Principles for Responsible Investment

PRI POSITION PAPER

HOW TO MAKE THE CSDD DIRECTIVE PRACTICABLE FOR THE INVESTMENT INDUSTRY

March 2023

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ABOUT THE PRI

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has now over 5,000 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles, representing US $121 trillion in assets under management.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that environmental, social and governance (ESG) factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

ABOUT THIS REPORT

The PRI welcomes the EU proposal for a directive on Corporate Sustainability Due Diligence (CSDD). It offers an important opportunity to create a harmonised framework to ensure that economic activities tied to the EU single market are conducted in a responsible manner. However, significant improvements are needed, as set out in PRI's position paper published September 2022. Due diligence is an important and necessary part of a responsible investor's toolkit, supporting sustainability assessments, risk analysis and investee-engagement. Many PRI signatories already implement the UNGPs and OECD Guidelines (under PRI's 2021 reporting, 36% of investment manager and asset owner signatories based in EU member states said they used the UNGPs and/or OECD guidelines to either set policies and/or identify sustainability outcomes from their activities. See also PRI's Advance initiative with 121 participants and 220 endorsers).

Given recent policy developments, the concerns highlighted by a number of stakeholders, and PRI's unique position as a global investors' organisation, **this accompanying briefing note focuses on the amendments required to make the due diligence obligations practicable for the financial sector (specifically institutional investors and asset managers).** Due diligence practices for the financial sector are different to non-financial companies and this should be reflected in the CSDD. PRI supports the ECON opinion as a step forward in this direction although further improvements should be made. The general approach reached in Council fails to recognise the important role financial institutions can play and risks market fragmentation across Member States.

For more information, contact

Elise Attal
Head of EU Policy
Elise.Attal@unpri.org

Hazell Ransome
Senior Policy Analyst, EU
Hazell.Ransome@unpri.org

Davide Cerrato
Senior Policy Specialist, Human Rights and Social Issues
Davide.Cerrato@unpri.org

PRI Principles for Responsible Investment

KEY RECOMMENDATIONS

Civil liability

- Support ECON amendments 140-144. In cases where investors are linked to impacts, they should not be subject to legal liability as it is otherwise set out in the proposal.

Risk-based approach

- Follow a risk-based approach, aligned with international standards and grounded in the concepts of severity and leverage to ensure clear, achievable and proportionate due diligence obligations for investors which will lead to positive impact.
- Support ECON amendments 54 and 56 (prioritising action based on severity), 68 and 82[1] (expectation to use leverage when directly linked), 85 and 70 (prioritisation based on UNGP 17) and 114, 116, and 117 (accompanying guidance).
- Remove UCITS and AIFMs funds from the personal scope (at fund-level).
- Support ECON amendment 95 and elaborate on the proposed Article 8a with a delegated act to clarify how far investors are expected to go in their efforts to increase their leverage and the different methods they could use to do this.
- Provide investors with guidance on how they should report on their stewardship.

Divestment

- Support the clarification in ECON amendment 94 that divestment must be considered only as a last resort.
- Expand upon this amendment to (i) specify the factors investors should consider when deciding whether divestment is appropriate (ii) clarify, at level 2, the conditions for divestment for different asset classes/investment strategies and (iii) specify, at level 1, that if the investor chooses to remain in the relationship they should document the steps taken and their reasoning for continuing to stay invested.

Coherence with the EU framework

- Support ECON amendment 108 to avoid duplicative reporting requirements for financial institutions subject to the CSDD and SFDR.
- Focus on harmonisation across the EU sustainable finance framework in the upcoming revision of SRD II and potential review of the SFDR.
- Publish level 3 guidance explaining how compliance with CSDD, SFDR, CSRD, SRD II (Article 3g(1) point a), AIFMD and the UCITS directive all interact.

Sector specific guidance

- Introduce level 3 legislation which clarifies what an “acceptable level” of due diligence is for different investor types, asset classes and strategies.
- Support and further specify ECON amendments 114, 116 and 117 so that the guidance not only looks at the financial sector but practices by type of investor, asset class and investment strategy.

[1] With the caveat that the addition of “within their means” in amendment 82 is unnecessary.

DETAILED ANALYSIS

CIVIL LIABILITY

PRI supports the approach taken by the ECON committee in amendments 140-144 and strongly recommends that, in cases where investors are linked to impacts, they should not be subject to legal liability as it is otherwise set out in the proposal.

The civil liability regime, introduced in Article 22 of the CSDD proposal, must be amended to provide legal clarity and certainty to all entities within scope. To achieve this, PRI, in line with the European Economic and Social Committee, encourages co-legislators to adopt the concepts “cause”, “contribute” and “directly linked” from the UNGPs[2] and OECD guidelines[3]. The responsibility related to situations of cause, contribution and linkage are set out in the UNGPs[4] and should be reflected in the CSDD text. While there are instances where an investor can cause or contribute to an adverse impact[5], in most cases investors are instead ‘linked’[6] to such adverse impacts[7]. The OECD clarifies that the expectations placed on enterprises directly linked to adverse impacts should not shift responsibility from the entity causing them[8].

A RISK-BASED APPROACH

The due diligence obligations under the CSDD should follow a risk-based approach. This should be aligned with international standards and grounded in the concepts of severity and leverage to ensure clear, achievable and proportionate due diligence obligations for investors which will lead to positive impact.

Investors should carry out due diligence to identify, prevent, and mitigate the negative human rights and environmental impacts with which they are connected. However, investors often have large numbers of investee companies in their portfolios, or assess a wide range of companies for investment. In such cases, the OECD Guidelines state investors are “encouraged to identify general areas where the risk of adverse impacts is most significant and, based on this risk assessment, prioritise [parts of their value chain] for due diligence”. This is commonly referred to as a risk-based approach: first, investors try to understand the scope of issues they may be directly linked to, and

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[2] UN OHCHR (2011), Guiding Principles on Business and Human Rights – see Guiding Principle 13.
[3] OECD (2011) OECD Guidelines for Multinational Enterprises – see section IV Human Rights, paragraphs 1-6 on pg. 31.
[4] UN OHCHR (2011), Guiding Principles on Business and Human Rights – see in particular GPs 13, 17, 19 and 22.
[5] As clarified by John G. Ruggie (2017) Comments on Thun Group of Banks Discussion Paper on the Implications of UN Guiding Principles 13 & 17 In a Corporate and Investment Banking Context (although the context of this letter is the banking sector this point holds true for the whole financial industry); the UN Working Group on Business and Human Rights (2021), Taking stock of investor implementation of the UN Guiding Principles on Business and Human Rights (pg. 5-8); and the OECD (2017), Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises (Box 4 pg. 15).
[6] The OECD states (pg. 35) “*a minority shareholder relationship, particularly in listed equities, is unlikely to lead to a substantial contribution to an adverse impact under the OECD Guidelines. Thus, in the vast majority of cases, institutional investors holding a minority shareholding will not be in a position to “contribute” to an adverse impact at an investee company*”. Instead, in most instances the investor will be “directly linked” to the adverse impact and should employ its leverage to try and end or minimise it. See also UN OHCHR (2012), The Corporate Responsibility to Respect Human Rights, An Interpretive Guide pg. 16.
[7] “Direct linkage” is defined by the Commentary to UNGP 22, as a situation where ““Where adverse impacts have occurred that the business enterprise has not caused or contributed to, but which are directly linked to its operations, products, or services by a business relationship.” Note that under the OECD Guidelines, a relationship between an investor and investee company including a minority shareholding can be considered a "business relationship".
[8] OECD (2017), Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises, pg. 35.

second, they prioritise and respond to them as appropriate[9]. These steps should be carried out both pre-investment and at regular times throughout the investment's life, or when a change in the situation makes it necessary. Due diligence should look at the full value chain[10].

Severity: Severity focuses on the significance of the negative effects of an adverse impact. Where it is not possible to address all actual and potential adverse impacts simultaneously, investors should be permitted to first seek to prevent and mitigate (directly or via their influence over investees) those that are most severe or where delayed response would make them irremediable. Severity depends on the scale of the outcome (on an individual right(s)), the scope (number of individuals affected) and the irremediable character (any limits on the ability to restore those affected to a situation at least equivalent to their previous situation). Investors will typically, and should be permitted to, identify areas with a high risk of negative impacts across their portfolios – by looking at factors such as geography, sector, business model, products and services – to prioritise investees for further assessment and engagement. PRI is currently developing guidance on this topic to help investors carry out effective due diligence. An assessment of the likelihood of an adverse impact taking place should be used as a final step in the rare cases where two or more impacts are judged to have a similar level of severity[11].

Leverage:[12] In cases where a business is *directly linked* to an adverse impact, they are expected to influence the entity causing the adverse impact to help prevent or mitigate it (use their "leverage"). While acknowledging that influence over an investee varies by investment instrument and strategy, investors should exercise, and build, leverage through their investment decisions, stewardship of investees and dialogue with policymakers and key stakeholders. If an investor lacks sufficient leverage, it should seek ways to increase it, including through collaboration with other investors (e.g., see PRI's Advance initiative)[13]. The OECD also clarifies that in considering how to respond to identified risks, investors may take into account the importance of the investee company to themselves and potential limitations on leverage, in addition to the significance of the adverse impact[14].

Given the above, **PRI supports the ECON opinion amendments 54 and 56 (prioritising action based on severity), 68 and 82**[15] **(expectation to use leverage when directly linked), 85 and 70 (prioritisation based on UNGP 17) and 114, 116, and 117 (accompanying guidance).** However, we note amendment 63 could be clarified to avoid conflation between how a company is linked to the impact versus the prioritisation of the impact. Also, **UCITS and AIFMs funds should not be in scope (at fund-level) as leverage is exercised at entity level (in line with our recommendation for the personal scope of the CSDD to match that of the CSRD).**

[9] OECD (2017), Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises, see section 1.3, pg. 18.
[10] See PRI's position paper. We support the intention of amendment 46 in the ECON opinion to closer align the definition of value chain for the financial sector with what is understood under the international guidelines. However, the language should be clarified, and the exclusion of SMEs needs to be removed. The explicit reference to contracts should also be removed, considering that often the relationship between investor and investee will be non-contractual in nature.
[11] OECD (2011), Due Diligence Guidance for Responsible Business Conduct, pg. 45, question 5.
[12] In the context of due diligence, the term "leverage" has a different meaning to the one usually employed by actors in the financial markets, and is defined as "*the ability of a business enterprise to effect change in the wrongful practices of another party that is causing or contributing to an adverse human rights impact.*"
[13] Collaborative engagement can be a crucial tool to increase investor leverage and avoid potentially less effective and more burdensome individual action. This is particularly relevant to investors with more limited leverage e.g. UCITS investment management companies that, by law, cannot hold more than 10 percent of the voting rights of an issuing body.
[14] OECD (2017), Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises, pg. 19.
[15] With the caveat that the addition of "within their means" in amendment 82 is unnecessary.

PRI also welcomes the intention of new Article 8a (amendment 95) to explicitly clarify that stewardship is an important tool within investor due diligence. This could be elaborated further by empowering the Commission to adopt a delegated act which clarifies, for different organisational sizes, asset classes and investment strategies, **how far investors are expected to go in their efforts to increase their leverage** and the different methods they could use to do this. Investors also need guidance on how they should report on their stewardship (see following section on coherence).

DIVESTMENT

Divestment may not always be appropriate or possible. Therefore, PRI welcomes the clarification in ECON amendment 94 that divestment must be considered only as a last resort. This amendment should be expanded to specify the factors investors should consider when deciding whether divestment is appropriate.

Investors who have exhausted, through an extended period of escalating engagement, their leverage over an investee that is causing impacts may choose to maintain the relationship or divest[16]. Where an investor can continue to exert some leverage, it could be important to remain as an "engaged investor", voicing the need for a company to change its practices. Divestment can also be counterproductive, leading to further negative consequences for those already affected. Finally, divestment can be very difficult, if not impossible, for certain investment products, asset classes or strategies (e.g., funds held in a passive index)[17].

In line with the OECD guidelines, ECON amendment 94 should specify that when deciding if divestment is appropriate, the following factors should be considered: the investor's leverage over the company; how crucial the relationship is to the investor; the severity of the impact; whether terminating the relationship with the company would result in adverse impacts; and whether divestment is prudent as understood in the context of a relevant jurisdiction's laws on fiduciary duty or prudent investment[18]. Furthermore, the phrase "terminate the […] financial service contract", currently used in the amendment, should be rephrased is not wholly representative of the sector, given that investment relationships are often non-contractual in nature.

PRI recommends amendment 94 is built on further to: (i) empower the Commission to adopt level 2 legislation to clarify the conditions for divestment for different asset classes/investment strategies (accounting for investors that might not be deemed able to fulfil their given mandate – for example pension provision – if they divest or exit, or where they are subject to asset allocation requirements) **and at level 1, (ii) specify that if the investor chooses to remain in the relationship** (given the assessment of factors listed above), **they should document the steps taken and their reasoning for continuing to stay invested**, and communicate this to clients, beneficiaries, affected stakeholders and other relevant parties.

[16] OECD (2011) OECD Guidelines for Multinational Enterprises, Commentary to General Policies, paragraph 22.
[17] OECD (2017), Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises, pg. 39, footnote 41.
[18] OECD (2017), Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises, pg. 39.

COHERENCE WITH THE EU FRAMEWORK

PRI supports amendment 108 of the ECON opinion, to avoid duplicative reporting requirements for financial institutions subject to CSDD and SFDR. Alignment with reporting under Article 3g of the Shareholder Rights Directive (SRD II) should also be considered. However, it is of the utmost importance that co-legislators seek *harmonisation* between the files, including in the upcoming revision of SRD II and potential review of the SFDR.

Institutional investors operating in the EU are subject to multiple pieces of sustainable finance legislation. Due diligence-related requirements already exist under SFDR, AIFMD and the UCITS directive[19]. Therefore, the CSDD must bring added value (as a behavioural obligation which enhances investor's sustainability assessments, risk analysis and company engagement) and complement and support the rest of the framework. For example, there must be coherent definitions of negative impacts in CSDD, SFDR and CSRD (as set out in our position paper).

The Commission and co-legislators should focus on harmonisation in the upcoming revision of SRD II and potential review of the SFDR. The European Supervisory Authorities should also assess how reporting against the SFDR templates overlaps with CSDD compliance and how this could be improved. In the meantime, **level 3 guidance should be published explaining how compliance with CSDD, SFDR, CSRD, SRD II (Article 3g(1) point a), AIFMD and the UCITS directive all interact.**

Finally, co-legislators should consider the potential disincentives from investing in emerging markets as a result of CSDD requirements. While this effect should be minimised via a risk-based approach and improved expectations around divestment (see sections above), co-legislators should encourage the development of complementary policies which support sustainable financing in emerging markets.

SECTOR SPECIFIC GUIDANCE

While the investor responsibility to respect human rights and protect the environment is applicable to all investment activities, products and services offered by institutional investors, due diligence approaches and an investor's ability to exercise influence over a company may vary according to the type of institutional investor, asset class and/or investment strategy (e.g., passive investors may require client consent to exercise influence). **This should be considered in the CSDD via level 3 legislation which clarifies what an "acceptable level" of due diligence is for different investor types, asset classes and strategies** (including mutual funds, hedge funds, exchange traded funds, passive funds, smart index funds, pooled funds, quant-based funds).

[19] Under Article 4 of the SFDR, investors are required to consider the principal adverse impacts (PAIs) of their investment decisions and to publish and maintain a due diligence statement. This statement must include a description of the actions taken to address adverse impacts, including a description of engagement policies with investees where applicable. Investors must also provide a reference to their adherence to internationally recognised standards for due diligence. Furthermore, under Article 1(7) and Article 1(2) of the delegated acts amending UCITS and AIFM from April 2021 respectively:

- A management company under UCITS must consider sustainability risks and PAIs (if they are considered under SFDR) when ensuring a "*high level of diligence in the selection and ongoing monitoring of investments*" and when "*exercising due skill, care and diligence when entering into, managing or terminating any arrangements with third parties*".
- AIFMs must consider sustainability risks and PAIs (if they are considered under SFDR), while applying a "*high standard of diligence in the selection and ongoing monitoring of investments*" and when they "*establish, implement and apply written policies and procedures on due diligence*".

Institutional investors have different tools at their disposal to carry out due diligence and exercise leverage compared to non-financial companies. Sectoral guidance on how to implement the UNGPs and OECD Guidelines is given in the OECD 2017 report, "Responsible business conduct for institutional investors", the UN Working Group on Business and Human Rights' report "Taking stock of investor implementation of the Guiding Principles on Business and Human Rights", published on the 10-year anniversary of the UNGPs, and PRI's report "Why and How Investors should act on Human Rights". Co-legislators should build on this guidance to create level 3 legislation which covers:

- How investors can use/augment the instruments they already have at their disposal to meet due diligence requirements (including systems put in place to comply with SFDR). For example, what do asset owners need to consider in the selection, appointment and monitoring of their investment managers.
- How investors can increase their leverage via collaboration, in line with competition law.
- Expectations for investor engagement with policymakers and standard-setting bodies.

Therefore, PRI welcomes amendments 114, 116 and 117 of the ECON opinion. However, this should be specified further so that the guidance not only looks at the financial sector but practices by type of investor, asset class and investment strategy. This guidance must also be precise, concise and timely to ensure effective implementation of the directive.

The PRI is working on these issues, for example by running workshops for firms operating in private markets, and has published reports on "Why and how investors should act on human rights" and "Human rights in sovereign debt" as well as a number of case studies on human rights due diligence which span various investor types, asset classes and strategies. PRI also has extensive guidance and expertise on stewardship, especially our work on "Active Ownership 2.0" which creates a framework where investors use their influence to take action on sustainability outcomes. Finally, in the coming months PRI will publish a stewardship-focused report as part of our policy toolkit series which will look at measures to enhance accountability and transparency for stewardship activities and encourage a market for effective stewardship. PRI would be happy to support the development of such legislation and convene its signatories to provide insights into how investors practically carry out due diligence.

Annex: Key recommendations from PRI's position paper, September 2022

- Remove the pre-service limitation to investor due diligence to include ongoing assessments, throughout the value chain, in line with international standards.
- Clarify the definition of 'financial services' to include equity investment.
- Broaden the personal scope of EU companies under the directive, in line with the CSRD.
- Harmonise definitions of negative impacts across CSDD, SFDR and CSRD.
- Mandate stakeholder engagement when identifying actual and potential adverse impacts.
- Broaden the range of sustainability factors that should be considered when setting variable remuneration.
- Strengthen the link between variable remuneration and sustainability performance.
- Take the wider workforce into account when setting variable remuneration.
- Strengthen requirements on transition plans and increase alignment with CSRD.
- Clarify how companies can support the just transition.
- Define key terms in transition plan requirements.