Investment Institute Sustainability

Why responsible investors can present a competitive hedge with the adoption of CSDDD

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Key points

- The Corporate Sustainability Due Diligence Directive marks the next stage in the evolution of European corporate due diligence
- Companies are liable in the event of due-diligence failure, with significant financial fines – up to 5% of their annual turnover
- Companies have an obligation of means to respect human rights and the environment – and to have a climate transition plan
- This regulation will impact certain supply chains and modify business relationships between ordering companies and suppliers
- Investors should consider the potential financial risks for their investee companies and define policies and have measures in place

On 23 February 2022, the European Commission submitted to the European Parliament and Council a proposal for a directive on Corporate Sustainability Due Diligence. Following much debate, discussion and delayed votes, the directive went live in May 2024 – notably prior to June's European Parliament elections, the outcome of which could have endangered the directive's adoption.

The directive, as laid out by the European Council, "introduces obligations for large companies regarding adverse impacts of their activities on human rights and environmental protection".[1]

We believe the final text represents an important step for human rights and the environment.

The first point of the Corporate Sustainability Due Diligence Directive's (CSDDD) preamble reaffirms core European Union (EU) values:

"As stated in Article 2 of the Treaty on the European Union, the Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights as enshrined in the EU Charter of Fundamental Rights. Those core values, that have inspired the Union's own creation, as well as the universality and indivisibility of human rights, and respect for the principles of the United Nations Charter and international law, should guide the Union's action on the international scene. Such action includes fostering the sustainable economic, social and environmental development of developing countries."[2]

Human rights and due diligence: Soft laws and concepts

"Where do universal human rights begin? In small places, close to home so close and so small that they cannot be seen on any maps of the world." Eleanor Roosevelt, **the first Chair of the United Nations (UN) Commission on Human Rights.**

The modern concept of human rights was born with the UN Charter (1945) and the Universal Declaration of Human Rights adopted in 1948 in Paris. Drafted by the committee chaired by Eleanor Roosevelt, this declaration affirms that 30 human rights are universal, inherent, inalienable and applicable to all human beings.

Subsequently, in December 1966, the UN General Assembly adopted two international treaties – the International Covenant on Economic Social and Cultural Rights as well as the International Covenant on Civil and Political Rights - completing the definition of human rights as we understand them today.[3]

It is important to note that during the 1970s, these concepts were the preserve of states, not corporates - the notion of company due diligence was still far from being defined.

From a supranational standpoint, the link between human rights and companies can be traced back to the International Labour Organization (ILO). Established in 1919, the ILO is the only tripartite UN agency which brings together governments, employers and workers of 187 member states. Its core Labour Standards are defined as:[4]

- Freedom of association and the effective recognition of the right to collective bargaining
- The elimination of all forms of forced or compulsory labour
- The effective abolition of child labour
- The elimination of discrimination in respect of employment and occupation
- A safe and healthy working environment

These principles were gathered as the ILO Declaration on Fundamental Principles and Rights at Work in Geneva in June 1998.

Harder laws take hold

Until 2010, all measures taken by companies in respect to human rights and the environment were mostly voluntary. Programmes, guidelines, and frameworks such as the UN Global Compact, the Global Reporting Initiative (GRI) or recommendations from the Organization for Economic Co-operation and Development (OECD) helped companies to report on a voluntary basis and adapt their policies to become more sustainable. But no hard law existed.

Even if some companies embraced such honourable commitments in the aftermath of the Cold War, it must be noted that numerous companies failed to respect the environment and/or human rights by acting with a relatively high level of impunity around the globe.

In that context, the UN Guiding Principles on Business and Human Rights (UNGPs) presented by John Ruggie, were adopted by the UN Human Rights Council in 2011.[5]

It was the first time the moral responsibility was partly transferred to business enterprises with three pillars: Protect, Respect and Remedy. The concept of due diligence is closely linked with these international norms and standards. AXA IM is committed to respect these in its ESG Standards Policies by excluding companies that fail to respect key pillars on human rights and the environment.

Following the UN call for National Action Plans (NAPs) in 2012, countries started to implement hard laws. For example, France was one of the first states – alongside the UK – to vote for the *Devoir de vigilance* (duty of care) which obliged companies to present a vigilance plan. The law came into force in 2017. As of today, only one company has been convicted in France for allegedly breaching this law – and the trial is ongoing. Other countries have their own due diligence laws, such as Germany, which is far more ambitious than France's and closer to CSDDD.

CSDDD: The legal expression of advances over the last decades

In terms of company obligations, the CSDDD lays down rules on:[6]

(a) obligations for companies regarding actual and potential human rights adverse impacts and environmental adverse impacts, with respect to their own operations, the operations of their subsidiaries, and the operations carried out by their business partners in the chains of activities of those companies.

(b) liability for violations of the obligations as referred to in point (a); and

(c) the obligation for companies to adopt and put into effect a transition plan for climate change mitigation which aims to ensure, through best efforts, compatibility of the business model and of the strategy of the company with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement.

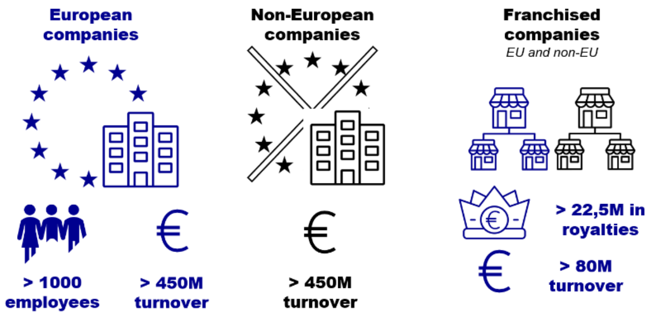
Companies which fall under CSDDD

EU-based companies with more than 1,000 employees and net sales of more than €450m fall within the scope of the directive.

Non-European or third-country companies with EU sales of more than €450m also fall within its scope, with no specific employee threshold. A specific group exists for franchised companies.

According to different estimations, around 5,400 companies are directly subject to the CSDDD[7] or 0.05% of European companies[8,9].

Financial institutions initially included in the directive are not obliged to comply with the directive via their investments but only via their own operations. "Only the upstream but not the downstream part of their chains of activities should be covered by this Directive." Still, regulated financial undertakings are expected to consider adverse impacts and to use their so-called 'leverage' to influence companies. The exercise of shareholders' rights can be a way to exercise leverage.



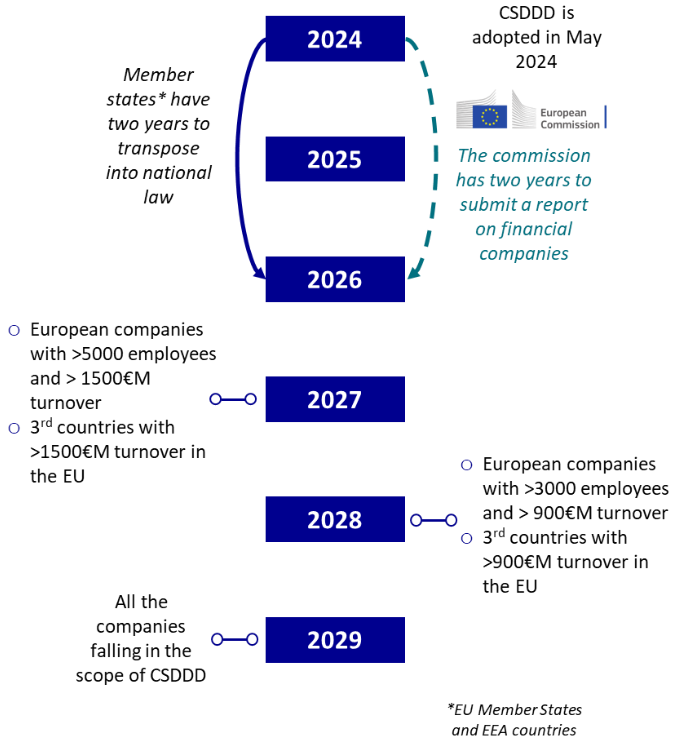
Source: AXA IM

CSDDD and CSRD

CSDDD introduces an obligation of means and not of results. For its part, the Corporate Sustainability Reporting Directive (CSRD), which came into force in early January 2024, lays down obligations for companies to disclose sustainability information. The two directives share a common objective: to encourage companies to report on the environmental and human rights impacts of their activities and value chains. Both directives are interdependent - to have only one would have been an exercise in incompleteness.

Implementaton timeline

The implementation is gradual and will concern only large corporations by 2027 with a full application for 2029.



Source: AXA IM

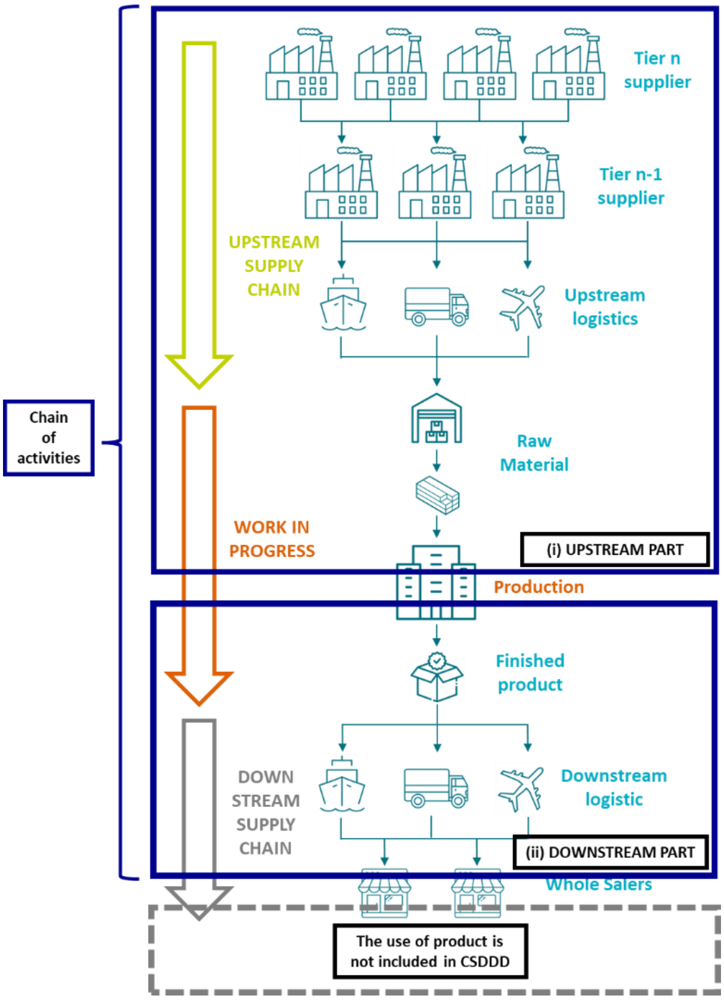
Chain of activitives and CSDDD

The concept of due diligence underlies the notions of supply chain, suppliers, upstream and downstream– the upstream supply chain represents the pre-production stage and the downstream supply chain represents activities that come after the finished goods are made and go to sellers and customers. Article 8 of CSDDD imposes corporates to *"take appropriate measures to identify and assess actual and potential adverse impacts arising from their own operations or those of their subsidiaries and, where related to their chains of activities, those of their business partners"*.

"Chains of activities" are defined in Article 3 of the directive as:

(i) Activities of a company's upstream business partners related to the production of goods or the provision of services by the company, including the design, extraction, sourcing, manufacture, transport, storage and supply of raw materials, products or parts of the products and development of the product or the service, and

(ii) **Activities of a company's downstream business partners related to the distribution, transport and storage of the product**, where the business partners carry out those activities for the company or on behalf of the company.



Source: AXA IM

Regarding the downstream flow, depending on the commercial relationships between the company and its business partners, the scope can vary. Activities that are not in the "chain of activities" are not in the scope of CSDDD.

Due diligence processes

In line with OECD Guidelines and the UNGPs, the CSDDD reproduces the concept of due diligence as a process. As mentioned before, companies will need to take "**appropriate measures which are capable of achieving the objectives of due diligence**".

From Articles 7 to 15, the directive describes the actions expected from companies when conducting this due diligence.

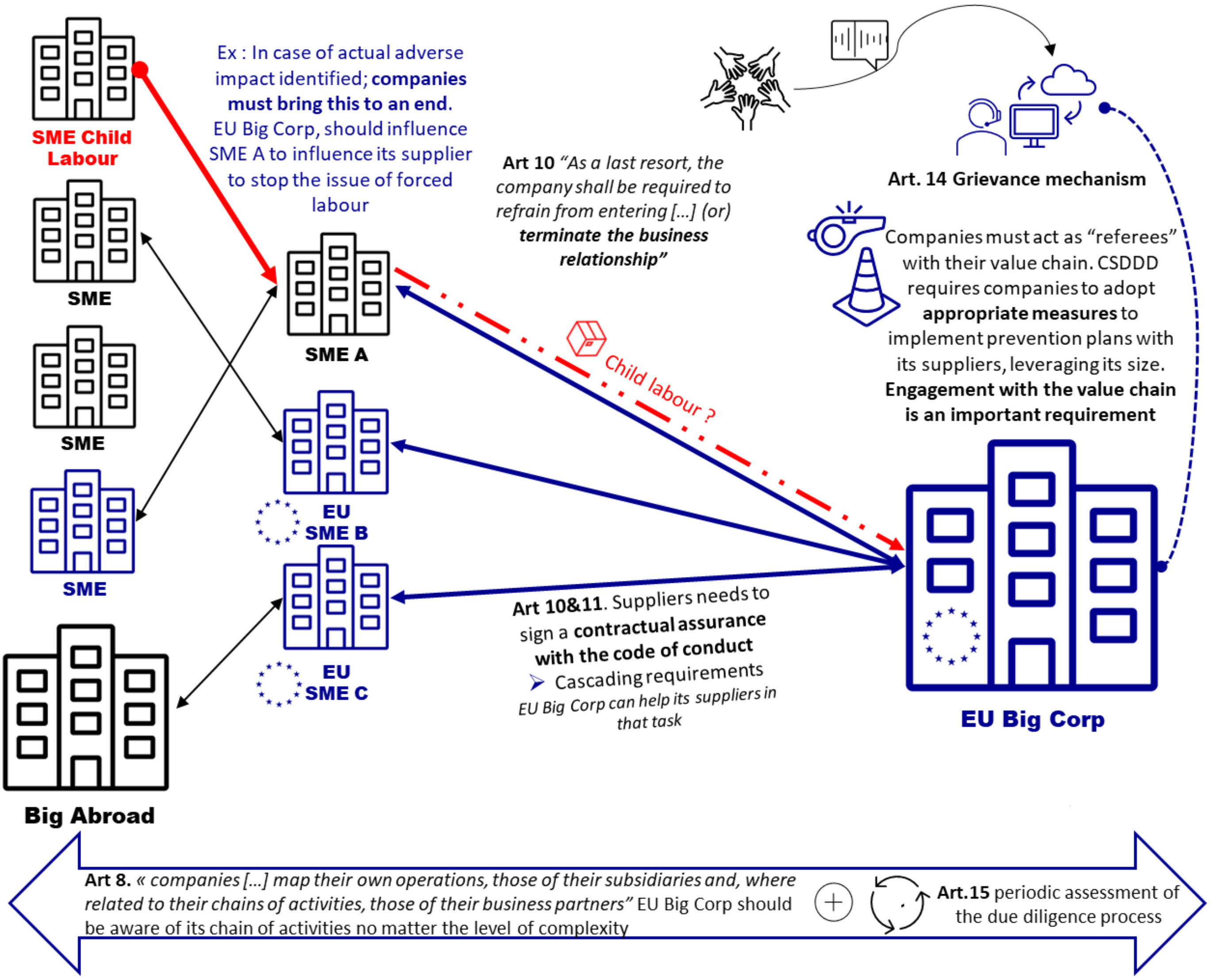
CSDDD is a major challenge for companies. As investors, we acknowledge the difficulties for corporates in implementing this directive and CSRD. From an operational perspective, it's costly and time consuming. Companies will need to adapt and support these costs. Corporates that have already implemented good due diligence procedures could, in the near future, have an advantage over laggards thanks to a lower need to bridge the gap as well as lower financial and reputational risk. Beyond the costs at stake, CSDDD imposes a new type of business relationship between suppliers and ordering companies.

Companies are expected to act as "arbiters" with their value chain even if they have no direct commercial link. The main purpose of the cascading effect is to go beyond direct suppliers and outside the EU.

In the infographic below, we present a hypothetical upstream value chain for a company named 'EU Big Corp'. If the company has suspicions or has been notified of child labour by its sub-suppliers, Articles 10 and 11 requires 'EU Big Corp' to prevent and bring to an end the potential impact.

In that example, 'EU Big Corp' needs to monitor the situation with its direct supplier the 'SME A'. In the code of conduct, contractual clauses should be included to fulfil its compliance with Articles 10 and 11. If after taking *appropriate measures* by 'EU Big Corp', 'SME Child Labour' seems to be incapable of bringing the material impact to an end, 'EU Big Corp' should cease *as a last resort* its business relationships with 'SME A'. Appropriate measures can include audits on site conducted by 'EU Big Corp' of 'SME Child Labour'.

The example would also concern any other obligations or prohibition described in Annex 1 of the CSDDD on human rights or the environment (deforestation, hazardous waste, etc).



Source: AXA IM

A step-by-step approach

Art.7

Integrating due diligence into company's policies and risk management systems

- The policy should include: a detail of the company's approach, a code of conduct that details relationships with suppliers and a process description

Art. 8

Identifying and assessing actual and potential adverse impacts

- Map company's own operations and its value chain
- From the mapping carry out an assessment of the company's own operations and prioritise adverse impacts based on severity and likelihood of the adverse impact

Art. 10

Preventing potential adverse impacts

- Take appropriate measures to prevent potential adverse impacts identified in Art. 8. The company should consider where and who may cause the impact. Idea of directly influencing its business partners
- Seek contractual assurances from direct business partners
- From the mapping carry an assessment of the company's own operations

Art. 11

Bringing actual adverse impacts to an end

- By considering the origin of the impact – where it's occurring in the chain of activity – the company needs to take when it's possible appropriate measures to bring the adverse impact to an end. The action should be in proportion with the severity of the impact.
- Engage with its value chain and its stakeholders
- The company shall provide remediation in line with the Art.12

Art. 14

Notification mechanism and complaints procedure

- Persons and organisations should have the possibility to submit complaints in a company-level mechanism.
- Establish a procedure that is fair, accessible, transparent and publicly available with reasonable steps to prevent retaliation.
- Maintain the complainant's safety. The complainant should receive a follow-up from the company.

Art. 15

Monitoring

- Carry out periodic assessments of their chain of activities and the effectiveness of the due diligence process in place.
- Provide qualitative and quantitative indicators

Art. 16

Communicating

- Companies that are in the scope of CSRD, will need to communicate via their annual sustainability reporting
- Companies outside the scope of CSRD must issue a dedicated annual statement

Art.22

Combating climate change

- "adopt and put into effect a transition plan for climate change mitigation which aims to ensure, through best efforts, that the business model and strategy of the company are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement"*
- Incentive for companies to participate to multi stakeholders' initiatives and be assessed by third parties.

**The exact terms from the Paris agreement are "Holding the increase in the global average temperature to well below 2 °C above preindustrial levels and pursuing efforts to limit the temperature increase to 1.5 °C above pre-industrial levels, recognizing that this would significantly reduce the risks and impacts of climate change;*

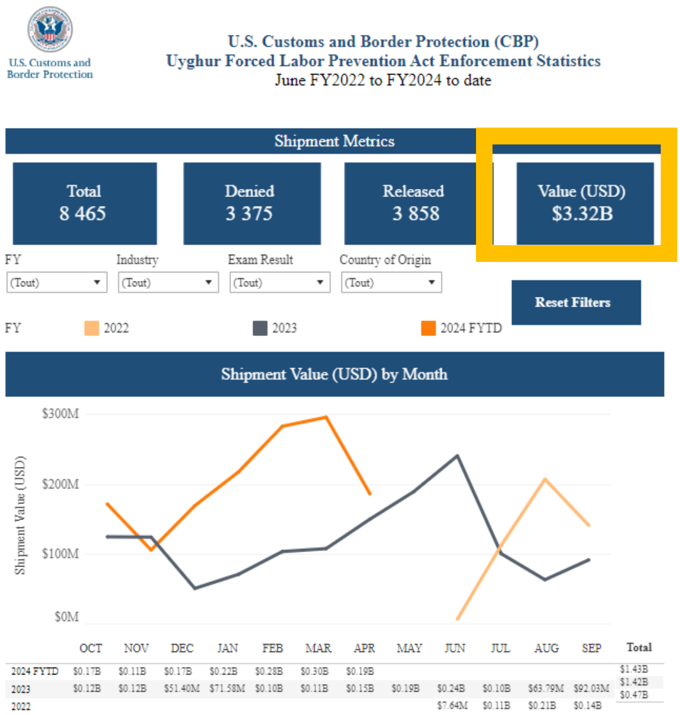
Source: AXA IM

The US Uyghur Forced Labor Prevention Act (UFLPA) is already a disruptor

Across the Atlantic, this supply chain disruption is a reality that should be considered seriously by investors.

After decades of market liberalisation, the US is leading the way by imposing bans on Chinese imports related to Xinjiang with the US Uyghur Forced Labor Prevention Act (UFLPA) signed into law by President Joe Biden on 23 December 2021.

Human rights are used as tools to protect US borders.



Source: US Customs and Border Protection

Imported products suspected to be made with forced labour are seized by US customs. As the supply chains are fully integrated, this can have significant impacts on whole sectors of certain industries. As of June 2024[10], more than US$3bn in value of shipments had been seized by US Customs since 2022.

As an example, the textile industry is exposed to cotton production. China counts for around 20%[11] of global cotton production, of which 90% is produced in Xinjiang. Textile companies have had to implement new practices such as cotton isotope testing to verify traceability of the products.[12]

It should be noted that all things being equal otherwise, textile companies present in our view relatively "good practices" in comparison with other sectors even if a lot of room for improvement exists. We do not mention any type of certification that may face controversies.

This example is used to demonstrate that from a given issue, an entire industry can be forced to find technical solutions to provide a good level of transparency to the authorities.

US Senate approach

The US Senate explicitly outlined its approach of cascading due diligence requirements in the supply chain in a May 2024 report.[13]

"For example, automaker A ("A") would require tier 1 supplier B ("B") to fill out a self-assessment survey that it would then run through software to gauge risk factors for potential human rights violations. B would then require tier 2 supplier C to undergo the same process to provide information in its disclosure to A. This chain of self-assessment and surveys can cascade through twelve or more tiers of a supply chain for a particular component. [...]

For example, if automaker A ("A") had a tier 1 supplier B ("B") that either was scheduled to undergo a routine audit or an audit triggered by concerns of forced labor, A could proceed with an audit of B's facilities. A could send either trained in-house staff or third-party auditors to conduct the audit. Should the audit substantiate a concern related to sustainability or human rights violations, A could then elect to work with B to resolve the issue.

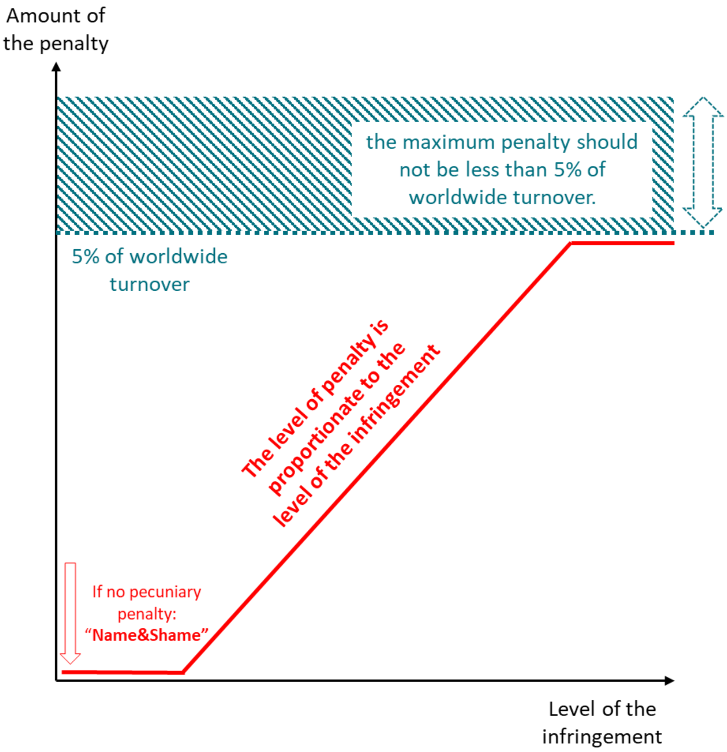
A would then engage in additional follow-up with B to ensure the improvement of conditions. Should B choose not to cooperate, or the violation could not be remediated, A could choose to place a hold on current and future transactions or ultimately terminate the contract".

Sanctions under CSDDD

From our discussions with corporates, we understand that due diligence regulations can have significant impacts on businesses. With the example of the UFLPA, bans on product imports are at stake. The financial impact for a company stems from its incapacity to sell its products on the largest market in the world or the need to change specific parts of the products to comply with the regulation.

In the case of CSDDD, Articles 27 and 29 of the directive describe penalties and a right for full compensation for companies that would fail to comply with this directive. To assess the level of penalties, *"Member States shall lay down the rules on penalties, including pecuniary penalties. […] The penalties provided for shall be effective, proportionate and dissuasive".*

Article 29: *"A company can be held liable for a damage caused to a natural or legal person. […] Where the company was held liable in accordance with paragraph 1, a natural or legal person shall have the right to full compensation for the damage occurred in accordance with national law. Full compensation under this Directive shall not lead to overcompensation, whether by means of punitive, multiple or other types of damages."*



Source: AXA IM

The idea of proportion in the penalty should consider the impact (nature, gravity, duration and severity); the investments made by the company to prevent and to bring adverse impacts to an end – Articles 10 and 11 - whether the company collaborated with other entities to address the impacts; the process and mapping in line with Article 8; if companies faced precedent issues; the remedial actions taken; the financial potential gain due to the infringement.

To summarise, the penalty should be proportionate by considering the entire capability from the company to conduct an adequate due diligence.

How are investors covered by CSDDD?

At the time of writing, financial institutions are not in the initial scope of the directive via their investments but only with the upstream part of their chain of activities. Still, the preambule of CSDDD expects financial undertakings to follow the OECD Guidelines which includes a due diligence process for their investments. The exemption of financial companies can change in the future.

In addition, large financial companies that fall under the directive will need to execute transition plans to comply with Article 22 with absolute emission reduction targets for greenhouse gas for scope 1, scope 2 and scope 3 (investments). This will necessarily impact the product offerings and holdings.

Even if the financial products are not included in the scope, investee companies are. Therefore, we believe that investors are *de facto* impacted. Even if there is not potential pecuniary sanctions or civil liabilities, investors have a fiduciary duty to monitor related risks.

Asset managers must serve the interests of their clients first and provide value-added financial services. This means keeping abreast of new material issues impacting investee companies. That is the case for CSDDD. With companies having to make trade-offs in their chain of activities to limit the risks of non-compliance, this directive can potentially drive shift in sections of value chains.

Investors should start implementing monitoring assessment tools internally to evaluate risks that, at present, may remain in a blind spot or not be considered. These capabilities need to be developed internally.

In line with the guide produced in June 2024 by the UN Human Rights Council[14], we believe at AXA IM that investors have an important role to play in the implementation of the UN Guiding Principles. The guide emphasises the need to connect the three pillars of ESG with a double materiality approach.

The guide promotes 10 recommendations to investors:

1. Embed human rights in their ESG and sustainability policies and strategies, with senior level oversight

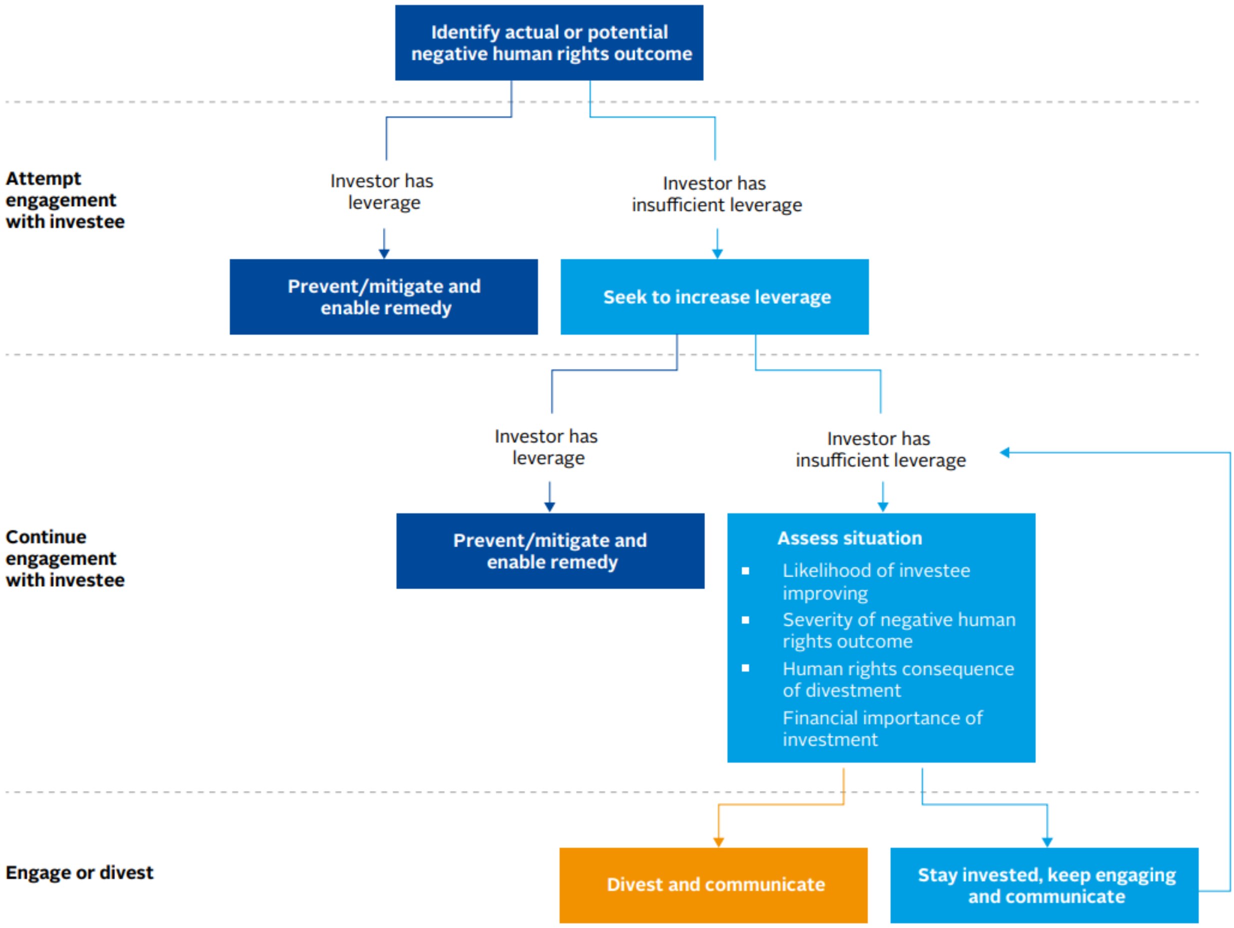
2. Identify and assess the actual and potential human rights impacts of investees prior to investing and on an ongoing basis once invested, and track the effectiveness of human rights due diligence efforts
3. Prioritize meaningful stakeholder engagement
4. Ensure that heightened human rights due diligence is undertaken for investments in conflict-affected areas and high-risk sectors
5. Use leverage over investees to ensure respect for human rights
6. Divest responsibly, in alignment with the UNGPs, when leverage cannot change investee practices
7. Promote and enable access to remedy for affected rightsholders
8. Ensure better articulation of the interconnected nature of E, S and G criteria so that human rights considerations are integrated across all three criteria in investment strategies
9. Invest in capacity-building and human rights education, and undertake research and peer-learning to share good practices
10. Press strongly for improved, coherent, and standardized data on human rights, as well as research methodologies aligned with the UNGPs by commercial data providers and proxy voting agencies

In addition, responsible investing body PRI on "*Why and how investors should act on human rights*"[15], and the due diligence principles mentioned before, remind investors of key steps they should implement to adapt their practices to fit the coming regulations.

1. **Policy:** Investors should adopt a policy commitment to respect internationally-recognised human rights and the environment

2. **Due Diligence Processes:**
    a. Identify actual and potential negative outcomes for people, arising from investees
    b. Prevent and mitigate the actual and potential negative outcomes identified
    c. Track ongoing management of human rights outcomes
    d. Communicate to clients, beneficiaries, affected stakeholders and publicly about outcomes, and the actions taken
3. **Access to remedy:** For outcomes the investor is directly linked to through an investee, the investor should use and build influence to ensure that investees provide access to remedy for people affected.
    a. Identifying good practices, engaging with corporates to push them to strengthen their processes and anticipate potential issues and putting in place concrete actions increases the resilience of corporates and hence of our investments. This is all the more crucial as the race to net zero puts some sectors and players at risk of downplaying some negative externalities of the energy transition. Solution providers and innovative corporates must embrace that dimension to keep their added value and positioning over the long term.

Below, extracted from the same report from the PRI, is a decision tree that can help investors to make decisions. When it comes to companies terminating business relationships with suppliers as a last resort, we believe that investors should divest as a last resort from investee companies failing to fulfil due diligence requirements.



Source: PRI

[1] Corporate sustainability due diligence: Council gives its final approval - Consilium (europa.eu)
[2] European Council pdf (europa.eu)
[3] International Bill of Human Rights | OHCHR
[4] ILO Declaration on Fundamental Principles and Rights at Work | International Labour Organization
[5] UN Guiding Principles | John Ruggie (harvard.edu)
[6] https://data.consilium.europa.eu/doc/document/PE-9-2024-REV-1/en/pdf
[7] Corporate Sustainability Due Diligence Directive (CSDDD) | EcoVadis
[8] CSDDD: Summary of the EU directive | denkstatt
[9] https://www.linkedin.com/posts/somo_making-a-killing-activity-7189488403111886848-Bk00?utm_source=share&utm_medium=member_desktop
[10] Uyghur Forced Labor Prevention Act Statistics | U.S. Customs and Border Protection (cbp.gov)
[11] USDA ERS - Cotton Sector at a Glance
[12] Wexton Urges DHS to Enhance Use of Isotopic Testing Technology to Crack Down on Cotton Sourced from Forced Labor | U.S. House of Representatives
[13] Insufficient Diligence - Car Makers Complicit with CCP Forced Labor.pdf (senate.gov)
[14] A/HRC/56/55: Investors, environmental, social and governance approaches and human rights - Report of the Working Group on the issue of human rights and transnational corporations and other business enterprises | OHCHR
[15] download (unpri.org)

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