

Investor due diligence obligations in the CSDDD

Executive Summary

The trilogue negotiations on the **EU Corporate Sustainability Due Diligence Directive (CSDDD)** are an opportunity to establish due diligence obligations for financial and non-financial companies across the EU market. With global temperatures rising and inequalities increasing, there is an urgent need for the financial sector, including institutional investors and asset managers, to conduct meaningful due diligence to adequately manage sustainability risks across their value chains and support strong human rights and environmental protection.

This briefing aims to:

- Demonstrate that **investor due diligence brings clear benefits** and **builds on practices that many investors already undertake** as part of their risk mitigation efforts
- Outline how **investor engagement is a key component of the due diligence process**
- Explain why **institutional investors and asset managers need to be included in the scope of the CSDDD**, with reference to the current proposals under discussion in **the trilogue negotiations**.

Investor human rights and environmental due diligence is not novel

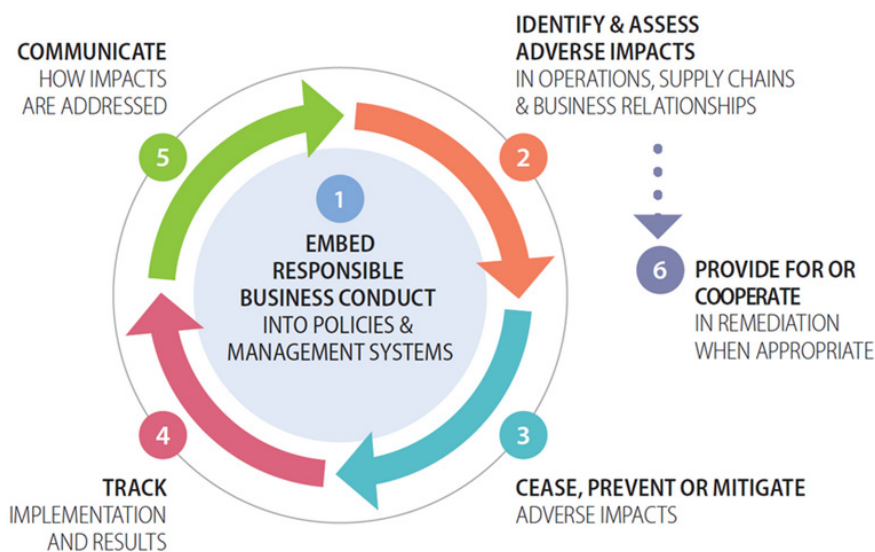
The financial sector plays a decisive role in the economy through fueling business activities. It is crucial to shaping a sustainable economic system which minimises risk and enhances stability. Investors have **significant leverage** over investee companies and the ability to **influence behaviour across sectors**. It is imperative that institutional investors and asset managers use this influence across their value chains to support more resilient business models that deliver sustainable financial returns over the long term. Conducting human rights and environmental due diligence is instrumental for achieving this.

The concept of **human rights and environmental due diligence** is set out in the United Nations Guiding Principles for Business and Human Rights and OECD Guidelines for Multinational Enterprisesⁱ. In this context, due diligence is a risk-based and continuous process through which businesses manage the adverse impacts of their operations, value chains, and other business relationships to people, planet, and society.

It thus differs from what is generally understood as due diligence in the investment sector, which refers to the assessment of legal and financial risks and mostly focuses on the pre-investment stageⁱⁱ. However, by routinely performing **financial due diligence**, investment sector practitioners are well accustomed to risk identification and management processes and have extensive knowledge and practices in place. These provide a foundation from which investors can build on when conducting environmental and human rights due diligence.

Investor engagement is a crucial step of the due diligence process

The due diligence process in the CSDDD should cover the **six steps** of the due diligence process defined by the **OECD Due Diligence Guidance on Responsible Business Conduct (RBC)**. These steps are outlined in the figure belowⁱⁱⁱ.



The OECD has produced **tailored guidance** on due diligence approaches for **institutional investors and asset managers**, which was developed in consultation with representatives from the financial sector, including BlackRock, J.P. Morgan and Aviva Investors. This guidance highlights that exerting “**leverage to influence investee companies**” is a key component of the due diligence process for investors, which is part of step three to cease, prevent, or mitigate adverse impacts^{iv}.

According to the OECD, the relationship between an investor and investee company is to be

considered a business relationship (even a minority shareholding). In most cases, adverse impacts occurring in an investor's own portfolio are "directly linked" to the investor by a business relationship, rather than caused, or contributed to, by them. In those cases, investors are expected to exert their leverage to the extent possible to influence the investee company to take action, but the responsibility to address the harm does not shift from the company to the investor^v.

Investors can exert this leverage in various ways, including through **engagement with investee companies**. Per the OECD, engagement approaches can include direct bilateral correspondence and meetings between the investor and investee company, attending and intervening at Annual General Meetings, the exercise of voting rights, and collaboration with other investors to exert leverage collectively. Investors can also reduce their investment position, with increased engagement activities as needed, including divestment as a last resort or for the most serious adverse impacts. **Investors are not expected to engage with every company in their portfolio**. Rather, a selection of companies to engage is carried out on **the basis of prioritisation**.

The OECD explains that the **prioritisation process should be risk-based**. First, investors screen their portfolios to identify general areas where the risk of adverse impacts is most significant. Second, this information is used to carry out in-depth assessments of investee companies that are, or are most likely to be, associated with the most severe risks^{vi}. The increasing availability of data derived from the Sustainable Finance Disclosure Regulation (SFDR) and Corporate Sustainability Reporting Directive (CSRD) should help to facilitate the risk identification process.

In view of the above, a significant part of the investor due diligence process often overlaps with investor **stewardship activities**, especially when it comes to engaging investee companies to prevent and mitigate risks. Therefore, some investors are already conducting steps of the due diligence process when carrying out activities which are core to their stewardship programmes^{vii}.



Examples of investor engagement

Data shows that a broad group of investors have engagement policies in place. Research conducted by ShareAction for the 2023 “Point of No Returns” report series found that all 23 EU asset managers surveyed have some sort of engagement policy in place, 19 of which cover climate change and social issues^{viii}.

For example, asset management firm Robeco states that its ‘enhanced engagement’ programme is carried out in accordance with the United Nations Guiding Principles and the OECD Guidelines for Multinational Enterprises (among other screening measures). If Robeco deems a company is in serious breach of these standards, an ‘enhanced engagement’ programme is applied that focuses on the misconduct and the company is no longer eligible for investments under Robeco’s enhanced ‘Level 2’ criteria. If the engagement does not lead to the desired change within a set period, Robeco will exclude a company from its investment funds^{ix}.

Another example is shown by the case of AXA Investment Managers’ (AXA IM) engagement with ‘climate laggards’ that lack sufficiently credible or ambitious emissions reduction targets or net-zero commitments. With these companies, AXA IM has a more robust ‘Three Strikes and You’re Out’ engagement policy. AXA IM communicates clear objectives at the beginning of the engagement with each company with the goal of substantial improvements to the company’s decarbonization strategy over three years. Over those three years, AXA IM will use escalation tools if the company does not show sufficient, and timely willingness to progress. If sufficient action is not taken and the engagement objectives are not reached at the end of the three year period, AXA IM will consider to divest^x.

However, despite examples of engagement on social and environmental issues, **the quality of policies and practices varies widely**. For example, 17% of EU asset managers do not include consequences in their engagement policies and 52% do not include specific triggers or timelines^{xi}. Further, EU-level rules on engagement do not set a strong standard^{xii}.

The CSDDD is an opportunity to set common due diligence rules

While engagement is a critical component of due diligence for investors, it alone is not sufficient.

- Due diligence is a six-step process, which also includes embedding Responsible Business Conduct (RBC) into policies and systems, identifying and assessing adverse impacts, tracking implementation and results, communicating how impacts are addressed, and having processes in place to enable remediation when appropriate.
- Data shows that investors are enhancing their due diligence efforts on environmental and social issues and seek to substantially increase their use of the practice. However, the lack of market consensus on the scope of what due diligence should entail remains a key challenge^{xiii}.

Moving from disclosure to mandated action remains a shortcoming in EU sustainable finance legislation. While the Shareholder Rights Directive II (SRD II) and Sustainable Finance Disclosure Regulation (SFDR) need to be reformed and strengthened, reviews of SRD II and SFDR alone will not be sufficient, nor likely to be completed in the short term.

The CSDDD is a crucial opportunity to embed the due diligence process into law and to set minimum requirements for all, including institutional investors and asset managers.

It is a chance to fill in key gaps and align the underlying due diligence, engagement, and disclosure concepts across the CSDDD, SRD II, and SFDR^{xiv}. In doing so, it will respond to investor calls to clarify what is expected of them and **create a level playing field** that enables them to better manage the adverse impacts of their investments^{xv}. Importantly, it will **create a common framework for financial and non-financial companies to address sustainability risks** across the EU market and drive outcomes in the real economy.

Current proposals under discussion in the CSDDD negotiations

In summary, investors already have several tools at their disposal and there is evidence of good practice across the industry of investors implementing key steps of the due diligence process, including engagement to address adverse impacts. However, practices still diverge quite significantly, which leads to fragmentation across the market.

The CSDDD gives policy makers an important opportunity to clarify how investors should consistently use their leverage to identify and mitigate adverse impacts across their value chains and establish a minimum set of requirements to conduct ongoing due diligence.

Including institutional investors and asset managers in the CSDDD will:

- Introduce clear minimum standards explaining what is expected from investors with regard to human rights and environmental due diligence, clarifying the various steps of the process, including engagement;
- Create a common framework with due diligence obligations for all enterprises, while taking into account the specificities of the various sectors, thereby maintaining the integrity of the CSDDD and coherence across the EU market as well as establishing a level playing field among institutional investors and asset managers;
- Enhance alignment with the responsibilities outlined in the SRD II and SFDR;
- Ensure that all market actors, both in the financial sector and the real economy, work efficiently and effectively to create a more sustainable European economy.

The proposed Article 8a is a step in the right direction

The **European Parliament's proposed Article 8a^{vi}** is a step in the right direction. It will help guide investors on what is expected of them and how they can use their leverage over investee companies to make the economy more sustainable. This article does not propose additional obligations for investors. Rather, **it provides clarity and guidance on how they can carry out due diligence**. It also aims to align EU legislation with key international standards such as the OECD Guidelines.

The inclusion of Article 8a in the CSDDD will also facilitate the development of **further technical guidance** to provide more detailed support and clarity for investors when carrying out due diligence. This will **help investors manage financial risks and adverse impacts more efficiently** and bring their activities in line with the increasing sustainability-related expectations of their clients and beneficiaries.

The CSDDD constitutes a turning point for how business is done at an EU and global level. The inclusion of institutional investors and asset managers in the final law is critical for aligning investments with our societal and environmental needs.

References

- i United Nations (2011), [Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework](#) ; OECD (2023), [OECD Guidelines for Multinational Enterprises on Responsible Business Conduct](#), OECD Publishing, Paris.
- ii The OECD provides a more detailed explanation of the differences between the due diligence concepts in Annex 1 of its guidance for investors. OECD (2017), [Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises](#).
- iii OECD (2018), [OECD Due Diligence Guidance for Responsible Business Conduct](#).
- iv OECD (2017), [Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises](#).
- v *ibid*
- vi OECD (2017), [Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises](#). The Principles for Responsible Investment (PRI) published a practical guide that further explains how investors can identify and prioritise human rights risks. PRI (2023), [How to identify human rights risks: A practical guide in due diligence](#).
- vii According to the UK Stewardship Code, "Stewardship is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society". Financial Reporting Council (2020), [The UK Stewardship Code 2020](#).
- viii ShareAction (2023), [Point of No Returns 2023](#).
- ix Robeco Institutional Asset Management (2022), [Exclusion Policy](#).
- x AXA Investment Managers (2023), [AXA IM Stewardship Report 2022](#).
- xi ShareAction (2023), [Point of No Returns 2023: Part II: Stewardship and Governance](#).
- xii ShareAction (2021), [Responsible Stewardship: How the EU can improve the Shareholder Rights Directive](#).
- xiii KPMG (2022), [2022 EMA ESG Due Diligence Study: How leading M&A teams are managing ESG DD](#).
- xiv It will also help to align related obligations in the Alternative Investment Fund Managers Directive (AIFMD) Delegated Regulation, Undertakings for Collective Instruments in Transferable Securities (UCITS) Delegated Directive, and the CSRD.
- xv PRI, Eurosif, Investor Alliance for Human Rights (2022), [Investor Statement of Support for an Ambitious and Effective European Directive on Corporate Sustainability Due Diligence](#).
- xvi European Parliament (2023), [P9_TA\(2023\)0209](#).

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