandated for in-scope companies that are required to adopt transition plans. In line with sub-indicator 8.2 of the CA100+ Benchmark, IIGCC suggests that the following criteria are incorporated into the proposals relating to variable remuneration:

- The company's CEO and/or at least one other senior executive's remuneration arrangements specifically incorporate climate change performance as a KPI for determining performance-linked compensation (reference to 'ESG' or 'sustainability performance' are insufficient);

- The company's CEO and/or at least one other senior executive's remuneration arrangements incorporate progress towards achieving the company's GHG reduction targets as a KPI for determining performance-linked compensation.

5. **Explicit incorporation of climate considerations into due diligence requirements, with clear links to director oversight and accountability**

The proposals require companies to identify and manage actual and potential adverse human rights and environmental impacts, and ensure board-level oversight of due diligence frameworks. However, there is no explicit mention of the need to integrate climate due diligence into company policies, and to establish a process for identifying, mitigating and addressing adverse climate impacts. We therefore recommend that the Directive legally defines the concept of "climate due diligence" in Article 4 of the proposals. Clear recognition of the need to undertake climate due diligence, including in relation to the goals of the Paris Agreement, will support the Directive's aim of combating climate change, in line with Article 15. Requirements to undertake climate due diligence should differentiate between the impacts of physical- and transition-related climate risks, given that companies will need to address these impacts in different ways and may be more or less exposed to one or the other categories. IIGCC's Investor Expectations of Companies on Physical Climate Risks and Opportunities sets out guidance on how companies and investors can identify and address physical climate impacts.

IIGCC recommends the amendment of the proposed requirements to ensure that company boards have clear oversight of climate change risks and demonstrate this through assigning explicit responsibility for climate risk management to a C-suite executive and/or a designated committee. To promote transparency over due diligence processes, the identification, mitigation and addressing of material actual and potential adverse climate impacts (of reporting entities' own operations and across the value chain) should be reported at board-level.

Beyond requirements for in-scope entities to undertake climate due diligence, we also recommended that the due diligence requirements should extend beyond "established business relationships". Climate-related adverse impacts can often be more pronounced further down the value chain, where business relationships are less established and formalised. The current proposals could create a risk that companies focus their attention on more proximate business relationships that are easier to influence, rather than those which are at risk of being most severely impacted by climate and wider adverse impacts.

6. **Maintain consistency with wider sustainable finance and real economy policies**

IIGCC welcomes the Commission's commitments to promote consistency between the Directive and other EU regulatory initiatives, including the CSRD proposal, the EU Taxonomy and the SFDR. A coherent regulatory framework for sustainable finance supports investors in channelling capital towards the companies and activities that will help us to reach net zero. However, references to how these initiatives interrelate with the Directive would benefit from greater precision. As noted by the Commission, CSRD will play a vital role in covering the last step of the due diligence duty, i.e. the reporting stage. But this will only be the case for those companies that are covered by both the Directive and CSRD. Given that CSRD covers a much greater scope of companies, we reiterate our recommendation that the Parliament and Council align the scope of the two directives. Moreover, it will be difficult for in-scope companies to adopt a transition plan without stronger links to CSRD, which provides clarity on how reporting entities can make related disclosures and report on their science-based targets. The proposed requirement to adopt transition plans that align with 1.5°C must therefore be explicitly connected to, and fully consistent with, the related transition plan disclosures that firms will need to make under the CSRD. Finally, the proposed timetables for implementing the proposals differ from the proposed timeline for CSRD. The likely earliest possible application of the sustainable due diligence requirements is Q1 2026, whereas companies could need to start disclosing in line with CSRD from 2024 onwards. Given that CSRD covers the last step of the corporate due diligence process, this could create implementation challenges and costs, particularly in relation to data collection, that will need to be managed.

As noted previously, more clarity is needed on how the Directive will support the processes and disclosures investors will need to develop and make under SFDR. The proposals in the Directive impose due diligence requirements on companies that should complement those that investors are subject to under SFDR (including in relation to the principal adverse impacts of investment decisions). This should, in turn, support the flow of information across the investment chain. However, it is not clear how the Directive enables investors to identify the climate-related adverse impacts of their investees, as there is no explicit requirement for in-scope companies to consider these impacts (per the Annex to the Directive). To rectify this, we propose that the Annex also references the need to account for climate-related adverse impacts, including Scope 1, 2 and 3 GHG emissions.