

Recommendations on Corporate Governance in the Draft EU Corporate Sustainability Due Diligence Directive

As part of its strategy to implement the European Green Deal and the Action Plan on Financing Sustainable Growth, the European Commission presented its proposal for a Corporate Sustainability Due Diligence Directive (CSDDD). **This paper specifically addresses the parts of the proposal that relate to corporate governance and directors' obligations, as well as to the responsibilities of the financial sector.** It intends to complement the analyses of non-governmental and expert organisations on the due diligence aspects.

1. Directors' obligations as part of due diligence
2. Directors' obligations with regard to climate change
3. Alignment of incentives to sustainability objectives
4. Responsibilities of the financial sector

In the explanatory memorandum of the draft CSDDD, the EU Commission recalls that one of the five specific objectives of the directive is *"(1) improving corporate governance practices to better integrate risk management and mitigation processes of human rights and environmental risks and impacts, including those stemming from value chains, into corporate strategies"*. However, the proposal initially referred to as 'Sustainable Corporate Governance' has been presented with only a few elements to foster integration of sustainability and long-term thinking in corporate governance rules. It is important that corporate governance keeps pace with sustainable finance and the demands of stakeholders and [investors](#), which themselves have supported the call on clarifying directors' obligations.

Briefing supported by:



1. Directors' obligations as part of due diligence

What the EU Commission is proposing with regard to corporate governance is not ambitious enough to be effective and falls short of the standards the OECD has developed. Including a clarification of directors' obligations in the CSDDD is key to move due diligence beyond compliance and a tick-box approach towards a more strategic and transformative one and address business impacts on people and the planet. The EU Commission does not live up to its own intention underlined in its [second Impact Assessment](#): "*Clarity on directors' duties and fostering long-term oriented business decision are key for due diligence to deploy its full potential.*"

The CSDDD essentially has to close a gap: The [OECD Guidance](#) and the UN Guiding Principles on Business and Human Rights spell out and [include](#) responsibilities for directors and existing disclosure obligations involve the identification of relevant risks and impacts connected to the business model of the company. However, most of the time, human rights, climate change and environmental consequences are [not adequately integrated](#) into business models and strategies. [Clarifying directors' responsibilities is needed](#), not only to align the due diligence obligations with the international standards of the OECD and the UN, but also to connect the due diligence of companies to sustainable finance action by investors.

Article 25 only pays lip service to the integration of sustainability matters to the duty of directors' to act in the best interest of a company. The actual wording used in Article 25, paragraph 1, is left very vague ("take into account the consequences of their decisions for sustainability matters"), which brings uncertainty to directors when conducting their duty. [Business leaders and academics](#) have also called for legal clarity in this regard. Article 25, paragraph 2, which refers to the breach of directors' duties, leaves a lot of discretion to Member States' company law.

Connecting due diligence to the directors' duty of care in **Article 26** strengthens the due diligence approach and prevents corporate responsibility or compliance departments from operating in a silo. In order to properly do so, some terms and procedures in this Article should be specified.

Recommendations:

- The wording of Article 25 should be strengthened, particularly to ensure the connectedness with the company obligations set out in the draft directive.
- The obligation to oversee due diligence in Article 26 should be further specified, concerning, e.g., the regularity of reporting to the board, the approval of decisions to adapt the business model and strategy and the necessity to act upon the implementation of due diligence.
- Article 26, paragraph 2, should spell out the obligation of directors' regarding climate change (see below).
- Companies have to be able to demonstrate that they comply with the duty of due diligence and take adequate due diligence measures. Governance can be one impactful way of evaluating the seriousness of a company's due diligence: Companies can respond to indicators looking at the frequency and content of discussions at board level, the existence of procedures to ensure oversight, etc.
- The language of Articles 25 and 26 should be improved in order to be aligned and more coherent with corporate sustainability reporting obligations.

2. Directors' obligations with regard to climate change

The European Commission has taken a step in the right direction by integrating climate change explicitly in the proposal via **Article 15** "Combating Climate Change". However, Article 15 is unfortunately not properly integrated with the rest of the company's obligations, neither with the due diligence part, nor with the directors' duties. This creates a big legal loophole: for example, the company's obligation to set a transition plan and emission reduction objectives is not part of the Board's oversight, which would make more sense given the Board's responsibility to set up a sustainability strategy that would contain those two key elements. There are no consequences attached to not complying with the company obligations regarding climate change, which would make the exercise almost voluntary (except administrative enforcement) rather than mandatory (even if the wording mentions "shall"). A clear connection to Article 25 (directors' duties), paragraph 2, that includes directors' liability, is missing.

In terms of the content of the obligations, the Commission has failed to provide the necessary detail for companies to adopt and set such a plan and objectives. There is no explicit link to the Corporate Sustainability Reporting Directive (CSRD) and the exercise of materiality determination, which is key before adopting such a plan and setting such objectives. In addition, the [European Parliament's position](#) on the CSRD provides the needed detail for companies on how to report on their transition plans and sustainability targets based on science¹ (and to develop a standard on both elements). Aligning different sustainability files is needed to ensure consistency. A considerable difference identified with the CSRD is that transition plans and sustainability targets would apply for all sustainability issues, not only climate change mitigation. It would be a mistake to reduce targets and related transition plans to climate change only, especially as this file was part of the European Green Deal, which covers all sustainability elements (E, S and G). The Commission has been too cautious in only referring to "emission reduction targets"; this would make companies miss many other important sustainability targets that can be identified via the double materiality determination exercise. The forward-looking projection of a company in terms of "doing good" would be too narrow otherwise, especially after the publication of the [latest IPCC report](#), which very clearly highlights the urgency of immediate and effective measures.

Recommendations:

- Climate obligations need to be explicitly mentioned in Article 26 as part of board oversight to ensure that directors are fully responsible for approving the company's strategy, which must encompass the company's sustainability targets based on science, including climate reduction objectives, related transition plans, and alignment of executives' remuneration with the achievement of those targets (see point 3 below). Boards should have a clear requirement to integrate sustainability risks and impacts in the company's strategy.
- In order to properly assess and identify the main risks and impacts before defining a transition plan and sustainability targets, the company should conduct a double materiality determination exercise and the identification part of the due diligence process under the supervision of directors. This can be done through an explicit connection with the Corporate Sustainability Reporting Directive (CSRD).

¹ Sustainability targets based on science means targets that are capable of urgently responding to scientific analysis and recommendations, and can ensure effective action (this applies to all sustainability targets mentioned throughout this paper)

- Reference to the [European Parliament's CSRD text](#) regarding the criteria for transition plans and the set of sustainability targets based on science must also be made.
- The scope of this article should go beyond companies with more than 500 employees only and should also include companies in high-risk sectors. There is no justification for the limited scope of this Article (even more so than for the full proposal).

3. Alignment of incentives with sustainability objectives

The proposal of the EU Commission to align incentives in remuneration policies remains voluntary, non-binding and limited in scope as it only refers to climate action. The provision spelled out in **Article 15, paragraph 3** will have very little effect in practice, as it only targets companies that have already integrated sustainability matters in directors' remuneration policies. A recent survey by [Reuters](#) (of 530 corporate executives, mostly from Europe and the US) showed that only a minority of companies (20%) have partially aligned executives' remunerations with sustainability targets. Companies whose policy is to index executive remunerations with financial criteria only – and which are now in the majority, will not be required to change their practices. Moreover, this provision is limited to climate objectives - whereas a coherent and effective approach requires greater articulation with general and specific obligations as spelled out in Articles 25 and 26.

Leaving room for flexibility - as outlined by the European Commission in its Impact Assessment - by inserting a general clause only is likely to have very limited impact. It may even have negative effects - as it may push companies associated with large GHG emissions to reconsider the inclusion of sustainability criteria into remuneration policies.

Recommendations:

- The provision in Article 15 (3) should actually be part of Article 26. Sustainability criteria used in remuneration policies need to encompass the full range of sustainability matters and be connected with the obligations for directors to ensure that a company's strategy responds to due diligence obligations, which must include the impact on climate.
- The provision should be strengthened by requiring that specific, measurable, and varied criteria, derived from sustainability targets, represent a significant portion of variable and share-based remunerations.
- It should be specified that the clause needs to apply to all companies, by removing the reference to existing practices.

4. Responsibilities of the Financial Sector

The EU Commission rightly includes the financial sector in the scope of the draft Directive. This is in line with [international due diligence standards](#) that are applicable to enterprises in the financial sector, including commercial, retail and investment banks, rating agencies, financial service providers, institutional investors, etc.

Yet, the European Commission has decided to significantly limit the application of the CSDDD provisions for the financial industry. This is not in tune with the [extensive OECD](#) and [UN guidance](#) for the financial industry on the [application of due diligence](#) produced in the past decade, nor with the [industry uptake](#) and subsequent best practice. The EU Commission has limited the application of the Directive by only including very large financial actors in scope and by restricting due diligence for financial institutions to the pre-contractual phase of relationships and to the activities of large corporate clients only.

These exemptions contradict and undermine international guidance and industry practice. Due Diligence should not be limited to very large financial institutions only, as severe climate, human rights and environmental impacts can occur in the activities of businesses of all sizes. Moreover, limiting the application of due diligence to certain clients or operation phases, goes against the ongoing and risk-based nature of due diligence.

Recommendations:

- The financial sector should be included as a high impact sector, in line with the Commission's own rationale to select high-impact sectors based on existing sectoral OECD due diligence guidance.
- The due diligence requirements for the financial industry should be aligned with provisions for other sectors and international guidance, to be based on ongoing identification and mitigation of impacts linked to operations, products, and services.
- It is important that due diligence requirements for financial institutions include their full business portfolio, rather than large corporate clients only.
- Directors' obligations should apply to financial institutions in scope.