Regulating ESG through Regional Initiatives: A Synopsis of the EU Corporate Sustainability Due Diligence Directive

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Introduction:

Environmental degradation has become a global problem and is not a respecter of borders. Climate change has become a major concern for the international community, companies, and policymakers, amongst others because climate action is number 13 of the United Nations Sustainable Development Goal.[2] There is no doubt that companies have a pivotal role to play in the environment and in shaping the world generally. Thus, in business operations, the protection of human lives and the environment must be the central focus of all organizations. Investors, suppliers, and consumers demand that businesses comply with the present sustainability trends. Hence, companies must not only be focused on operation activities and profit maximization but must take environmental, social, and managerial issues into consideration in their daily activities. This, if not done, can expose such companies to financial risks and distress.[3] Initially, requests for transparency and in-depth data regarding a company's environmental risks, and mitigating actions, coupled with audits to enhance its reliability which have been in demand from companies globally, were initially treated as a reputational risk in the corporate world. However, this has now been strengthened by new regulatory standards and practices.

Environment Social and Governance (ESG) has become extremely important for both the demand and supply aspects of investment. The supply of sustainable assets has made an impression and caught the attention of companies.[4] This yardstick is mostly used to appraise the environmental risks the company is likely to face and how those risks are being managed by the company. Also, assurances are created by companies where it does not partake in unlawful business practices, especially in the appointment of their board members.[5] To further champion the observance and adherence of the ESG principles, the European Union (EU) parliament introduced the Corporate Sustainability Due Diligence Directive ('CSDDD' or the 'Directive') in December 2023. This article gives an overview of the EU CSDDD and suggests how regional collaborations can drive compliance with the ESG principles.

What is ESG?:

The Environmental Social and Governance (ESG) principles were formulated as a set of standards governing a company's operation taking into consideration the environment and the people.[6] ESG is made up of three components. These elements consist of the company's energy

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[2] Rocco Redondo Alamilos and Frederic de Mariz, "How Can European Regulation on ESG Impact Business Globally" (2022) 15 (291) *Journal of Risk and Financial Management*; 1.

[3] S. A. Badayi and others, "Does Corporate Social Responsibility Influence Firm Probability of Default?" (2020) 136 (3) International Journal of Finance & Economics. 26-44.

[4] *Journal of Risk and Financial Management*; page 7

[5] Ibid.

[6] Corporate Governance Institute, "What is ESG and Why is it Important" <https://www.thecorporategovernanceinstitute.com/insights/news-analysis/what-is-esg-and-why-is-it-important/> assessed 12 February 2024.

use, waste or pollution generation, natural resources conservation, compliance with regulation, business relationship, employee wellbeing, volunteer work and collaboration with local communities, and incorporation of stakeholders' interests. Furthermore, Investors are also concerned with the accuracy and transparency in companies' accounting and reporting methods as well as how shareholders are treated and how shareholders' rights are exercised. ESG is the recognition that business sustainability is complex and extends beyond environmental issues to people, resources, and systems. Thus, when businesses invest in energy-efficient technologies, they create a good impact on the communities. Furthermore, inputs and feedback from people the business has affected, help businesses to achieve consistent growth and have stronger models.

The European Union Corporate Sustainability Due Diligence Directive (EU CSDDD) 2023:

The EU CSDDD is a legal framework mandating EU and non-EU companies operating in the EU, to identify, mitigate, and report on the impact of their operations and supply chains on human rights and the environment[7] both in the EU and globally. It is aimed at improving the EU's regulatory framework on sustainability due diligence and human rights, to aid its transition to a climate-neutral and green economy. Also, the CSDDD will establish consistency across different EU directives, such as the Non-Financial Reporting Directive (NFRD), the CSRD, and the Sustainable Finance Disclosure Regulations (SFDR).[8] Furthermore, the CSDDD will ensure that the EU operates a single market through the harmonisation of ESG due diligence laws. This obligatory enactment will take effect either by 2025 or 2026, particularly focusing on high-risk industries. However, Member States of the EU are obligated to reflect this framework in their national laws on or before 16th June 2024.[9]

Obligations, Scope, and Applicability of the EU CSDDD:

The Directive mandates companies to carry out due diligence by identifying, preventing, mitigating, and remediating actual and potential adverse impacts on people and the environment. The EU CSDDD requires companies to maintain robust ESG due diligence processes covering the whole value chain. Due diligence is a continuous process, which serves as an early warning system for a company, for ESG issues to be addressed immediately after they arise. Information gathered through the due diligence process will provide the basis for assessing material ESG impacts on people and the environment. Furthermore, companies, including in the financial sector must implement a detailed climate transition plan. Companies are to set out their strategies for the reduction of greenhouse gas

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7 Policy Centre, "EU Corporate Sustainability Due Diligence Directive (CSDDD)" <https://plana.earth/policy/eu-corporate-sustainability-due-diligence-directive csddd#:~:text=ies.&text=The%20European%20Union%20(EU)%20has,encouraging%20corporate%20responsibility%20and%20sustainability.> assessed 12 February 2024.

8 Krsity Balsanek and others, "EU's Proposed Directive on Corporate Sustainability Due Diligence: What US Companies Need to Know" <https://www.dlapiper.com/en/insights/publications/global-esg-alert/2023/eus-proposed-directive-on-corporate-sustainability-due-diligence-what-us-companies-need-to-know> assessed 28 January 2024.

9 Ropes & Gray, "EU Corporate Sustainability Reporting Directive Signed into Law- Implications and Near-term Compliance Steps for U.S.-based Multinational" <https://www.ropesgray.com/en/insights/alerts/2022/12/eu-corporate-sustainability-reporting-directive-signed-into-law> assessed 27 January 2024.

emissions under the transition plan by the provisions of the Paris Agreement 2015 temperature goals**.**
The EU CSDDD applies to the following companies:

1. **EU companies**: the CSDDD will apply in two categories firstly, to companies with over 500 employees and a net global turnover of more than €150 million incorporated in the EU. Secondly, companies that do not meet the first requirement, but have over 250 employees and a net global turnover of €40 million, with at least €20 million generated from certain "high-risk" sectors (e.g., textiles, agriculture, mineral resources, food and beverage, construction). The CSD will apply to companies that satisfy these criteria for two consecutive financial years before the assessment**.**[10]

2. **Foreign companies**: the Directive will apply the different categories of alien companies: companies with an EU net turnover of at least €150 million, whether or not they have a physical business place in the EU; companies with an EU net turnover of more than €40 million but not more than €150 million if they generate at least €20 million in "high-risk" sectors; parent companies with a global net turnover of €40 million having a licensing or franchising agreements with EU companies delivering annual royalty payments of more than €7.5 million. These requirements must be satisfied for two consecutive financial years before assessment.

However, a temporary exception has been made for the financial sector from certain obligations of the CSDDD. The due diligence provisions will only apply with respect to the operations and value chain of the financial firm. Thus, due diligence for downstream and relationships with clients will not be required.

Besides the reporting requirements, CSDDD is an important way of dealing with the impact of businesses on humans and the environment because it requires companies to integrate ESG due diligence and planned ESG actions into all of their corporate policies. Also, requires companies to take actions to prevent, end, and remediate adverse ESG impacts and monitor their effectiveness. Furthermore, CSDDD, makes provision for a double enforcement mechanism viz: public enforcement and civil liability and will be enforced at the Member State level. Member States are to designate a supervisory authority to monitor the compliance of companies with their due diligence obligations. Also, Companies will be held liable for damages for failure to comply with obligations to mitigate or prevent, any potential adverse impacts that are avoidable but for such default.

What companies need to do to prepare for the EU CSDDD:

1. Identify existing and potential adverse environmental and human rights impacts of the company's activities across its value chain:

2. Prevent potential adverse impacts:

3. Mitigate adverse impacts:

[10] Sidley, "New EU ESG Legislation will affect Non-EU Companies with Significant EU Revenues" <https://www.sidley.com/en/insights/newsupdates/2023/12/new-eu-esg-legislation-will-affect-non-eu-companies-with-significant-eu-revenues> assessed 31 January 2024.

4. Create effective grievance and remediation mechanisms:
5. Track and monitor ESG due diligence outcomes.

Companies will need to undertake these steps and adopt and integrate policies that will conform with the laid down requirements.

Other Multilateral Initiatives:

a. USAID-Vietnam ESG Initiative 2022

In November 2022, the United States Agency for International Development (USAID) and the Vietnam Ministry of Planning (MPI) launched a new initiative to drive inclusive and sustainable growth. This new initiative promotes socially conscious business behavior, known as Environmental, Social, and Governance (ESG) standards. Investors use ESG standards to measure how a company protects the environment; manages its relationships with workers, customers, and the communities where it operates; and employs transparent and accountable corporate governance.[11] This initiative is focused on small and growing businesses (SGBs) which account for over 90 percent of Vietnam's private sector, since these SGBs play a pivotal role in the environmental sustainability and socio-economic development of Vietnam. This initiative will also aid the SGBs to adopt ESG standards and it is expected that ESG technical assistance packages will be delivered to 300 businesses by 2025. Additionally, 20 businesses will receive additional assistance to implement their innovative ESG business concepts. This initiative backs up Vietnam's Green Growth Strategy 2021-2030.

b. The Agreement on Climate Change, Trade, and Sustainability (ACCTS) 2019

New Zealand, Costa Rica, Fiji, Iceland, Norway, and Switzerland launched this initiative – "the Agreement on Climate Change, Trade and Sustainability" (ACCTS) in September 2019. Negotiations and commitments between the countries are ongoing to harness trade policies in addressing climate change actions collectively. The initiative is mostly focused on how trade-related issues can potentially contribute meaningfully to addressing climate change and other environmental issues, thus, prioritising climate objectives. The ACCTS makes a case that the removal of fossil fuel subsidies (FFS) is feasible.

The ACCTS covers the following actions:

a. **Tariff removal on environmental goods and new binding commitment for environmental services**: This includes a wide range of clean energy-related products, products designed to monitor environmental health or degradation, and products that intend to rectify environmental harm. These products are expected to be cheaper.
b. **Elimination of fossil fuel subsidies:** this will help in eliminating the harmful effects of these on the environment, and improve the competitiveness for the use of greener

[11] USAID, "USAID, Vietnam Launch New Initiative to Promote Private Sector-Driven Sustainable Growth" <https://www.usaid.gov/vietnam/press-releases/nov-22-2022-united-states-vietnam-launch-new-initiative-promote-private-sector-driven-sustainable-growth> assessed 20 February 2024.

energies. This can potentially deliver a lot of environmental, social, and economic benefits.

c. **The development of voluntary eco-labeling programs and guidelines:** this aims at informing customers about the environmental credentials of each product.

Beyond this, states like California signed the Climate Corporate Data Accountability Act (SB 253) and the Climate-Related Financial Risk Act (SB 261) both known as the Climate Accountability Package in October 2023.[12] The law imposes unmatched reporting requirements on all US companies carrying on business in the U.S., whether public or private. These companies are required to disclose annually Scope 1 and Scope 2 greenhouse gas (GHG) emissions beginning in 2026 and Scope 3 GHG emissions in 2027 as well as submit biennially, climate-related financial risk reports to the California Air Resources Board (CARB) beginning in 2026.

These frameworks put in place also intend to achieve the objective of the Greenhouse Gas Protocol 1998 which seeks to develop internationally acceptable greenhouse gas (GHG) accounting and reporting standards for business and to promote their broad adoption.

Conclusion:
The EU CSDDD legislative framework is a step in the right direction toward achieving the goals set out in the Paris Agreement 2015 and the Greenhouse Gas Protocol. Even though the Directive will be effective, once domesticated into the national laws of EU Member States, companies are to assess themselves to ascertain whether or not, they will be subject to the new legislation. Those likely to fall within the scope of the Directive are advised to begin implementation of due diligence policies or streamline already existent ones by the Directive to prevent disruptions of their operations in the future. Companies adopting and aligning their strategies towards ESG practices promote human rights and the environment and also enhance their financial performance in the long run. However, the role of trade policies is quite substantive in environmental, social, and governance frameworks. ESG requirements have now been extended to trade, climate change, and sustainability agreements. There is a dire need for increased global action for the reduction of GHG emissions. Countries are being called upon to increase their environmental and climate actions.

[12] Sidley, "California Enacts Landmark Climate Accountability Package Requiring Expansive Disclosure of Climate-Related Risks" <https://www.sidley.com/en/insights/newsupdates/2023/10/california-enacts-landmark-climate-accountability-package> assessed January 19 2024.