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Sent: jeudi 27 mai 2021 14:38

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Subject: Flash Report: Event with the German Institute for International and Security Affairs (SWP): European Due Diligence Legislation and Implications for the World Economy, 26 May 2021

Attachments: Flash Report_German Institute for International and Security Affairs_26 May 2021.docx

Sent on behalf of [redacted]

Flash Report: Event with the German Institute for International and Security Affairs (SWP): European Due Diligence Legislation and Implications for the World Economy, 26 May 2021

All speakers were supportive of a European due diligence legislation, highlighting different aspects to be considered. Some participants expressed the concern that the question of directors' liability could lead to a deadlock.

<u>Key elements discussed:</u>

The speakers made, amongst others, the following points:

- **Introduction by** [redacted] **SWP)** emphasising the importance of the issue in light of the massive human rights violations in Xinjiang. Companies might be forced to rethink their engagement in the economy. Due diligence legislation might affect the structure of global supply chains and change how the global economy works.
- **Keynote Address by** [redacted] underlining that **companies do not have to fear a EU legislation**. Both own empirics as well as sample third party empirics show that in terms of

competitiveness, innovation capability and profitability those companies, which follow a 360-degree sustainability strategy are in the long-run faring better. Their performance is increasing.
This can especially be seen in the Covid-19-crisis.
In regards to **SMEs** [redacted]tressed that they will not be left alone. There will be **mechanisms through which companies can discharge their due diligence duties in a collective manner** through for example a trade association in a certain sector or a cross-sectoral organisation focusing on hot spots. This will make the implementation of the legislation much more effective and reduce costs.
Moreover, [redacted] underlined the **key advantages of binding rules on an EU level**:

- They create a **level playing field.**
- Without binding rules for everyone, it is easier for sellers in third countries to turn away companies that already want to comply with sustainability standards. However, when an entire continent is under the same due diligence obligation it **changes the dynamics in the relationship between buyers and sellers**. Third-country sellers need to think carefully about whether they can afford to cut off customers from an entire continent. Given Europe's immense buying power, this is highly unlikely.
- Companies gain a **competitive advantage** through the creation of a level playing field within Europe. All companies are under the same obligations. Moreover, the relative power of speech and being heard and the ability to refer your suppliers to existing legal obligations increase considering that every European company has this obligation.

Panel 1: Towards a mandatory due diligence system in Europe:

- **MEP Marie-Pierre Vedrenne (Renew, European Parliament)** stressed that a voluntary approach is insufficient. The French due diligence legislation alone is not enough to have a decisive impact. **A European legislation is needed**. All EU trade agreements should include a chapter on sustainable development including provisions on compliance with for example the ILO Convention. She called for a legally binding instrument that builds on already existing initiatives and considers stakeholder views. In this regard she presented the following **key demands**:
    - Due diligence obligation means that the company must **identify, mitigate, address and correct their impact** on human rights and the environment.
    - Legislation should apply to **all companies** operating in the European Market, including non-European companies. Also SMEs must be included but support and technical assistance must be provided.
    - **Sanctions** and **access to justice and remedies** for victims must be guaranteed.
    - New **instrument for prohibition of import of products linked to serious human rights violations** to give special attention to child and forced labour.
- **MEP Bernd Lange (S&D, European Parliament)** pointed out the difficulty of tackling two tracks within the initiative, being the change of company law and the trade related side on supply chains. Management responsibilities have to be changed to include long-term sustainability aspects. Moreover, he pointed out the importance of binding due diligence obligations in the whole supply chains. Lessons are to be learned from already existing binding due diligence rules as the ones for minerals coming from conflict. He raised the following **key demands**:
    - **Clear definition of the due diligence obligations** including definitions of human rights, labour rights and environmental standards
    - **Risk based approach** that encompasses the whole supply chain
    - **Risk management system** to change the situation on the ground

    - Strong possibilities for **penalties** similar to the ones provided in the GDPR
    - System must be **acceptable for SMEs**. Already existing voluntary frameworks should be integrated into the legislation and could fulfil obligations if properly certified
    - **Support companies in their duties** through:
        - Guidelines by the EC to indicate specific risks
        - Artificial Intelligence to develop better knowledge.
- **Remarks, questions & answers:**
    - [redacted] **(SWP): Do you fear that a mandatory system could lead to divestment? If yes, what could we do about it?**
        - [redacted]: A cut and go system is not desirable. The goal is to stabilize investment in a fair manner. A risk management plan must be created.
    - [redacted] **(Human Rights and Responsible Business):** Appreciates the holistic debate at the European level. [redacted] believes that the question of directors' liability is in the course of killing the German law. **Do you think that including directors' liability is necessary?**
        - [redacted]: Liability should be included in the legislation.
        - [redacted]: The biggest resistance is on the company law element of the initiative. It might be a solution to split the initiative into two elements: supply chain due diligence and company law. The company law element should not block the entire proposal.
    - [redacted] **(SWP): Is the due diligence process too bureaucratic for SMEs? What are the biggest challenges for SMEs and how would you respond to their concerns?**
        - [redacted] It is important to work with the companies and not against them. For an efficient initiative SMEs need to be included as a lot of them are operating in high risk sectors such as mining and textiles. They need help complying with the legislation.
        - [redacted] SMEs need clarity on what their obligations are.
    - [redacted] **(University Osnabrück):** Is there a risk that less visible risks as for example the ones in local communities will be overseen?
        - [redacted]: A system is required that addresses all the risks such as local communities and deforestation. A mechanism to which they can appeal to is necessary.
        - [redacted]: Everything needs to be considered. A handbook from the Commission is needed to give an overview of the risks related to specific companies
    - [redacted] **(SWP): What is the planning to interlink the proposal on due diligence and the deforestation proposal? How to intervene with the broader issue of development policy?**
        - [redacted]: It is more efficient to work on a separate instrument to enforce deforestation, which is then to be linked to the due diligence legislation.
        - [redacted] The proposals need to be coherent. Human rights issues cannot be solved by due diligence legislation alone. Cooperation with countries, governments and civil society is crucial.
    - [redacted] **(HSB): What is planned with regard to monitoring companies and ensuring their compliance?**

    - [redacted]: Penalties need to be relevant. A good example is the GDPR fines, which are linked to the turnover of a company. Victims need to have access to justice.
  - [redacted] **(SWP): How should Civil Society Organisations become involved?**
    - [redacted] Commission needs to increase work with Civil Societies and not only include those based in Brussels or other EU capitals.
    - [redacted] Civil Society involvement is needed especially for the handbook and in establishing a risk management system on the ground.

Panel 2: Positioning European HRDD in a Global Economy

- [redacted] **International Trade and Investment, Kiel Institute for the World Economy (IfW))** pointed out the pessimistic and optimistic view. **Pessimists** would say that due diligence increases costs, which feeds through to the price of the final good and leads to reduction in competitiveness. Firms may switch suppliers. **Optimists** would say that due diligence increases costs also for support and that better support and pressure from customers improve working conditions, which leads to better performance and improved competitiveness. [redacted] **favored the optimistic view** as it is supported by empirical research. A due diligence legislation would give EU **a unique selling point** that may **increase competitiveness**. There would be the possibility of the **Brussels Effect** to inspire especially African countries to implement similar legislation.
- [redacted] **ÖFSE)** mentioned on **possible costs** that the compliance costs for EU lead firms would be **manageable** as indicated by various studies. As many companies have already invested in sustainability and certificates they are interested in leveling the playing field. [redacted] also stated that the **withdrawal of European companies from an entire country due to a high-risk context** is **not very high** and even if so that they would be likely to return. To minimize the risk the EU could introduce support via targeted Aid for Trade programs [redacted] also mentioned that lead firms are **not likely to abandon their supplier.** They will rather try to fix the problem given the fact that single sourcing is the most widespread sourcing strategy. The real risk is related to the uneven distribution of compliance costs due to structural power asymmetries between EU lead firms and suppliers. A possible solution could be an independent EU ombudsperson. Even if firms terminate their relations with suppliers due to human rights violations he expects the following **countervailing effects**:
  - If suppliers have to close, a **reallocation of labor** from non-compliant company to compliant companies will occur.
  - As working conditions improve **labor productivity should be expected to rise**, which will create positive spillovers for domestic economy.
  - Less developed countries are in need of foreign currency. If companies leave, it is to be expected that **governments will react and increase their standards**. The EU could support the government action.
- [redacted] **Business Europe)** stated that it is unclear what the scope of the legislation will be and what the role of companies and states will be [redacted] stressed that **companies should not replace the role of states** [redacted] argued that in some states there is no rule of law, no transparency and a very strong role of the state in the economy. This would limit the ability of companies to act as well as comply and would have an impact on the costs. [redacted] also pointed out that SMEs represent 90 % of the economy and that the major impact on them needs to be considered. The following **key points** were highlighted:

- The legislation needs to be **proportionate.**
- It needs to take into account the **size of the companies, the specificities of sectors and the variety of policy instruments.**

[redacted] mentioned that **a possible problem for competitiveness** with countries outside of the EU could be that the EU for a certain period will be alone with such obligations and that some governments already have threatened companies that there will be retaliation if they comply with the obligations.

- **Remarks, questions & answers:**
  - [redacted] **DIE): What are the likely effects for companies in developing countries?**
    - [redacted] Companies would have to prepare if they want to enter the European Market. Research has shown that is possible. Some suppliers would be left out but not the majority.
    - [redacted]: A due diligence legislation will not make a huge difference. A number of studies in Asia and Africa have already shown that if countries want to participate in value chains, they have to comply with certain standards already. The problem is the necessary upfront investment. There are companies, which will not be able to make that investment. The EU could step in to help.
    - [redacted] The effects will depend on how far the legislation will go. If a shareholder is liable for something that happens somewhere along the supply chain, circumstances in supply chains are observed more carefully. Unclear is what happens if the legislation is conflicting with the legislation of a producing country.
  - [redacted] **(SWP): What should the EU do to make sure that the positive effects of the legislation will actually materialize in producing countries?**
    - [redacted] The effects are not automatic. Firms have to be active and support suppliers. The EU should help in this process. Aid for Trade could be a possible framework. Local firms should be able to improve their technology.
  - [redacted] **WZB): How will the question of certificates and labelling be addressed?**
    - [redacted] Ideally there would be one EU label and not a lot of different labels.
    - [redacted] The problem is that there are very different labels depending on sectors. There is a need to address certification on the EU level. Legal standards for certification have to be introduced.
    - [redacted] It is very important to define how labelling will be done to prevent frauds. Clear rules have to be ensured.
  - [redacted] **(SWP): Are there specific examples of states threatening to retaliate?**
    - [redacted] In China there have been cases of companies being threatened that if they don't work in a certain region there will be retaliation. The legislation poses the risk for companies that they could be faced with opposition by local governments. It is unclear whether the EU would support the companies in such situations.
- **Key recommendations/final remarks:**
  - [redacted] It is important to recognize that companies are responsible for what they produce. Due diligence law can lead to an **increase in competitiveness**.
  - [redacted] **A mandatory due diligence system on the EU level is the way forward**. The combination of already existing and new instruments is necessary. Companies need to be required to play a more active part.

- [redacted] is not against mandatory due diligence but the new legislation needs to be proportionate, to have a good balance between state and government obligations and to be used together with already existing instruments.

- **Outlook and Closing Remarks by [redacted] SWP):** The issue of civil liability of enterprises should not lead to a deadlock in the discussion. Relationships between states and companies have to be rediscussed, also on a local level. The discussion should include different stakeholders. Possible future impacts should be considered.