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IN EU SUPPLY CHAINS

How the EU's revision of the Non-Financial Reporting Directive and the upcoming initiatives on deforestation-free supply chains and sustainable corporate governance will impact companies based in the EU or exporting to the EU market.

The European Commission is taking action to ensure companies develop sustainable corporate governance models and supply chains, reporting publicly on the environmental, social and human rights impacts of business activities and on measures they are putting in place to achieve responsible business conduct. Three legislative initiatives will be presented in the second quarter of 2021 to achieve the above objectives: a revision of the Non-Financial Reporting Directive; a proposal on sustainable corporate governance; and on minimising the risk of deforestation and forest degradation associated with products placed on the EU market.

International bodies such as the UN and the OECD have previously embarked on efforts to establish global voluntary standards and guidance for sustainable business conduct. However, the EU's planned initiatives, albeit driven by the same underlying vision and ambitions, are likely to have a much more significant impact on the way EU companies operate as the European Commission will set out a binding legal framework.

By imposing binding requirements on companies to integrate sustainability, labour and human rights into their corporate governance models and supply chains, the European Commission is entering virtually uncharted territory. Furthermore, by bringing forward three separate initiatives rather than a single, comprehensive proposal, there is a risk that overlaps and/or conflicting requirements could lead to potentially burdensome compliance costs and create further uncertainty for businesses operating in the EU as well as foreign companies exporting to the EU market.

This briefing navigates the key elements of the three planned legislative initiatives and looks at their potential impact on business stakeholders.

REVISION OF THE NON-FINANCIAL REPORTING DIRECTIVE (NFRD)

BACKGROUND

The NFRD proposal is currently expected in mid-April 2021. The existing legislation was adopted in 2014 and places an obligation on large listed companies, banks and insurance companies with more than 500 employees to report annually information on four key sustainability issues: the environment, social and employee issues, human rights, and bribery and corruption.

Information provided under the NFRD must include:

1. a description of the policies pursued in relation to these issues, including due diligence processes implemented
2. the outcome of those policies
3. the risks linked to the companies' operations, including their business relationships, products or services, which are likely to cause adverse impacts in relation to these issues, and how companies manage those risks

Since companies started to provide non-financial reports in 2018, a number of key shortcomings of the new law have emerged.

First, reported non-financial information is not sufficiently comparable or reliable. Second, companies often do not report all the information that investors need to ensure the sustainability of their investments while at the same time they do report irrelevant information.

This has become more problematic since the adoption of the Sustainable Finance Disclosure Regulation (SFDR), which started to apply on 10 March 2021. The SFDR requires financial market participants with more than 500 employees to make disclosures on the Environmental, Social and Governance (ESG) performance of their aggregate investments and on the ESG performance of their products.

However, a significant practical obstacle to the application of the SFDR is the lack of non-financial data needed to make ESG disclosures.

To make the disclosures required under SFDR practicable, the scope of the NFRD would need to be broadened in terms of the granularity of the information to be reported and the number of companies to which it applies.

This is in line with the vision set out in the EU Green Deal communication, which states that:

> **"Companies and financial institutions will need to increase their disclosure on climate and environmental data so that investors are fully informed about the sustainability of their investments"**

OBJECTIVE OF THE INITIATIVE AND POTENTIAL IMPACTS

The Commission is currently assessing different policy options for the revision of the NFRD. Based on available preparatory materials, we anticipate it will contain the following:

It is highly likely that the scope of the NFRD will be extended to cover a wider set of companies, potentially including SMEs. Some member states are reportedly in favour of lowering the threshold of application of the NFRD to companies with 250 employees or more, down from the current 500.

The revised NFRD will be significantly more specific about which information companies are expected to provide. Also, the revised NFRD could define a standard of quality that all non-financial reports have to meet.

The revised NRFD could strengthen existing requirements regarding the assurance of non-financial information. Currently, audit companies are only required to verify that non-financial reports are provided but there is no obligation for them to verify the information made available by companies.

SUSTAINABLE CORPORATE GOVERNANCE (SCG)

BACKGROUND

The planned legislative initiative on sustainable corporate governance is intended as a way to address the issues raised in two separate studies prepared for the European Commission by external consultancies, on (1) due diligence requirements through supply chains and (2) directors' duties and sustainable corporate governance.

The first study shows that in a large sample of mostly large companies participating in a survey, only one in three businesses claim to undertake due diligence regarding all human rights and environmental impacts. Therefore, voluntary initiatives, even when backed by transparency, do not sufficiently incentivise good practice. The study shows wide support, including from industry stakeholders, for mandatory EU legislation on due diligence.

The second study finds that publicly listed companies within the EU tend to focus more on the short-term benefits of shareholders rather than on the long-term interests of the company. The study shows that, to some extent, corporate "short-termism" finds its root causes in regulatory frameworks and market practices. These trends work together to promote a focus on short-term financial return rather than on long-term sustainable value creation.

OBJECTIVE OF THE INITIATIVE AND POTENTIAL IMPACTS

The proposal, which is expected in Q2 2021, will likely take the form of a directive and include new binding legal requirements.

It will focus on:

- Directors' duties: helping company directors to consider wider stakeholder interests and a company's long-term interests as part of their duty of care and to withstand short-term pressures
- Mandatory due diligence: strengthening the resilience and long-term performance of companies through sustainable business models and reducing adverse human rights, social and environmental impacts throughout the value chain

Due diligence in supply chains

The European Commission has made clear on several occasions that the future SCG directive will impose a new mandatory requirement for EU companies to carry out due diligence in order to identify, prevent, mitigate and account for actual or potential human rights and environmental impacts in their own operations or supply chains.

Based on the preparatory study, the due diligence process can be understood as an ongoing, context-specific process which includes the following components:

1. Identifying and assessing actual and potential impacts
2. Integrating and acting on the findings
3. Tracking the effectiveness of the actions undertaken
4. Communicating how impacts are addressed, including through reporting

Companies would then be legally required to carry out due diligence and meet a certain standard of care for their due diligence processes, rather than simply be subject to an obligation to provide non-financial reports (as is the case now under the NFRD). Overall, the due diligence duty would be designed by building on existing authoritative guidelines using well-established definitions as developed by the UN and later expanded by the OECD.

Directors' duties

Based on the policy options considered in the second preparatory study, the future SCG initiative could bring forward new measures requiring the following:

- New, wider formulation of company directors' duties at EU level, requiring directors to:
  - Properly balance the long-term interests of the company (beyond 5-10 years), of employees and customers, of local and global environment and of society at large, alongside the interests of shareholders
  - Identify and mitigate sustainability risks and impacts, both internal and external, connected to the company's business operations and value chain
- Longer shareholding periods
- Requirements for corporate boards to integrate sustainability aspects into business strategies and set measurable, specific, time-bound, and science-based sustainability targets aligned with overarching goals (such as the SDGs).

- Requirements to align executive remuneration policy with long-term and sustainability goals, in particular by: (1) regulating executives' ability to sell the shares they receive as pay, and (2) making compulsory the inclusion of non-financial ESG metrics in executive pay schemes.
- Rules on board composition of listed companies, including a requirement for companies to consider sustainability criteria in the board nomination process.
- Rules requiring corporate boards to establish mechanisms for engaging with and involving internal and external stakeholders in identifying, preventing and mitigating sustainability risks and impacts as part of their business strategy.

It should be noted that both binding and non-binding "softer" regulatory measures will be considered by the European Commission when designing measures to address issues related to the duties of company directors.

DEFORESTATION-FREE SUPPLY CHAINS

BACKGROUND

The protection of ecosystems and biodiversity is one of the key objectives of the EU Green Deal and the European Commission has put great emphasis on the protection and restoration of forests worldwide.

In the Green Deal Communication, the Commission announced:

> **"Measures, both regulatory and otherwise, to promote imported products and value chains that do not involve deforestation and forest degradation"**

This issue of deforestation and of the potential impact of products originating from forest-risk areas placed on the EU market is not new: palm oil, for example, has long been on the EU's radar. However, it returned to prominence in light of recent controversies on agriculture-driven deforestation in the Amazon region and the EU-Mercosur trade negotiations, as well as during the 2019 wildfire crisis in Australia.

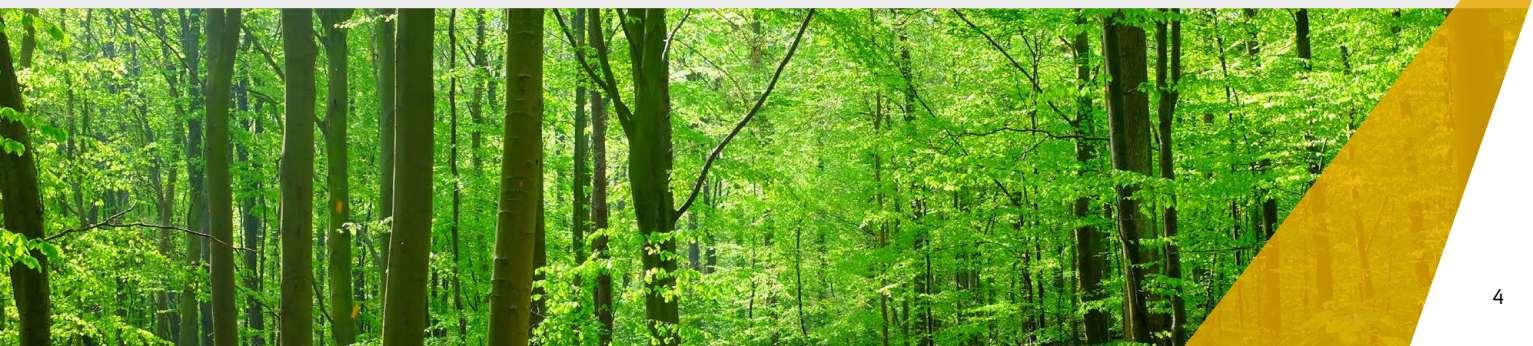
OBJECTIVE OF THE INITIATIVE AND POTENTIAL IMPACTS

The aim of the planned legislation is to avoid or minimise the placing of products associated with deforestation or forest degradation on the EU market. The exact scope is still to be decided but it is highly likely to cover the following commodities: beef, wood, palm oil, soy, rubber, cereals, cocoa and coffee. Selected derived products might also be covered by the proposal.

Originally, the European Commission indicated that both mandatory and non-mandatory actions would be considered to achieve the objective. However, on several subsequent occasions it made clear that this initiative will feature binding requirements for all actors – both EU and non-EU. The initiative will likely take the form of a regulation and is expected at the end of Q2 2021.
We expect that the initiative will include a "deforestation-free" requirement with which products will need to comply. This requirement should be non-discriminatory vis-à-vis third countries, based on science, and implementable in practice. The "deforestation-free" requirement is likely to be based on existing internationally recognised definitions (e.g. the FAO definition of deforestation) and complemented by one (or a combination) of the following measures:

- Due diligence requirement for companies
- Benchmarking of countries/country carding system
- Mandatory public certification of goods
- Mandatory labelling of goods

Competent national authorities in EU countries will have to scrutinise compliance and will be responsible for implementing effective sanctions for non-compliant operators.



CONCLUSION

The European Commission has set out several initiatives aimed at mainstreaming sustainability in companies' governance models and supply chains across all sizes and sectors.

These initiatives will impact on companies based or operating in the EU as well as on those exporting to the EU from third countries. Indeed, the Commission sees the EU's global leadership as a regulator as something which will help to achieve the uptake of international standards in partner countries.

The increase of transparency and scrutiny brought by this package is a clear signal to business that sustainability can no longer be just a policy issue.

It requires system change and will affect how companies communicate and engage with customers, staff, investors and government – all have more power today than ever before.

Hume Brophy is a leading sustainability adaptation advisory firm that can help you think through your needs and strategic positioning with your stakeholders in this new landscape.

This briefing was written by Lorenzo Livraghi:
he specialises in advising clients on trade and agriculture from our Brussels office.

Contact us at brussels@humebrophy.com
to discuss how we can support you.

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www.humebrophy.com