AGREEMENT REACHED ON THE EU CORPORATE SUSTAINABILITY DUE DILIGENCE DIRECTIVE – WHAT FINANCIAL SERVICES FIRMS NEED TO KNOW

After months of political wrangling, EU member states have finally reached agreement on the Corporate Sustainability Due Diligence Directive (CS3D). On 15 March 2024, the Council of the EU reached a compromise on the wording of the CS3D which, if adopted by European Parliament, paves the way for this landmark human rights and environmental due diligence legislation to finally become a reality, albeit in a significantly narrower form than was originally proposed.

One of the most controversial topics to emerge from the political negotiations over the past few years was how CS3D would apply to financial services firms – referred to in the directive as 'regulated financial undertakings'. In this briefing, we take a look at where we have ended up and what in-scope financial services firms need to be aware of if, as is expected, CS3D becomes law in the EU.

For further information on the CS3D see our earlier **blog**.

The aims and objectives of CS3D

CS3D seeks to establish a common framework for companies operating in the EU to adopt and implement due diligence policies and processes to identify and address adverse human rights and environmental impacts (known as human rights and environmental due diligence, or 'HREDD') with which the companies may be involved, either through their own operations, those of their subsidiaries or through business relationships in their value chain.

CS3D and financial services firms

Precisely how CS3D would apply to financial services firms has been hotly contested. Ultimately, the compromise agreed by EU countries is far less onerous for financial services firms than that adopted by the European Commission in February 2022. Now, the key points that financial services firms need to be aware of are:

- More limited scope: CS3D now has a far more limited scope, significantly reducing the number of companies that will have to comply.

- Exemptions from scope: there are specific exemptions for Alternative Investment Funds (AIFs) and UCITS.
- Reduced scope of due diligence for financial services firms: in addition to carrying out periodic assessments of their own operations and those of their subsidiaries, in-scope financial services firms need only diligence the upstream and not the downstream part of their 'chain of activities' i.e. the activities that take place before a final product or service are provided, such as the design of a financial product, risk assessments and due diligence. This is specified in Recitals 19 and 36(b). However, there is some ambiguity on this as the definition of 'chain of activities', which is a substantive provision, does not specify this limitation.
- Specificities of the financial services industry and relevance of the OECD Guidelines for Multi-national Enterprises (OECD Guidelines) for due diligence: when conducting their upstream due diligence, financial services firms must take into account the specificities of the financial services industry. The OECD Guidelines are cited as providing indications of the types of measures that would be appropriate and effective for due diligence in a financial services context. Financial services firms would be expected to consider adverse impacts and to use their 'leverage' to influence companies, for example through exercising their shareholders' rights.
- Climate Transition Plans: financial services firms will be required to adopt and put into place a climate transition plan, unless already required to do so under the Corporate Sustainability Reporting Directive, to avoid duplication.
- Overlap with other financial services regulations: to avoid overlap with other financial service regulations that have reporting obligations, such as the SFDR, it is made clear that CS3D does not impose additional reporting obligations.
- Possible expansion of requirements for financial services firms in the future: in contrast to previous iterations of the directive, no political statement on the necessity to further develop 'appropriate legal requirements' for financial services firms will be included in the final legislation. However, the Commission is required to provide to the Parliament and Council within two years of CS3D coming into force a report on the necessity for additional sustainability due diligence requirements, tailored to financial services firms, which may include a legislative proposal, so it may be that additional requirements will be introduced in the future. That said, it is unclear what the Commission might include in its report, as the phased implementation of CS3D means that its provisions will apply after the date on which the report from the Commission is due. Similarly, the deadline for member states to adopt and publish the regulations and administrative provisions necessary to comply with the directive is required, at the latest, two years from the date CS3D enters into force, which again raises questions on the possible substance of the Commission's report.

Next Steps

The European Parliament is set to vote on the CS3D in plenary on 24 April 2024. Should it be voted through as expected, the CS3D will enter into force 20 days after its publication in the Official Journal. Member states will then have two years to transpose the provisions of the CS3D into national law.

What financial services firms should be doing now

Although CS3D still needs to be transposed into the national law of each EU Member State, and obligations will only start to apply from 3 years after entry into force, there are some initial preparatory steps that financial services firms could start to take.

- **Impact assessment:**
  - Identify group entities subject to CS3D;
  - Identify business lines and services most likely to be affected by the CS3D;
  - Develop an implementation plan, including identifying employees who will be responsible for implementation.
- **Information availability:**
  - Assess information already available to the firm – what information does the firm already have, what is publicly available;
  - Where relevant information is not already available, assess the firm's ability to obtain the information and what new measures may need to be put in place in order to obtain it.
- **Develop policies and procedures:**
  - Develop policies and procedures to ensure compliance by impacted business lines;
  - Establish which employees will need to have a good awareness of CS3D and implement training programmes;
  - Establish internal reporting lines.
- **Communications and documentation changes:**
  - Identify what external communications may be needed;
  - Identify any documentation changes that may be required (e.g., in connection with managing liability for breaches, or ability to terminate agreements following identification of human rights or environmental concerns).
- **Monitor ongoing developments:**
  - Monitor national implementing legislation in relevant jurisdictions;
  - Monitor any further clarification or changes in interpretation of CS3D (e.g., Commission Q&A or guidelines) as well as any future proposal regarding impact on downstream activities;
  - Monitor any overlapping or supplementary due diligence requirements (e.g., under the EU Deforestation Regulation, or under the legislation of other jurisdictions)

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