

The EU Wants Companies To Care More About Human Rights

Bentley Kaplan: Hello and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode.

And on today's show, we are going to talk about the EU's Corporate Sustainability Due Diligence Directive, or the CSDDD. It's a directive that could substantially change how some companies monitor, report on, and address their impacts on human rights and the environment.

On this episode, we're going to be tackling the human rights component of the CSDDD and looking at how well-prepared some industries are to rise to this regulatory challenge and which ones may still have some way to go. Thanks for sticking around. Let's do this.

So, let's address the elephant in the room first up. The Corporate Sustainability Due Diligence Directive is a mouthful, even in its abbreviated form of the CSDDD. And as with many EU directives, just as you finish saying its name out loud, you really should be listing a bunch of caveats.

And that's because there is a long and negotiated road between proposals in a directive and actually seeing them come into law in different EU member states. And the CSDDD has just about finished its journey through the EU's law-making machinery.

Three key EU bodies, that is the European Parliament, the European Council and the European Commission have taken slightly different positions on some key parts of the directive, including which companies it will apply to, like whether financial institutions will be included and how it will be enforced, like whether company directors should be held personally responsible for missteps by their own companies. And even though we don't know exactly where the final version will land, the directive has seen some recent momentum and may find itself incorporated into national laws in EU member states in the next 18 months.

But with that said, we do know the general shape of the directive, and it's something that investors and companies may well be taking note of. And that's because broadly, the CSDDD is about getting companies to monitor and measure their negative impacts on human rights and the environment, with the latter largely focused on greenhouse gas emissions.

But what is really setting a high bar in the directive is that the CSDDD is also about getting companies to address these negative impacts, to lessen them, and to show and measure how they've done so. And this is a big deal.

Now, in today's episode, we are focusing on the human rights component of the CSDDD and putting a temporary pin in the environmental side because there

may be several independent regulatory efforts that are looking to bring climate change front and center, and we've spoken about them at length on the show. But in terms of regulating company impacts on human rights, the CSDDD is relatively pioneering.

To find out a little more about what the directive could mean practically for companies, I brought in Aura Toader out of our London office who has been watching developments very keenly.

Aura Toader: So under CSDDD, companies are expected to protect human rights along their value chains by conducting due diligence in their own operations, but also their subsidiaries and direct and indirect suppliers. And the scope of due diligence includes activities that are related to the manufacturing of a product, but also the extraction and supply of raw materials and components that go into that product.

Practically, companies must establish the necessary processes to identify, prevent, mitigate, and address adverse impacts of their operations on human rights. They can train suppliers. They can collaborate with NGOs to talk to workers about their rights. They can audit factories to make sure that their standards are respected. They also need to set up grievance mechanisms. And most importantly, in my opinion, and probably the requirement with the biggest cost for corporates is remediation. A type of remediation can be paying back lost wages to workers, which can be significant for the bottom line of some corporations.

And this is what really sets CSDDD apart from other modern slavery regulations. It is not only a reporting requirement such as the UK Modern Slavery Act, for example, but it mandates human rights due diligence. And there is civil liability for companies that fail to show that they have adequate due diligence programs.

For some companies, violations of human rights are more likely to be related to the supply chain labor, but human rights violations can also occur in a company's own operations, so everything from the raw material to the finished product. The European Parliament has removed downstream relationships from the scope of the directive, so everything that happens after the product is made. For example, the use of a product or its recycling or landfilling are no longer subject to due diligence requirements. Some NGOs are concerned about this exclusion of downstream business relationships because this is where adverse impacts can be most severe for some industries. If you think of a company that makes surveillance technology, for example, the most severe human rights impacts can materialize downstream if the technology is used in a way that infringes on the basic right of privacy.

Bentley Kaplan: Okay, so there is a lot to take in there, but really there are three key things to remember. One, the CSDDD is not only about a company's own employees and operations, but also about its supply chains, contractors, third parties, et cetera. As Aura mentioned, this does not include the downstream use of products, which has left a few open questions for now.

Two, the CSDDD is not only looking to include EU companies, but also larger non-European companies that earn a portion of their revenue in the EU. And with that wide net, the relevance of the CSDDD goes much further than companies based in the European Union, and it could end up touching on a wider range of given portfolios.

And takeaway number three, to meet these requirements, companies are going to need to bring their efforts to monitor and prevent human rights violations into core operational considerations.

And for both companies and investors, it's this last point that raises a natural question, just how risk-prone are different companies or industries in terms of human rights impacts? And then, how ready are they to pick their way through these new regulatory gauntlets?

Aura dug a little further into some data to help me get some answers.

Aura Toader:

All companies that derive some revenue in the EU will have to conduct due diligence along their value chain. But what we saw in our analysis of large cap constituents is that while most companies have a human rights policy for their own workforce, fewer extend that policy to other stakeholders such as supply chain workers or communities affected by the company's operations. And less than half also had due diligence processes in place.

And this analysis was done for some of the largest companies by market cap. If we expand the analysis to smaller cap companies, the percentage of companies that have due diligence processes drops to 31%. So companies do not appear ready for this new directive.

And the parliament has identified high-risk sectors as priority areas for due diligence. The commission was tasked to develop some sector-specific due diligence guidelines. So we will find out exactly what is required from each sector soon, hopefully.

Some of the industries that have been identified as high risk are consumer industries like foods, products, beverage, textiles, apparel and footwear, but also technology, the mining sector, oil and gas, construction, and others.

And we found that companies in these high-risk sectors are more prepared for regulation than companies in other industries. And that can be because they have been in the spotlight for a while now on their human rights practices, so they had time to improve and have some due diligence processes in place.

However, within these high-risk sectors, we found that on average, electronic component manufacturers and food and beverage peers had the biggest gaps in practices and performance. And these are the industries that should perhaps be prioritized by investors in their engagement efforts.

Food and beverage companies rely on agricultural commodities, and electronic manufacturing relies on conflict minerals and cobalt. And the human rights

violations associated with sourcing these raw materials are systemic, widespread and very difficult to solve.

But labor standards in the supply chain may be more relevant for a consumer company than a mining company, for example. All these high-risk sectors are very different, and they are not exposed to the same human right salient risks. And given that the directive covers a wide range of sectors and business model, prioritizing and focusing on the most relevant risk for each company will be really important in navigating this new directive for both corporates and investors.

Bentley Kaplan:

Right. So, the CSDDD is looking to draw in a lot of different companies. And at a very high level, the extent to which these companies in Aura's analysis have basic human rights due diligence programs in place is pretty low. Bigger companies tended to have them more often than smaller ones, but by and large, these programs were focused on a company's own workforce and operations, not contractors, or upstream suppliers. But the directive also acknowledges that the likelihood of human rights violations being associated with a company and its supply chain is not going to be the same for all companies.

High-risk sectors include things like textiles or agriculture and forestry, manufacturing food and extracting mineral resources. And as Aura explains, there are some clear differences in where these risks might express themselves depending on where along the value chain different companies are operating.

A mining company is having to square off against risks in its own workforce, its contracted workers, or in surrounding communities, where its actual mining operations create risks of human rights abuses. But for something like a consumer electronics company, the risk tends to lie much more with their upstream suppliers, either through manufacturers in regions where human rights abuses are more common, or even further up the supply chain where the raw materials needed for electronics, so-called conflict minerals, could be sourced from artisanal mining operations or even larger mines that have limited protections for human rights. So, a company needs a good understanding of its own context, against this backdrop and the different ways that human rights violations can occur.

And for any aggregated analysis of whole industries or investment portfolios, it really requires a bottom-up understanding of supply chains. Aura and team leveraged data from Elevate, a sustainable supply chain assessment firm, in combination with our own in-house data sets to draw insights into the risks associated with sourcing different goods across the globe.

And what Aura found when she was looking through these different industries was that those that have had to contend with higher risks of human rights violations tended to have better practices in place to manage those risks.

And really getting to grips with supply chain risks may be of increasing interests to investors looking to understand how their portfolio companies may be

positioned as the CSDDD passes through the EU's legislative process and into laws in different member states.

But it's also worth taking a slight step back because not so long ago, the idea of being able to aggregate this type of data, of understanding and quantifying how exposed specific industries or companies are to activities that are linked to human rights violations would probably have felt like a bit of a long shot. And this is really indicative of how the topic of human rights is moving from a sometimes peripheral investment consideration to a much more central question for both companies and their investors.

To get a sense of how this work has evolved and how regulations have been ramping up and what this means for companies and investors, I spoke to Leslie Swynghedauw coming out of our Frankfurt office. Leslie's been working in ESG for 10 years, very much focused in Europe and keeping an eye on how human rights issues have developed for both companies and investors.

Leslie Swynghedauw: So it has always been of interest to some investors, but for a long time, it was mostly motivated by impacts or value objectives to ensure that investments were directed towards company that did not harm people and especially vulnerable populations.

I would say this has changed in the past few years. What we have observed is a significant increase of demand on this, especially in Europe. And this is coming from mainstream investors, not only for some specific sustainability or impact funds, but really to integrate that information across the broader investment activities.

The objective is to protect themselves against reputational risk and also better account for material risks to business. Because human rights is indeed, as you mentioned, becoming more financially relevant for companies.

The CSDDD does not come out of the blue. If you look at regulations affecting corporates, there has actually been a huge momentum since 2015 with several modern slavery acts being enacted in the UK, Australia, and more recently in Canada.

And in Europe, what we have seen is several national legislations going beyond those actual disclosure obligations and requiring actions and changes in behavior. That's the case in France and in Germany, and that's also the spirit of the CSDDD. And it could be particularly costly for a company. The Supply Chain Due Diligence Act in Germany, or the CSDDD, include fines up to 2 or 5% of total turnover.

The other regulatory driver that needs to be considered is around the sustainable finance regulations in Europe, which are integrating human rights disclosure obligations for investors. That's the case, for example, with the minimum safeguard of the EU Taxonomy, but also with some of the social indicators of SFDR. And as you say, the CSDDD could also include financial institutions.

I think it's also important to add that this growing interest is not only driven by regulations. Asset owners and retail clients are asking for better integrations of human rights issues. And more and more institutional investors consider that the most egregious impacts on people often converge with material risks to business. And the multiplication of investors coalitions on human rights in the past year, I think it's a very good illustration of that.

Bentley Kaplan:

And that is it for the week. A massive thanks to Aura and Leslie for their take on the news with an ESG twist. And a special thanks to Liz Houston who I didn't drag in front of the mic this time round, but had some very valuable contributions when it came to producing this episode.

And most of all, thank you very much for tuning in. As always, if you have some time to throw us stars on your platform of choice, that is always appreciated. In the meantime, take care of yourselves and those around you and Mike will be back again next week.

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