THE EU CS3D TRILOGUE NEARS CONCLUSION

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US Policy and Regulatory Alert

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INTRODUCTION

The Corporate Sustainability Due Diligence Directive (CS3D or Directive) is a mandatory framework of rules for companies that operate in the European Union (EU) and exceed certain revenue and employee thresholds. The Directive will govern how businesses approach and remedy their harmful impacts on the environment and on human rights across their value chains (i.e. their "negative externalities"). Further, it will impose affirmative obligations on covered enterprises to consider adverse impacts of their own operations, those of their subsidiaries, as well as in their relationships with business partners. Notably, the stated purpose of CS3D is to help the EU meet its legal commitment "...to becoming climate neutral by 2050 and to reducing climate emissions by at least 55% by 2030. Both of these commitments *require changing the way in which companies produce and procure.*" In contrast to various global regulatory proposals to enhance corporate disclosures, CS3D will mandate specific changes in corporate conduct extraterritorially.

CS3D MANDATES

The European Commission (Commission) published the proposed Directive on 23 February 2022. Since June 2023, the European Council (Council) and the European Parliament (Parliament) have been negotiating to iron out differences in an inter-institutional negotiations process called a "trilogue." Discussions center on employee and turnover thresholds for EU-based companies (for non-EU companies, there are no employee thresholds). It has been estimated that approximately 4,000 non-EU enterprises would be covered, depending upon the turnover thresholds ultimately adopted and the scope of activities contained in the final version.

For companies based outside of the EU, the original Commission proposal would apply to businesses with a net turnover of over €150 million produced in the EU (Group 1). Businesses with a turnover of over €40 million and below €150 million (Group 2) will also be subject to the new rules if 50% of that turnover was produced in listed "high-impact sectors" such as textiles and agriculture. Meanwhile, the Parliament proposal would apply to non-EU companies with greater than €150 million in global net turnover, where €40 million was generated within the EU, including turnover generated by subsidiaries and third parties in a vertical agreement. The Parliament has abandoned the high-impact differentiation. Lastly, the Council proposal proposes that non-EU companies would be in scope of the Directive if they meet, for two consecutive years, one of the following criteria: (i) they generated more than €150 million in the EU; or (ii) they had a net turnover of €40 million and generated less than €150 million in the EU, provided that €20 million were generated in a high impact sector.

Other provisions under scrutiny include the types of adverse impacts to be identified, the extent of penalties for noncompliance, the role of "business partners" in due diligence measures, and the inclusion of financial services providers under the new rules. The last of these has proven to be a point of contention as certain countries, including the Netherlands and Denmark, want all financial services to fall under the CS3D purview, while others–particularly, France–want them to be exempted. Still others, including Germany, Italy, and Ireland, want the framework to apply only to banks and insurers.

CHALLENGES FOR US ISSUERS

In response to investor demands, many US corporations have been voluntarily making sustainability disclosures in accordance with the recommendations of the Financial Stability Board (FSB) Task Force on Climate-Related Financial Disclosures (TCFD). Meanwhile, the US Securities and Exchange Commission (SEC) has yet to issue the long-awaited final version of its proposed Climate-Related Disclosure Rule. California also recently enacted its own climate disclosure laws; see "California Enacts Landmark ESG Legislation" for more detail. Further, the European Commission has issued its Corporate Sustainability Reporting Directive (CSRD), which is yet another corporate risk disclosure regime.

The challenge for investors is that TCFD disclosures are not standardized and therefore are not comparable. As a consequence, many of those companies are expected to adopt disclosure standards promulgated by the International Sustainability Standards Board (ISSB), a private-sector global standard setter operating under the auspices of the International Financial Reporting Standards Foundation (IFRSF). Indeed, there is a growing chorus of support for establishing a "global baseline" for sustainability disclosures to help corporate issuers meet ever increasing compliance obligations. This desire for a global standard was evidenced just this week at COP28; the ISSB announced that nearly 400 organizations from across 64 jurisdictions, comprised of nongovernmental organizations, stock exchanges, companies, and accounting firms, are committed to voluntarily adopting the ISSB's first round of climate-related reporting standards issued in June of this year.

CONCLUSION

In 2008, the Eurozone and US had comparably-sized economies as measured by GDP (i.e., US$14.2 trillion and US$14.8 trillion respectively). Since then, cumulative Eurozone economic growth has been anemic, growing only 5.6% in comparison with 81.8% growth over the same period in the United States. Moreover, according to the Securities Industry and Financial Markets Association, the US has more than twice the equity market capital of the EU and China combined. Finally, of the EU countries, only Germany is among the World's top 10 CO_2 emitters.

Enhancing corporate disclosure of financially material risks so investors can make informed investment decisions is consistent with US law, while directed changes to US corporate behavior by foreign governments as a condition of market access is not. During an oversight hearing before the House Financial Services Committee (HFSC) in June 2023, Treasury Secretary Janet Yellen expressed her concern with the potential impacts of CS3D, and stated, "we're looking very carefully at the EU's corporate sustainability directive and we're concerned about the impact it could have on US firms. We're consulting with the EU and making clear that we're concerned about the directive's extra-territorial scope." With the exception of HFSC Republicans, who sent a letter to Secretary Yellen in June 2023 outlining their concerns with the extraterritorial scope of CS3D, most U.S. policymakers have not yet focused on CS3D; when they do so, it will likely result in U.S. opposition to the proposal.

RELATED RESOURCES

On 7 September 2023, the US Chamber of Commerce held an event entitled "Decoding Disclosure: What International Disclosure Standards Mean for US Business", and featured a fireside chat with ISSB Chairman Emmanuel Faber. The Chamber's position paper on CS3D, which was a key topic of focus during this event, is available here.

To learn more about the current state of ESG in American politics, as well as the firm's role in this space, please visit our previous publications, including:

- "California Enacts Landmark ESG Legislation";
- "GOP ESG Bills Await US House Floor Consideration";
- "The ESG Debate Heats Up: State AGs Investigating Asset Manager Involvement in ESG Initiatives and Related Proxy Voting";
- "ESG Investing and Proxy Voting: DOL's New Final Rule";
- "SEC Adopts Final Rule Requiring Additional Proxy Voting Disclosures";
- "Déjà Vu All Over Again: SEC Reverses 2020 Proxy Rules Changes and Proposes Shareholder Proposal Rule Changes";
- "SEC Takes First Step Toward Standardized ESG Disclosures for Funds and Investment Advisers";
- "SEC Issues Climate-Related Risk Disclosure Rule Proposal"; and
- "2023 ESG State Legislation Wrap Up"

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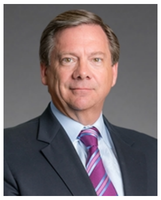
KEY CONTACTS



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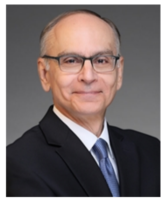

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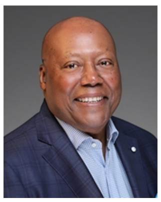

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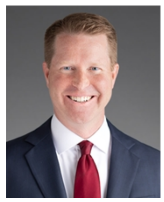

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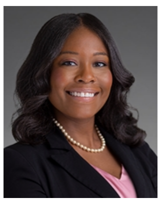

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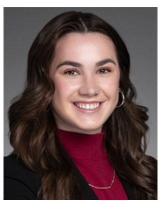

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