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On behalf of Invest Europe, the Voice of Private Capital

Position paper on the European Commission's Proposal for a Directive on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937

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Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Invest Europe welcomes the European Commission's proposal to promote sustainable and responsible corporate behaviour throughout global value chains. We fully support the principles behind the proposal, and in particular the idea of holding those involved in the management of a company accountable for creating real, long-term value, since it mirrors what is already today done in the private equity and venture capital industry. Furthermore, we agree that it is right to expect high standards in the EU and amongst European companies on issues such as environmental protection and human rights.

However, the Proposal on Corporate Sustainability Due Diligence ('CSDD') as it currently stands would lead to significant risks and uncertainties for the European economy, notably due to the potential increased liabilities of directors of boards in unpredictable and unintended ways and a lack of clarity in a number of other respects.

Considering the various pieces of ESG legislation on the table that the financial services industry is/will be subject to, in particular, the Taxonomy Regulation, the Sustainable Finance Disclosure Regulation and the Corporate Sustainability Reporting Directive, it is crucial that we have coherent terminology, concepts, and requirements across all files. Moreover, it is important to highlight that corporate governance models across Europe differ from one country to another, due to historic as well as legal reasons as different countries have differing corporate laws. For example, you may find two tier or one tier boards, and boards may be appointed or elected through different processes.

Therefore, we would urge EU policy makers to take into account the following concerns and recommendations for changes, in order to ensure that the proposal will be sufficiently well-balanced and targeted to be able to fulfil its worthy objectives without the risk of significantly hampering the continued opportunities for investments into the real economy.

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Application to AIFs and AIFMs

While it is clear that AIFs and AIFMs are, in principle, included in the scope of the proposal, we are concerned about the lack of clarity in relation to how the proposed directive would apply to AIFs and AIFMs in practice. Therefore, we believe that the following elements would benefit from further clarifications:

- Scope of the due diligence obligations (article 6 paragraph 3, article 7 paragraph 6 and article 8 paragraph 7): For regulated financial undertakings in general, there are some substantive differences between the obligations on financial undertakings where they provide credit, loan or other financial services, versus other entities, namely i) they need only identify the adverse impacts "at the inception of the contract", before providing the services, rather than periodically as other entities are required to do, and ii) they are not required to terminate those credit, loan or other financial services upon discovery of severe potential or actual adverse impacts, where doing so can reasonably be expected to cause substantial prejudice to the entity receiving the services. As the regulatory treatment for the provision of different types of financial services varies, it is crucial to have a clear definition of "other financial services". From our reading of the articles related to due diligence obligations, we understand that **the provision of equity (and equity-related finance) is out of scope**. That is logical because equity investors are not providing a service to the investee company, they may not have the opportunity to do extensive due diligence on the investee company and they may not enter into a contract with the investee company, although in some instances they may do so. We think that it is important to clarify that equity investors are not subject to the due diligence obligations, including when they provide shareholder loans (which are equity-related instruments).

- Application to portfolio companies: It is critical for the PE/VC industry to clearly draw the boundaries of their due diligence obligations. It is clear that the obligations of the Directive apply to such entities, but it should be made clear that their portfolio companies are not within the scope of their due diligence obligations, which should apply at the level of the investee company itself. We believe that the appropriate way to address this would be to expressly state that investment entities that do not consolidate their investee companies in their financial statements are not treated as parent companies for the purpose of the Directive.

- Definition of value chain (article 3(g)): The value chain of financial undertakings providing specific services is potentially more limited than other types of entities, namely defined as follows: "*'value chain' with respect to the provision of these specific services shall only include the activities of the clients receiving such loan, credit, and other financial services and of other companies belonging to the same group whose activities are linked to the contract in question. The value chain of such regulated financial undertakings does not cover SMEs receiving loan, credit, financing, insurance or reinsurance of such entities;*". The wording "*with respect to the provision of these specific services*" leads to unclarities on whether financial undertakings which are not providing specific services, or not "providing credit, loan or other financial services" are subject to these more limited obligations. **Again, we find it problematic that the concept of "other financial services" is broad and not defined**. According to our understanding of the draft Directive text, the provision of equity and equity-related finance is not included in the scope of this article as equity holders are not part of the value chain of a portfolio company. Furthermore, we would expect that AIFs/AIFMs are not considered to be in a business relationship with a portfolio company whether it subscribes for new shares or acquires them from someone else. This needs to be clarified in the text of the draft Directive.

- The value chain of financial services entities is also dependent on which companies within their group are "linked to the contract in question". There is no specification of how a group company will be considered "linked" to a contract, nor how closely linked it must be to be brought into the value chain. Furthermore, it must be clarified whether just the entity's subsidiaries are to be brought into the value chain, or also its parent company; at present the use of the phrase "other companies belonging to the same group" in the definition of "value chain" is distinct from the use of "subsidiaries" in other places in the draft text (and in contrast to recital (19)). Moreover, it should be made clear that the definition of "group" refers to the accounting rules and do**es not include company's which are not consolidated with its shareholder** (for example, because the shareholder is an investment entity).

- Calculation of turnover: It appears to be unclear how the turnover is calculated (and for non-EU entities, how the turnover in the EU is calculated). Since this has an impact on whether an entity will fall under the scope of the directive or not, it is crucial that sufficient clarifications are provided on this issue.

- High-impact sectors: Risks of uncertainties remain around to what extent AIFs and AIFMs could potentially be considered operating in high-impact sectors. It could helpfully be clarified that holding investments in an investee company operating in a high-impact sector – whether as a majority or minority shareholder – would not lead to an entity being classified as high-impact. Furthermore, high-impact sectors should be specified by using NACE codes or customs nomenclature. Should uncertainties remain around this issue, it could also lead to directors not being willing to take on the directorship in these sectors at all, notably due to the risk of personal liabilities, or cause investment to be diverted from these sectors, which would be damaging for the many legitimate European companies operating in these sectors.

Increased liabilities of directors

A key concern of the private equity and venture capital (PE/VC) industry in relation to the CSDD proposal is the **risks of increased liabilities imposed on non-executive or supervisory directors in relation to matters over which they have no control**. One of the cornerstones of our industry is active investment, where PE managers provide not only capital to businesses, but also often join the board of directors, in order to improve corporate governance and provide active and long-term support such as business expertise, knowledge and networks, helping the investee businesses thrive, grow and expand. However, such PE and VC nominated directors are non-executive and are not engaged in the day to day running of the business. It is not that directors of boards are generally shying away from exposure/liability as such, as it does come with the job, but more the risk of being sued for matters beyond one's control (especially if there is not clear enough division of responsibility/liability) or which are simply so-called nuisance claims, but which while being handled can cause significant financial exposure and stress.

PE and VC funds invest in a diverse range of businesses; a typical fund could hold investments in sectors as diverse as industrial products, life sciences, computer and consumer electronics, energy and environment, transportation and agriculture. The majority of the investee businesses are start-ups, scale-ups and SMEs[1], which would otherwise not have been able to get capital elsewhere or it would

[1]In 2021 alone, PE and VC funds invested over €138bn in the European economy, and supported almost 7,500 SMEs. For more information, please see the Invest Europe Private Equity activity 2021 research report (published May 2022)

have been too expensive. PE investments are thereby an essential driver of European growth, innovation, economic and social prosperity, as well as the creation of almost 10 million jobs[2] in the EU. It should be noted that, SMEs, as a part of the value chains of the larger firms captured under CSDD, will be indirectly impacted by this legislation (as noted in the European Commission's Impact Assessment Report[3]).

As long-term investors, the long-term value creation for the business is evidently the key priority for our members when they act as directors of boards of their portfolio companies. In this value creation, various stakeholders and other externalities are already today being taken into account, as they have an important impact on the performance of the company. It is vital that the company retains discretion to determine what weight and prioritisation to give to each group of stakeholders on a case-by-case basis. It should be clearer from the legislative text that this is indeed a matter for the directors of the company, and should not be open to challenge from outside the company, in line with current national rules on breach of directors' duties.

It is already difficult today to find directors for companies within the financial services sector due to the increase of personal liability. Adding more uncertainty in this regard, through unclear division of responsibility & liability risks further reducing competence at board levels. Notably, non-EU non-executive directors often bring a lot of expertise to EU companies, though with a lack of clarity around the liability regime, EU companies could be cut off from overseas leadership talent.

In order to facilitate the role of effective non-executive and supervisory board members, who can play an active role in improving companies, it is vital that the liability regime is **both clear and fair**. It is also helpful if the position is similar across the EU, rather than subject to dramatic variations between Member States. Even if liability risk remains remote, lack of clarity and the risk of unwarranted and spurious litigation can have a chilling effect on effective corporate governance and entrepreneurial decision-making, which is essential for economic growth.

In particular, it would be seriously damaging for the functioning of the PE model, and thereby the PE industry's ability to continue supporting European businesses with active and responsible stewardship and oversight, if these reforms created additional and unclear liability risks for non-executive or supervisory directors in relation to matters outside of their control.

In order to address these concerns and make the proposed directive more apt for the PE model, we therefore recommend the changes outlined in the below.

Definition of directors (Art. 3(1)(o))

The definition of directors as it currently stands is very broad, which could lead to uncertainties, divergences across jurisdictions and, most importantly, liability of directors falling in the wrong place. Capturing also supervisory and non-executive directors appointed by PE firms to their investee businesses would cause the risk of liability not necessarily falling in the right place, and thereby discourage the active and hands-on support provided by our members to the businesses they invest in. Any uncertainty or ambiguity as to where ultimate responsibility for a companies' activities and or who the relevant stakeholders actually are, risks creating unclear divisions/layers of responsibility and corresponding liability between owners/investors, boards and a corporation's executive management.

[2]9.9 million European employees worked in PE backed companies in 2020. For more information, please see the Invest Europe Private Equity at Work research report (published April 2022)

[3]Commission staff working document executive summary of the impact assessment report accompanying the document proposal for a directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 (published on 23 February 2022).

Therefore, we would suggest amending the definition of directors to be limited to executive directors, to better reflect who has the actual day-to-day responsibility of managing the company.

Recommendation 1

We suggest modifying Article 3(1)(o) as such:

*(o) **for the purpose of this directive**, 'director' means:*
***(i)** any **executive** member of the administrative, management or supervisory bodies **responsible for the day-to-day operations** of a company;*
(ii) where they are not members of the administrative, management or supervisory bodies of a company, the chief executive officer and, if such function exists in a company, the deputy chief executive officer;
~~(iii) other persons who perform functions similar to those performed under point (i) or (ii);~~

Directors' duty of care (Art. 25)

As also discussed above, any potential risks of unquantified liability of directors or lack of clarity over how to discharge the duty of care will be damaging for the incentives to take up the mandate as a director; this is true for executive as well as non-executive directors.

As noted above, the directors' discretion in terms of what factors to consider in acting in the best interests of the company should not be fettered. Whilst it is of course correct that sustainability matters should be taken into account where they are relevant, directors' decisions must be taken in the round in view of all relevant factors. Moreover, such business judgements are taken in conditions of inherent uncertainty and directors must feel able to make honest, good faith judgements without being concerned that they will be judged with the benefit of hindsight. As a general point, we believe that the balance between the responsibility of the board as a collegiate entity and individual directors as to duty of care, should reflect the impact that individual vs collegiate decisions may have.

Furthermore, we note that the regulation of directors' duties and liabilities is today not harmonised within the EU. Consequently, important questions such as whether and to what extent directors owe duties to third parties and can be held accountable to them for breach of such duties are regulated differently in the various EU jurisdictions[4]. There is, hence, a risk that EU Member States would implement the rules of the proposed directive concerning directors' liability to stakeholders in accordance with their own internal law, and this would likely result in legal discrepancies, confusion and room for arbitrage.

Therefore, we suggest introducing specific wording obliging Member States to ensure that (i) directors who do not take an active role in the management and decision-making for the company cannot be held liable for things they cannot control, and (ii) executive directors' discretion in decision-making is clearly retained, in order to limit the potential risks on individual directors, and thereby encourage directors to take up the mandate and ensure the highest possible level of directors. It should also be clear that directors' primary liability remains to the company (enforced by its shareholders). Placing an obligation on directors to pursue both the company's interest and diverse external stakeholders' interests, which may well be contradictory, would generate conflicting situations.

[4] See for example the following comparative study sponsored by the EU Commission: Gerner-Beuerle, Carsten, Paech, Philipp and Schuster, Edmund-Philipp, *Study on directors' duties and* liability, LSE Enterprise Limited, London, UK, April 2013.

Recommendation 2

We suggest modifying Article 25 as such:

Article 25

Directors' duty of care

1. Member States shall ensure that, when fulfilling their duty to act in the best interest of the company, directors of companies referred to in Article 2(1) take into account, where relevant, the consequences of their decisions for sustainability matters, including, where applicable, human rights, climate change and environmental consequences, including in the short, medium and long term.

2. Member States shall ensure that their laws, regulations and administrative provisions providing for a breach of directors' duties actionable by the company through its shareholders apply also to the provisions of this Article. Member States shall ensure that the duty of care expected of a director pursuant to this Article does not extend beyond the level of care, skill and diligence that it would be reasonable to expect from a director in the position that the actual director had in the company concerned at the time the decision was made.

Setting up and overseeing due diligence (Art. 26)

While we acknowledge the importance of the role of directors in setting up and overseeing due diligence actions, and hereunder taking into account relevant input from stakeholders and civil society organisations, we believe that this is rather a duty of the company as a whole and, even though directors should play a role in this, the ultimate responsibility should lay with the company rather than the individual director.

Therefore, we believe it is key to clarify that this should not lead to external parties having the right to sue the directors personally as opposed to the companies.

Recommendation 3

We suggest modifying Article 26 as such:

Article 26

Setting up and overseeing due diligence

1. Member States shall ensure that directors of companies referred to in Article 2(1) are responsible for putting in place and overseeing the due diligence actions referred to in Article 4 and in particular the due diligence policy referred to in Article 5, with due consideration for relevant input from stakeholders and civil society organisations. The directors shall report to the board of directors in that respect.

2. Member States shall ensure that directors take steps to adapt the corporate strategy to take into account the actual and potential adverse impacts identified pursuant to Article 6 and any measures taken pursuant to Articles 7 to 9.

3. Member States shall ensure that civil liability under Article 22 shall apply to the companies and not the directors individually.

Remuneration of directors

We do not agree with the provision set out in Article 15(3) requiring the company to link the variable remuneration of directors to the contribution to climate change objectives in certain circumstances. This is overly prescriptive. We believe that directors who are focused on long-term value creation and sustainability will need to take into account a wide variety of factors and these will vary from sector to sector and from company to company. We do not believe that the legislators should be so prescriptive as to require that directors' remuneration is linked to any one particular factor.

Shareholders will always expect directors to take into account the long-term interests of the company. That is, especially the case in the context of PE, where investors are highly incentivised to focus on the long-term prospects for the company, and the PE investment model is therefore highly focused on long-term value creation. PE backed companies design corporate governance structures that hold directors to account and incentivise long-term value creation. This will naturally also be reflected in the remuneration policies and will ensure a well-balanced remuneration system that takes into account long-term interests and material externalities. Interfering with mandatory rules directing the remuneration policies would be counterproductive for the alignment of interests already taking place in the PE industry and could undermine the effectiveness of the existing PE model, as such rules could be too standardised and burdensome, or too unclear and diverging across the different jurisdictions. For example, in Scandinavia, it is typically at the Annual General Meeting (AGM) (i.e. the shareholders) who set overall standards on executive pay and management/employee incentive programmes and then the Board (with help from remuneration committees) who break these down into finer details. It should be left to these bodies to decide upon what needs to form part of these guidelines, at each single step of a company's development phase, to ensure sustainable operations of the company and safe guard shareholder value.

Furthermore, different pieces of existing EU legislation (e.g. CSRD, AIFMD, SHRD) already contain provisions regarding remuneration structures. Therefore, we believe that adding another provision on remuneration would be unnecessary and lead to more open questions than actual solutions to address important issues such as climate change.

General points

While our arguments outlined above are more specific to our industry, there are some additional points we feel are worth mentioning that could bring more clarity to the text, notably under the definitions.

Article 3 (g): value chain

Covering the entire value chain (upstream and downstream) could disproportionately expose companies to liability for actions outside of their control, including decisions made by third parties along the value chain. We suggest restricting due diligence obligations to direct relationships in the value chain.

More specific to AIFMs and AIFs, we welcome the limitation of their value chain to activities of the clients receiving their services, and the exclusion from their value chain of SMEs receiving their services.

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We therefore suggest the following wording for article 3 (g):

> *"'value chain' means activities **directly** related to the production of goods or the provision of services by a company including the development of the product or the service and the use and disposal of the product as well as the related activities of upstream and* downstream established business relationships of the company. As regards companies within the meaning of point (a)(iv), 'value chain' with respect to the provision of these specific services shall only include the activities of the clients receiving such loan, credit, and other financial services and of other companies belonging to the same group whose activities are linked to the contract in question. The value chain of such regulated financial undertakings does not cover SMEs receiving loan, credit, financing, insurance or reinsurance of such entities".

Article 3 (n): stakeholders

The current definition of stakeholders is too broad and trying to balance the interests of all stakeholders will be challenging if not impossible. As mentioned previously, we find it very worrying that it is unclear whether stakeholders' interests would be weighted equally with those of shareholders and, if so, how directors are expected to resolve conflicts between various stakeholders and shareholder constituencies.

Additionally, considering "stakeholders whose rights or interests could be affected by the products, services and operations of the company, its subsidiaries and its business relationships" places a wide and heavy burden on companies and is hardly possible in practice.

We suggest the following wording:

> "Stakeholders whose rights or interests **could be directly and identifiably** affected by the products, services and operations of the company, its subsidiaries and its business relationships"

Article 6, 7, and 8: general concerns over lack of clarity

Regarding article 6, we believe that addressing actual and potential human rights and environmental adverse impacts should be limited to the most prominent and actual impacts. For instance, we welcome that Article 6 paragraph 2 sets out that smaller companies in "high-risk" sectors should only identify "severe" adverse impacts. For article 7 and 8, we see potential difficulty in practical implementation to address adverse impacts that should have been identified. It would be difficult for a company to take measure to prevent or mitigate impacts that they have not identified in the first place.

Regarding financial entities, we welcome the provisions in article 7 paragraph 6 and article 8 paragraph 7 exempting financial companies from the obligation to terminate the financial service contract when such termination may cause substantial prejudice to the entity receiving the relevant service. We would however appreciate more clarity around what constitutes "substantial prejudice".

Article 9: complaints procedure

Importantly, we would like to highlight the need for smooth articulation between the wording in the CSDD and the wording in the Whistleblowing Directive 2019/1937. Notably, the CSDD should refer to "reports" rather than "complaints" throughout the text.

In order to avoid bottlenecks stemming from unfounded complaints, we see the need to limit the scope of those who can submit complaints to those concerned about **severe** adverse human rights or environmental impacts with respect to their own operations and to trade unions and organisations which have **legitimate** concerns.

We suggest rewording article 9 (2) as follows:

> Member States shall ensure that the complaints may be submitted by:
> (a) persons who are affected or have reasonable grounds to believe that they might be **directly** affected by **an identifiable** adverse impact,
> (b) trade unions and other workers' representatives representing individuals working in the value chain concerned **which have legitimate concerns**,
> (c) civil society organisations active in the areas related to the value chain concerned **which have legitimate concerns**.

Article 11: Communication by smaller companies

In order to maintain simplified reporting obligations for SMEs, we see the need to specify how these firms should report under this Directive. As currently worded, article 11 will place annual disclosure rules on some firms that are not caught under Directive 2013/34.

We suggest the following addition to article 11:

> "Member States shall ensure that companies that are not subject to reporting requirements under Articles 19a and 29a of Directive 2013/34/EU report on the matters covered by this Directive by publishing on their website an annual statement in a language customary in the sphere of international business. The statement shall be published by 30 April each year, covering the previous calendar year.
>
> The Commission shall adopt delegated acts in accordance with Article 28 concerning the content and criteria for such reporting under paragraph 1, specifying information on the description of due diligence, potential and actual adverse impacts and actions taken on those.
>
> **The Commission shall develop simplified reporting obligations applicable to companies referred to in Article 2(1), point (b), and Article 2(2), point (b) of this Directive, and, no later than one year after the entry into force of this Directive, provide guidelines to support them in fulfilling their obligations."**

Articles 12, 13, and 14: development of model clauses, guidelines and accompanying measures

We welcome the development of model clauses as long as they remain voluntary. It should also be ensured that accompanying measures are practical and efficient. In addition, any financial support from Member States should not generate an unlevel playing field for companies in the EU.

It would be useful to have these clauses, guidelines and accompanying measures developed and in place well ahead of the implementation date of the Directive. In particular, we call for the model clauses to be developed no later than one year after the entry into force of the proposed Directive.

> "In order to provide support to companies to facilitate their compliance with Article 7(2), point (b), and Article 8(3), point (c), the Commission shall adopt guidance about voluntary model contract clauses **no later than one year after the entry into force of this Directive**."

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Article 18: power of supervisory authorities

We would like to underline that, cumulatively, remedy actions (investments, suspension or termination of the business relationship…) and sanctions (pecuniary compensations, absence of public support…) may place a heavy weight on companies.

We therefore suggest adding the below provision to article 18:

> **When exercising their powers, supervisory authorities shall take due account of the cumulative effects of the different measures or sanctions imposed on companies. Any decision shall be reasonable, non-discriminatory and proportionate**."

Article 20: sanctions

Despite the Commission's intentions to bring in a harmonised framework at EU level, sanctions are laid down by the different Member States. We are concerned that market players are not placed on a level playing field depending on the tools available to the supervisory authorities in their jurisdiction. In other words, this situation may lead to regulatory arbitrage.

We suggest the following wording for article 20 (1)

> "~~Member States~~ **The Commission** shall lay down ~~the rules~~ **a list of** ~~on~~ sanctions applicable to infringements of ~~national provisions adopted pursuant to~~ this Directive **no later than one year after its entry into force. Member States**~~, and~~ shall take **adequate sanctions from the list and** all measures necessary to ensure that they are implemented. The sanctions provided for shall be effective, proportionate and dissuasive".

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About Invest Europe

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members' role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

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