ESG Business Risk and the New Legal and Regulatory Frontier

Presented by the
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Business Law Section

AMERICAN BAR ASSOCIATION

ESG: Business Risk and the New Legal and Regulatory Frontier

Traditionally, corporations' main risk factors were related to business and business environment, and the primary criterion for evaluating corporate action was maximizing shareholder welfare and return. Recently a new set of risk criteria outside the traditional focus on financial performance is gaining prominence: Environmental, Social and Governance (ESG) risk management. ESG risks are more than just reputational – they can include costly litigation, hefty fines, seizures at US ports, debarment, bank insecurity, and plunging stock value. Bottom line: ESG risks can now stop or seriously delay company operations.

This panel will consider the evolution of ESG concerns and reporting from philanthropic and discretionary to an area of required disclosure and regulatory focus; the breadth of shareholder proposals related to ESG; board governance and oversight; and the need for internal ESG governance processes for assessing materiality. The panelists will examine such risks through the eyes of not only major company or financial institution general counsel or senior in house and outside counsel, but also of a diverse group of professionals in this area from a number of perspectives, including the founder and president of a leading human rights litigation advocacy group. These perspectives include:

- regulatory activity regarding climate risk within the financial services sector, including expectations of the Office of the Comptroller of the Currency and the Federal Reserve Board. In addressing climate risk, financial institutions must analyze physical risk (e.g., the risk associated with the direct impact of climate change on institutions' physical assets and the physical assets of their borrowers), transition risk (e.g., the risk associated with increased market demand for lower carbon-producing products and services), acute risks (e.g., the risks associated with a specific short-term climate event, such as a natural disaster), and chronic risks (e.g., the risks associated with the increase in frequency of natural disasters over time). We will provide an overview of the recent developments and discuss the practical implications for financial institutions and their customers.

- litigation risks for both companies as well as board members and officers, whether from regulatory agencies, private plaintiffs, or public interest organizations, including the status of strategic litigation in the human rights arena, other mechanisms underway that can disrupt labor trafficking such as the Trade Facilitation and Trade Enforcement Act and the Federal Acquisition Regulation, trends in the litigation arena, and the status of extraterritorial application in human rights cases;

- risks springing from the draft EU Directive requiring human rights due diligence and remediation of adverse impact issues in supply chain management and specific contract assurances addressing such human rights initiatives, including the concept of shared responsibility (recently addressed in a unique buyer code of conduct found in Version 2.0 of the Model Contract Clauses to Protect Human Rights in International Supply Chains (the MCCs) which incorporate the UNGPs and OECD Guidelines and are drawn from the ABA Model Principles on Labor Trafficking and Child Labor). Published in the most recent Winter Issue of *The Business Lawye*r, the MCCs integrate human rights due diligence into every stage of the supply chain contract, allow enforcement by every buyer and supplier in the chain (eliminating conventional privity of contract) and prioritize remediation of human rights harms over conventional contract remedies; and

- other newly manifest risks that have surfaced in recent years.

The program will emphasize that companies, banks, investors, and advisors who ignore these and other ESG risks do so at their peril and miss the chance to create long term value. We will also discuss essential, practical tools for measuring, monitoring, and proactively managing ESG risk. Given the ever-increasing ESG initiatives impacting so many aspects of business today and beyond, evidenced in part by the number of ESG related CLE's we will identify at this meeting, almost every member of the Business Law Section should be interested in this Showcase Program.

Climate Risks in Financial Services

Physical risk versus transition risk

Acute risk versus chronic risk

U.S. Bank Regulatory Developments

- Federal Reserve
  - Focused on the impact of climate risk on financial stability
  - Climate stress scenarios are likely to be a strategic priority

- Office of the Comptroller of the Currency (OCC) released draft climate-related financial risk principles in December 2021
  - Governance
  - Incorporation of climate-related financial risks into policies, procedures, and limits
  - Consideration of climate-related financial risks in setting strategy, risk appetite, and financial, capital & operational plans
  - Risk management
  - Data, risk measurement, and reporting
  - Scenario analysis

[PLACEHOLDER SLIDE TO DISCUSS OVERVIEW OF COMMENTS RECEIVED ON PROPOSED OCC GUIDANCE (COMMENT PERIOD ENDS ON FEB. 14) AND POTENTIALLY DISCUSSION OF THE FINAL GUIDANCE]

117TH CONGRESS
1ST SESSION

S. 65

AN ACT

To ensure that goods made with forced labor in the Xinjiang Uyghur Autonomous Region of the People's Republic of China do not enter the United States market, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Uyghur Forced Labor Prevention Act".

SEC. 2. FINDINGS.

Congress finds the following:

(1) In the Xinjiang Uyghur Autonomous Region of the People's Republic of China, the Government of the People's Republic of China has, since April 2017, arbitrarily detained more than 1,000,000 Uyghurs, Kazakhs, Kyrgyz, Tibetans, and members of other persecuted groups in a system of extrajudicial mass internment camps, and has subjected detainees to forced labor, torture, political indoctrination, and other severe human rights abuses.

(2) Forced labor, a severe form of human trafficking, exists within the Xinjiang Uyghur Autonomous Region's system of mass internment camps, and throughout the region, and is confirmed by the testimony of former camp detainees, satellite imagery, and official leaked documents from the Government of the People's Republic of China as part of a targeted campaign of repression of Muslim ethnic minorities.

(3) Researchers and civil society groups have issued reports documenting evidence that many factories and other suppliers in the Xinjiang Uyghur

Autonomous Region are exploiting forced labor, on July 22, 2020, the Bureau of Industry and Security of the Department of Commerce added 11 entities to the Entity List set forth in Supplement No. 4 to part 744 of title 15, Code of Federal Regulations, after determining the entities had been "implicated in human rights violations and abuses in the implementation of China's campaign of repression, mass arbitrary detention, forced labor and high-technology surveillance against Uyghurs, Kazakhs, Kyrgyz, Tibetans, and members of other persecuted groups in the Xinjiang Uyghur Autonomous Region".

(4) Since October 2019, the Bureau of Industry and Security of the Department of Commerce has added a total of 48 entities of the Government of the People's Republic of China to the Entity List set forth in Supplement No. 4 to part 744 of title 15, Code of Federal Regulations, in connection with their implication in human rights abuses in the implementation of China's campaign of repression, mass arbitrary detention, forced labor, and high-technology surveillance against Uyghurs, Kazakhs, and other members of Muslim minority groups in the Xinjiang Uyghur Autonomous Region. As a consequence of their addition to the Entity List, com-

prehensive restrictions apply to the export, reexport, and in-country transfer of most United States-origin items to those 48 entities. Audits and traditional due diligence efforts to vet goods and supply chains in the Xinjiang Uyghur Autonomous Region are unreliable for identifying the absence of forced labor in the production of goods because of interference by the Government of the People's Republic of China, including through intimidation of potential witnesses and concealment of relevant information.

(5) Reports cited by the Department of Labor estimate that hundreds of thousands of ex-detainees who are Uyghurs, Kazakhs, Kyrgyz, Tibetans, or members of other persecuted groups in the People's Republic of China may be working in conditions of forced labor following detention in re-education camps. Moreover, nongovernmental organizations estimate that more than 80,000 Uyghurs were transferred out of the Xinjiang Uyghur Autonomous Region to work in factories across the People's Republic of China between 2017 and 2019, and some of them were sent directly from detention camps.

(6) The Department of State's June 2020 Trafficking in Persons Report found, "Authorities offer subsidies incentivizing Chinese companies to open

factories in close proximity to the internment camps and to receive transferred detainees at satellite manufacturing sites in other provinces. Local governments receive additional funds for each inmate forced to work in these sites at a fraction of minimum wage or without any compensation. The government has transported tens of thousands of these individuals to other areas within Xinjiang and to other provinces for forced labor under the guise of poverty alleviation and industrial aid programs.".

(7) U.S. Customs and Border Protection has issued 11 withhold release orders on goods suspected to be produced with forced labor in the Xinjiang Uyghur Autonomous Region. Goods subject to the withhold release orders include all cotton, cotton products, tomatoes, and tomato products, as well as certain garments, hair products, apparel, computer parts, and other goods.

(8) In its 2019 annual report, the Congressional-Executive Commission on China found that goods reportedly produced with forced labor by current and former mass internment camp detainees included textiles, electronics, food products, shoes, tea, and handicrafts.

(9) Under section 1091(a) of title 18, United States Code, a person commits genocide if the person "whether in time of peace or in time of war and with the specific intent to destroy, in whole or in substantial part, a national, ethnic, racial, or religious group as such—

"(1) kills members of that group;

"(2) causes serious bodily injury to members of that group;

"(3) causes the permanent impairment of the mental faculties of members of the group through drugs, torture, or similar techniques;

"(4) subjects the group to conditions of life that are intended to cause the physical destruction of the group in whole or in part;

"(5) imposes measures intended to prevent births within the group; or

"(6) transfers by force children of the group to another group.".

(10) As a direct result of the campaign of targeted and coercive population control of the Government of the People's Republic of China's against Uyghurs, the birthrate of the Uyghur population in the Xinjiang Uyghur Autonomous Region plummeted by 24 percent from 2017 to 2018, with birth-

rates in the Uyghur majority regions of Hotan and Kashgar decreasing by more than 60 percent from 2015 to 2018.

(11) The policies of the Government of the People's Republic of China are in contravention of its human rights commitments and obligations, including under—

(A) the Universal Declaration of Human Rights;

(B) the International Covenant on Civil and Political Rights, which the People's Republic of China has signed but not yet ratified; and

(C) the United Nations Protocol to Prevent, Suppress and Punish Trafficking in Persons Especially Women and Children (commonly known as the "Palermo Protocol"), to which the People's Republic of China has been a state party since February 2010.

SEC. 3. STATEMENT OF POLICY.

It is the policy of the United States—

(1) to strengthen the prohibition against the importation of goods made with forced labor, including by ensuring that the Government of the People's Republic of China does not undermine the effective enforcement of section 307 of the Tariff Act of 1930

(19 U.S.C. 1307), which prohibits the importation of all "goods, wares, articles, and merchandise mined, produced or manufactured wholly or in part in any foreign country by . . . forced labor";

(2) to lead the international community in ending forced labor practices wherever such practices occur through all means available to the United States Government, including by stopping the importation of any goods made with forced labor, including those goods mined, produced, or manufactured wholly or in part in the Xinjiang Uyghur Autonomous Region;

(3) to actively work to prevent, publicly denounce, and end human trafficking, including with respect to forced labor, whether sponsored by the government of a foreign country or not, and to restore the lives of those affected by human trafficking, a modern form of slavery;

(4) to regard the prevention of atrocities as a priority in the national interests of the United States; and

(5) to address gross violations of human rights in the Xinjiang Uyghur Autonomous Region—

(A) through bilateral diplomatic channels and multilateral institutions in which both the

United States and the People's Republic of China are members; and

(B) using all the authorities available to the United States Government, including visa and financial sanctions, export restrictions, and import controls.

SEC. 4. STRATEGY TO ENFORCE PROHIBITION ON IMPORTATION OF GOODS MADE THROUGH FORCED LABOR IN THE XINJIANG UYGHUR AUTONOMOUS REGION.

(a) PUBLIC COMMENT.—

(1) IN GENERAL.—Not later than 45 days after the date of the enactment of this Act, the Secretary of the Treasury and the Secretary of Homeland Security shall jointly, and in consultation with the United States Trade Representative, the Secretary of State, and the Secretary of Labor, publish in the Federal Register a notice soliciting public comments on how best to ensure that goods mined, produced, or manufactured wholly or in part with forced labor in the People's Republic of China, including by Uyghurs, Kazakhs, Kyrgyz, Tibetans, and members of other persecuted groups in the People's Republic of China, and especially in the Xinjiang Uyghur Au-

tonomous Region, are not imported into the United States.

(2) PERIOD FOR COMMENT.—The Secretary of the Treasury and the Secretary of Homeland Security shall provide the public with not less than 60 days to submit comments in response to the notice required by paragraph (1).

(b) PUBLIC HEARING.—

(1) IN GENERAL.—Not later than 45 days after the close of the period to submit comments under subsection (a)(2), the Secretary of the Treasury, the Secretary of Homeland Security, the Secretary of Labor, the United States Trade Representative, and the Secretary of State shall jointly conduct a public hearing inviting witnesses to testify with respect to the use of forced labor in the People's Republic of China and potential measures, including the measures described in paragraph (2), to prevent the importation of goods mined, produced, or manufactured wholly or in part with forced labor in the People's Republic of China into the United States.

(2) MEASURES DESCRIBED.—The measures described in this paragraph are—

(A) measures that can be taken to trace the origin of goods, offer greater supply chain transparency, and identify third country supply chain routes for goods mined, produced, or manufactured wholly or in part with forced labor in the People's Republic of China; and

(B) other measures for ensuring that goods mined, produced, or manufactured wholly or in part with forced labor do not enter the United States.

(c) DEVELOPMENT OF STRATEGY.—After receiving public comments under subsection (a) and holding the hearing required by subsection (b), the Secretary of the Treasury and the Secretary of Homeland Security shall jointly, and in consultation with the Secretary of Labor, the United States Trade Representative, the Secretary of State, and the Director of National Intelligence, develop a strategy for preventing the importation into the United States of goods mined, produced, or manufactured wholly or in part with forced labor in the People's Republic of China.

(d) ELEMENTS.—The strategy developed under subsection (c) shall include the following:

(1) A comprehensive assessment of the risk of importing goods mined, produced, or manufactured wholly or in part with forced labor in the People's Republic of China, including from the Xinjiang

Uyghur Autonomous Region or made by Uyghurs, Kazakhs, Kyrgyz, Tibetans, or members of other persecuted groups in any other part of the People's Republic of China, that identifies, to the extent feasible—

(A) threats, including through the potential involvement in supply chains of entities that may use forced labor, that could lead to the importation into the United States from the People's Republic of China, including through third countries, of goods mined, produced, or manufactured wholly or in part with forced labor; and

(B) what procedures can be implemented or improved to reduce such threats.

(2) A comprehensive description and evaluation—

(A) of "pairing assistance" and "poverty alleviation" or any other government labor scheme that includes the forced labor of Uyghurs, Kazakhs, Kyrgyz, Tibetans, or members of other persecuted groups outside of the Xinjiang Uyghur Autonomous Region or similar programs of the People's Republic of China in which work or services are extracted from

Uyghurs, Kazakhs, Kyrgyz, Tibetans, or members of other persecuted groups through the threat of penalty or for which the Uyghurs, Kazakhs, Kyrgyz, Tibetans, or members of other persecuted groups have not offered themselves voluntarily; and

(B) that includes—

(i) a list of entities working with the government of the Xinjiang Uyghur Autonomous Region to move forced labor or Uyghurs, Kazakhs, Kyrgyz, or members of other persecuted groups out of the Xinjiang Uyghur Autonomous Region;

(ii) a list of products mined, produced, or manufactured wholly or in part by entities on the list required by clause (i);

(iii) a list of entities that exported products described in clause (ii) from the People's Republic of China into the United States;

(iv) a list of facilities and entities, including the Xinjiang Production and Construction Corps, that source material from the Xinjiang Uyghur Autonomous Region or from persons working with the government of the Xinjiang Uyghur Autonomous Region or the Xinjiang Production and Construction Corps for purposes of the "poverty alleviation" program or the "pairing-assistance" program or any other government labor scheme that uses forced or involuntary labor;

(v) a plan for identifying additional facilities and entities described in clause (iv);

(vi) an enforcement plan for each such entity, which may include issuing withhold release orders to support enforcement of section 5 with respect to the entity;

(vii) a list of high-priority sectors for enforcement, which shall include cotton, tomatoes, and polysilicon; and

(viii) an enforcement plan for each such high-priority sector.

(3) Recommendations for efforts, initiatives, and tools and technologies to be adopted to ensure that U.S. Customs and Border Protection can accurately identify and trace goods made in the Xinjiang

Uyghur Autonomous Region entering at any of the ports of the United States.

(4) A description of how U.S. Customs and Border Protection plans to enhance its use of legal authorities and other tools to ensure that no goods are entered at any of the ports of the United States in violation of section 307 of the Tariff Act of 1930 (19 U.S.C. 1307), including through the initiation of pilot programs to test the viability of technologies to assist in the examination of such goods.

(5) Guidance to importers with respect to—

(A) due diligence, effective supply chain tracing, and supply chain management measures to ensure that such importers do not import any goods mined, produced, or manufactured wholly or in part with forced labor from the People's Republic of China, especially from the Xinjiang Uyghur Autonomous Region;

(B) the type, nature, and extent of evidence that demonstrates that goods originating in the People's Republic of China were not mined, produced, or manufactured wholly or in part in the Xinjiang Uyghur Autonomous Region; and

(C) the type, nature, and extent of evidence that demonstrates that goods originating in the People's Republic of China, including goods detained or seized pursuant to section 307 of the Tariff Act of 1930 (19 U.S.C. 1307), were not mined, produced, or manufactured wholly or in part with forced labor.

(6) A plan to coordinate and collaborate with appropriate nongovernmental organizations and private sector entities to implement and update the strategy developed under subsection (c).

(e) SUBMISSION OF STRATEGY.—

(1) IN GENERAL.—Not later than 270 days after the date of the enactment of this Act, and annually thereafter, the Secretary of Homeland Security, in consultation with the Secretary of Labor, the United States Trade Representative, and the Secretary of State, shall submit to the appropriate congressional committees a report that—

(A) in the case of the first such report, sets forth the strategy developed under subsection (c); and

(B) in the case of any subsequent such report, sets forth any updates to the strategy.

(2) UPDATES OF CERTAIN MATTERS.—Not less frequently than annually after the submission under paragraph (1)(A) of the strategy developed under subsection (c), the Secretary shall submit to the appropriate congressional committees updates to the strategy with respect to the matters described in clauses (i) through (vi) of subsection (d)(2)(B).

(3) FORM OF REPORT.—Each report required by paragraph (1) shall be submitted in unclassified form, but may include a classified annex, if necessary.

(4) PUBLIC AVAILABILITY.—The unclassified portion of each report required by paragraph (1) shall be made available to the public.

(f) RULE OF CONSTRUCTION.—Nothing in this section may be construed to limit the application of regulations in effect on or measures taken before the date of the enactment of this Act to prevent the importation of goods mined, produced, or manufactured wholly or in part with forced labor into the United States, including withhold release orders issued before such date of enactment.

SEC. 5. REBUTTABLE PRESUMPTION THAT IMPORT PROHIBITION APPLIES TO GOODS MINED, PRODUCED, OR MANUFACTURED IN THE XINJIANG UYGHUR AUTONOMOUS REGION OR BY CERTAIN ENTITIES.

(a) IN GENERAL.—The Commissioner of U.S. Customs and Border Protection shall, except as provided by subsection (b), apply a presumption that, with respect to any goods, wares, articles, and merchandise mined, produced, or manufactured wholly or in part in the Xinjiang Uyghur Autonomous Region of the People's Republic of China or produced by an entity on a list required by clause (i), (iii), or (iv) of section 4(d)(2)(B)—

(1) the importation of such goods, wares, articles, and merchandise is prohibited under section 307 of the Tariff Act of 1930 (19 U.S.C. 1307); and

(2) such goods, wares, articles, and merchandise are not entitled to entry at any of the ports of the United States.

(b) EXCEPTIONS.—The Commissioner shall apply the presumption under subsection (a) unless the Commissioner determines that—

(1) the importer of record has—

(A) fully complied with the guidance described in section 4(d)(5) and any regulations issued to implement that guidance; and

(B) completely and substantively responded to all inquiries for information submitted by the Commissioner to ascertain whether the goods were mined, produced, or manufactured wholly or in part with forced labor; and

(2) the good was not mined, produced, or manufactured wholly or in part by forced labor.

(c) REPORT REQUIRED.—Not less frequently than every 180 days, the Commissioner shall submit to the appropriate congressional committees and make available to the public a report that lists all instances in which the Commissioner declined to apply the presumption under subsection (a) during the preceding 180-day period.

(d) REGULATIONS.—The Commissioner may prescribe regulations—

(1) to implement paragraphs (1) and (2) of subsection (b); or

(2) to amend any other regulations relating to withhold release orders in order to implement this section.

(e) EFFECTIVE DATE.—This section takes effect on the date that is 300 days after the date of the enactment of this Act.

SEC. 6. DIPLOMATIC STRATEGY TO ADDRESS FORCED LABOR IN THE XINJIANG UYGHUR AUTONOMOUS REGION.

(a) IN GENERAL.—Not later than 90 days after the date of the enactment of this Act, the Secretary of State, in coordination with the heads of other appropriate Federal agencies, shall submit to the appropriate congressional committees a report that includes a United States strategy to promote initiatives to enhance international awareness of and to address forced labor in the Xinjiang Uyghur Autonomous Region of the People's Republic of China.

(b) MATTERS TO BE INCLUDED.—The Secretary shall include in the report required by subsection (a) the following:

(1) A plan to enhance bilateral and multilateral coordination, including sustained engagement with the governments of countries that are partners and allies of the United States, to end the use of Uyghurs, Kazakhs, Kyrgyz, Tibetans, and members of other persecuted groups in the Xinjiang Uyghur Autonomous Region for forced labor.

(2) A description of public affairs, public diplomacy, and counter-messaging efforts to promote awareness of the human rights situation, including

with respect to forced labor, in the Xinjiang Uyghur Autonomous Region.

(3) A plan—

(A) to coordinate and collaborate with appropriate nongovernmental organizations and private sector entities to raise awareness about goods mined, produced, or manufactured wholly or in part with forced labor in the Xinjiang Uyghur Autonomous Region; and

(B) to provide humanitarian assistance, including with respect to resettlement and advocacy for imprisoned family members, to Uyghurs, Kazakhs, Kyrgyz, Tibetans, and members of other persecuted groups, including members of such groups formerly detained in mass internment camps in the Xinjiang Uyghur Autonomous Region.

(c) ADDITIONAL MATTERS TO BE INCLUDED.—The Secretary shall include in the report required by subsection (a), based on consultations with the Secretary of Commerce, the Secretary of Homeland Security, and the Secretary of the Treasury, the following:

(1) To the extent practicable, a list of—

(A) entities in the People's Republic of China or affiliates of such entities that use or benefit from forced labor in the Xinjiang Uyghur Autonomous Region; and

(B) foreign persons that act as agents of the entities or affiliates described in subparagraph (A) to import goods into the United States.

(2) A plan for working with private sector entities seeking to conduct supply chain due diligence to prevent the importation of goods mined, produced, or manufactured wholly or in part with forced labor into the United States.

(3) A description of actions taken by the United States Government to address forced labor in the Xinjiang Uyghur Autonomous Region under existing authorities, including—

(A) the Trafficking Victims Protection Act of 2000 (22 U.S.C. 7101 et seq.);

(B) the Elie Wiesel Genocide and Atrocities Prevention Act of 2018 (Public Law 115–441; 22 U.S.C. 2656 note); and

(C) the Global Magnitsky Human Rights Accountability Act (subtitle F of title XII of Public Law 114–328; 22 U.S.C. 2656 note).

(d) FORM.—The report required by subsection (a) shall be submitted in unclassified form, but may include a classified annex, if necessary.

SEC. 7. IMPOSITION OF SANCTIONS RELATING TO FORCED LABOR IN THE XINJIANG UYGHUR AUTONOMOUS REGION.

(a) IN GENERAL.—Section 6(a)(1) of the Uyghur Human Rights Policy Act of 2020 (Public Law 116–145; 22 U.S.C. 6901 note) is amended by adding at the end the following:

"(F) Serious human rights abuses in connection with forced labor.".

(b) EFFECTIVE DATE; APPLICABILITY.—The amendment made by subsection (a)—

(1) takes effect on the date of the enactment of this Act; and

(2) applies with respect to the first report required by section 6(a)(1) of the Uyghur Human Rights Policy Act of 2020 submitted after such date of enactment.

(c) TRANSITION RULE.—

(1) INTERIM REPORT.—Not later than 180 days after the date of the enactment of this Act, the President shall submit to the committees specified in section 6(a)(1) of the Uyghur Human Rights Policy

Act of 2020 a report that identifies each foreign person, including any official of the Government of the People's Republic of China, that the President determines is responsible for serious human rights abuses in connection with forced labor with respect to Uyghurs, Kazakhs, Kyrgyz, or members of other Muslim minority groups, or other persons in the Xinjiang Uyghur Autonomous Region.

(2) IMPOSITION OF SANCTIONS.—The President shall impose sanctions under subsection (c) of section 6 of the Uyghur Human Rights Policy Act of 2020 with respect to each foreign person identified in the report required by paragraph (1), subject to the provisions of subsections (d), (e), (f), and (g) of that section.

SEC. 8. SUNSET.

Sections 4, 5, and 6 shall cease to have effect on the earlier of—

(1) the date that is 8 years after the date of the enactment of this Act; or

(2) the date on which the President submits to the appropriate congressional committees a determination that the Government of the People's Republic of China has ended mass internment, forced labor, and any other gross violations of human

rights experienced by Uyghurs, Kazakhs, Kyrgyz, Tibetans, and members of other persecuted groups in the Xinjiang Uyghur Autonomous Region.

SEC. 9. DEFINITIONS.

In this Act:

(1) APPROPRIATE CONGRESSIONAL COMMITTEES.—The term "appropriate congressional committees" means—

(A) the Committee on Foreign Affairs, the Committee on Financial Services, the Committee on Ways and Means, and the Committee on Homeland Security of the House of Representatives; and

(B) the Committee on Foreign Relations, the Committee on Banking, Housing, and Urban Affairs, the Committee on Finance, and the Committee on Homeland Security and Governmental Affairs of the Senate.

(2) FORCED LABOR.—The term "forced labor"—

(A) has the meaning given that term in section 307 of the Tariff Act of 1930 (19 U.S.C. 1307); and

(B) includes convict labor and indentured labor under penal sanctions.

(3) FOREIGN PERSON.—The term "foreign person" means a person that is not a United States person.

(4) PERSON.—The term "person" means an individual or entity.

(5) UNITED STATES PERSON.—The term "United States person" means—

(A) a United States citizen or an alien lawfully admitted for permanent residence to the United States; or

(B) an entity organized under the laws of the United States or any jurisdiction within the United States, including a foreign branch of such an entity.

Passed the Senate July 14, 2021.

Attest:

Secretary.

117TH CONGRESS
1ST SESSION

S. 65

AN ACT

To ensure that goods made with forced labor in the Xinjiang Uyghur Autonomous Region of the People's Republic of China do not enter the United States market, and for other purposes.

Principles for Climate-Related Financial Risk Management for Large Banks

Introduction

The Office of the Comptroller of the Currency (OCC) has identified the effects of climate change and the transition to a low carbon economy as presenting emerging risks to banks[1] and the financial system.[2] Banks are likely to be affected by both the physical risks and transition risks associated with climate change (referred to in these draft principles as climate-related financial risks). Physical risks refer to the harm to people and property arising from acute, climate-related events, such as hurricanes, wildfires, floods, and heatwaves, and chronic shifts in climate, including higher average temperatures, changes in precipitation patterns, sea level rise, and ocean acidification. Transition risks refer to stresses to certain banks or sectors arising from the shifts in policy, consumer and business sentiment, or technologies associated with the changes necessary to limit climate change.

Weaknesses in how banks identify, measure, monitor, and control the potential physical and transition risks associated with a changing climate could adversely affect a bank's safety and soundness, as well as the overall financial system. Adverse effects could include potentially disproportionate impact on the financially vulnerable, including low- to moderate-income (LMI) and other disadvantaged households and communities.[3] Many banks are considering these risks and would benefit from additional guidance as they develop capabilities, deploy resources, and make necessary investments to address climate-related financial risks.

These draft principles provide a high-level framework for the safe and sound management of exposures to climate-related financial risks, consistent with the existing risk management framework described in existing OCC rules and guidance. The principles are intended to support efforts by banks to focus on key aspects of climate risk management. The principles will help bank management make progress toward answering key questions on exposures and incorporating climate-related financial risks into banks' risk management frameworks.

Although all banks, regardless of size, may have material exposures to climate-related financial risks, these draft principles are targeted at the largest banks, those with over $100 billion in total

[1] In this issuance, the term "bank" refers collectively to national banks, Federal savings associations, and Federal branches or agencies of foreign banking organizations.

[2] See e.g. Semiannual Risk Perspective at pp. 2-4 (Fall 2021), available at https://www.occ.treas.gov/publications-and-resources/publications/semiannual-risk-perspective/files/pub-semiannual-risk-perspective-fall-2021.pdf. For additional background, see generally *Report on Climate-Related Financial Risk*, Financial Stability Oversight Council (Oct. 21, 2021) (FSOC Climate Report).

[3] For further information, see Staff Reports, Federal Reserve Bank of New York, *Understanding the Linkages between Climate Change and Inequality in the United States*, No. 991 (November 2021), *available at* https://www.newyorkfed.org/research/staff_reports/sr991.html.

consolidated assets. The OCC is inviting public feedback on the principles for 60 days, until February 14, 2022. The OCC plans to elaborate on these principles in subsequent guidance that would distinguish roles and responsibilities of boards of directors (boards) and management, incorporate the feedback received on the principles, and consider lessons learned and best practices from the industry and other jurisdictions. In keeping with the OCC's risk-based approach to supervision, the OCC intends to appropriately tailor any resulting supervisory expectations to reflect differences in banks' circumstances such as complexity of operations and business models.

General Principles

Governance. An effective risk governance framework is essential to a bank's safe and sound operation. A bank's board and management should demonstrate an appropriate understanding of climate-related financial risk exposures and their impact on risk appetite to facilitate oversight. Sound governance includes reviewing information necessary to oversee the bank, allocating appropriate resources, assigning climate-related financial risk responsibilities throughout the organization (i.e., committees, reporting lines, and roles), and clearly communicating to staff regarding climate-related impacts to the bank's risk profile. Responsibility and accountability may be integrated within existing organizational structures or by establishing new structures for climate-related financial risks. Where dedicated units are established, the board and management should clearly define these units' responsibilities and interaction with existing governance structures.

The board should have adequate understanding and knowledge to assess the potential impact of climate-related risks on the bank and to address and oversee these risks within the bank's strategy and risk appetite, including an understanding of the potential ways in which these risks could evolve over various time horizons and scenarios. Relevant time horizons may include those that extend beyond the bank's typical strategic planning horizon. The board should actively oversee the bank's risk-taking activities and hold management accountable for adhering to the risk governance framework. Management is responsible for executing the bank's overall strategic plan. This responsibility includes effectively managing all risks, including climate-related financial risks, and their effects on the bank's financial condition. Management should also hold staff accountable for controlling risks within established lines of authority and responsibility. Additionally, management is responsible for regularly reporting to the board on the level and nature of risks to the bank, including climate-related financial risks.

Policies, Procedures, and Limits. Management should incorporate climate-related risks into policies, procedures, and limits to provide detailed guidance on the bank's approach to these risks in line with the strategy and risk appetite set by the board. Policies, procedures, and limits should be modified when necessary to reflect the distinctive characteristics of climate-related risks and changes to the bank's activities.

Strategic Planning. The board and management should consider material climate-related financial risk exposures when setting the bank's overall business strategy, risk appetite, and financial, capital, and operational plans. As part of forward-looking strategic planning, the board and management should address the potential impact of climate-related financial risk exposures on the bank's financial condition, operations (including geographic locations), and business objectives over various time horizons. The board and management should also consider climate-related financial risk impacts on stakeholders' expectations, the bank's reputation, and LMI and other disadvantaged households and communities, including physical harm or access to bank products and services. The OCC recognizes that the incorporation of material climate-related financial risks into various planning processes is iterative as measurement methodologies, models, and data for analyzing these risks continue to evolve and mature over time.

Any climate-related strategies, including any relevant corporate social responsibility objectives, should align with and support the bank's broader strategy, risk appetite, and risk management framework. In addition, where banks engage in public communication of their climate-related strategies, boards and management should ensure that any public statements about their banks' climate-related strategies and commitments are consistent with their internal strategies and risk appetite statements.

Risk Management. Climate-related financial risks typically impact banks through a range of traditional risk types. Management should oversee the development and implementation of processes to identify, measure, monitor, and control climate-related financial risk exposures within the bank's existing risk management framework. A bank should employ a comprehensive process to identify emerging and material risks stemming from the bank's business activities and associated exposures. The risk identification process should include input from stakeholders across the organization with relevant expertise (e.g., business units, independent risk management, and legal). Risk identification includes assessment of climate-related financial risks across a range of plausible scenarios and under various time horizons.

As part of sound risk management, banks should develop processes to measure and monitor material climate-related financial risks and to inform management about the materiality of those risks. Material climate-related financial risk exposures should be clearly defined, aligned with the bank's risk appetite, and supported by appropriate metrics (e.g., risk limits and key risk indicators) and escalation processes. Boards and management should also incorporate climate-related risks into their internal control frameworks, including internal audit.

Tools and approaches for measuring and monitoring exposure to climate-related risks include, among others, exposure analysis, heat maps, climate risk dashboards, and scenario analysis. These tools can be leveraged to assess a bank's exposure to both physical and transition risks in both the shorter and longer term. Outputs should inform the risk identification process and the short- and long-term financial risks to a bank's business model from climate change.

Data, Risk Measurement, and Reporting. Sound climate risk management depends on the availability of relevant, accurate, and timely data. Management should incorporate climate-related financial risk information into the bank's internal reporting, monitoring, and escalation processes to facilitate timely and sound decision-making across the bank. Effective risk data aggregation and reporting capabilities allow management to capture and report material and emerging climate-related financial risk exposures, segmented or stratified by physical and transition risks, based upon the complexity and types of exposures. Data, risk measurement, modeling methodologies, and reporting continue to evolve at a rapid pace; management should monitor these developments and incorporate them into their climate risk management as warranted.

Scenario Analysis. Climate-related scenario analysis is emerging as an important approach for identifying, measuring, and managing climate-related risks. For the purposes of this guidance, climate-related scenario analysis refers to exercises used to conduct a forward-looking assessment of the potential impact on a bank of changes in the economy, financial system, or the distribution of physical hazards resulting from climate-related risks. These exercises differ from traditional stress testing exercises that typically assess the potential impacts of transitory shocks to near-term economic and financial conditions. An effective climate-related scenario analysis framework provides a comprehensive and forward-looking perspective that banks can apply alongside existing risk management practices to evaluate the resiliency of a bank's strategy and risk management to the structural changes arising from climate-related risks.

Management should develop and implement climate-related scenario analysis frameworks in a manner commensurate to the bank's size, complexity, business activity, and risk profile. These frameworks should include clearly defined objectives that reflect the bank's overall climate risk management strategies. These objectives could include, for example, exploring the impacts of climate-related risks on the bank's strategy and business model, identifying and measuring vulnerability to relevant climate-related risk factors including physical and transition risks, and estimating climate-related exposures and potential losses across a range of plausible scenarios. In the near term, a climate-related scenario analysis framework can also assist the bank in identifying data and methodological limitations and uncertainty in climate risk management and informing the adequacy of its climate risk management framework.

Climate-related scenario analyses should be subject to oversight, validation, and quality control standards that would be commensurate to their risk. Climate-related scenario analysis results should be clearly and regularly communicated to all relevant individuals within the bank, including an appropriate level of information necessary to effectively convey the assumptions, limitations, and uncertainty of results.

Management of Risk Areas

A risk assessment process is part of a sound risk governance framework, and it allows boards and management to identify emerging risks and to develop and implement appropriate strategies to mitigate those risks. Boards and management should consider and incorporate climate-related financial risks when identifying and mitigating all types of risk. These risk assessment principles describe how climate-related financial risks can be addressed in various risk categories. The OCC will elaborate on these risk assessment principles in subsequent guidance.

Credit Risk. The board and management should consider climate-related financial risks as part of the underwriting and ongoing monitoring of portfolios. Effective credit risk management practices could include monitoring climate-related credit risks through sectoral, geographic, and single-name concentration analyses, including credit risk concentrations stemming from physical and transition risks. As part of concentration risk analysis, management should assess potential changes in correlations across exposures or asset classes. The board and management should determine credit risk appetite and lending limits related to these risks.

Liquidity Risk. Consistent with sound oversight and liquidity risk management, the board and management should assess whether climate-related financial risks could affect liquidity buffers and, if so, incorporate those risks into their liquidity risk management and liquidity buffers.

Other Financial Risk. Management should monitor interest rate risk and other model inputs for greater volatility or less predictability due to climate-related financial risks. Where appropriate, management should include corresponding measures of conservatism in their risk measurements and controls. The board and management should monitor how climate-related financial risks affect the bank's exposure to risk related to changing prices. While market participants are still researching how to measure climate price risk, the board and management should use the best measurement methodologies reasonably available to them and refine them over time.

Operational Risk. The board and management should consider how climate-related financial risk exposures may adversely impact a bank's operations, control environment, and operational resilience. Sound operational risk management includes incorporating an assessment across all business lines and operations, including third-party operations, and considering climate-related impacts on business continuity and the evolving legal and regulatory landscape.

Legal/Compliance Risk. The board and management should consider how climate-related financial risks and risk mitigation measures affect the legal and regulatory landscape in which the bank operates. This consideration includes possible changes to legal requirements for, or underwriting considerations related to, flood or disaster-related insurance. It also includes possible fair lending concerns if the bank's risk mitigation measures disproportionately affect communities or households on a prohibited basis such as race or ethnicity.

Other Nonfinancial Risk. Consistent with sound oversight, the board and management should monitor how the execution of strategic decisions and the operating environment affect the bank's financial condition and operational resilience as discussed in the strategic planning section. The board and management should also consider the extent to which the bank's activities may increase the risk of negative financial impact from reputational damage, liability, or litigation, and implement adequate measures to account for these risks where material.

Request for Feedback

The OCC welcomes feedback on all aspects of these draft principles, including on the following questions. Among other uses, the OCC would consider responses in connection with developing any future guidance on climate-related financial risks. Refer to OCC Bulletin 2021-62 for instructions on submitting feedback.

Applicability

1. Are there additional categories of banks (i.e., based on asset size, location, business model) to which these principles should apply?

Tailoring

2. How could future guidance assist a bank in developing its climate-related financial risk management practices commensurate to its size, complexity, risk profile, and scope of operations?

General

3. What challenges do banks face in incorporating these principles into their risk management systems? How should the OCC further engage with banks to understand those challenges?

Current Risk Management Practices

4. What specific tools or strategies have banks used to successfully incorporate climate-related financial risks into their risk management frameworks?

5. How do banks determine when climate-related financial risks are material and warrant greater than routine attention by the board and management?

6. What time horizon do banks consider relevant when identifying and assessing the materiality of climate-related financial risks?

7. What, if any, specific products, practices, and strategies–for example, insurance or derivatives contracts or other capital market instruments–do banks use to hedge, transfer, or mitigate climate-related financial risks?

8. What, if any, climate-related financial products or services–for example, "green bonds," derivatives, dedicated investment funds, or other instruments that take climate-related considerations into account–do banks offer to clients and customers?[4] What risks, if any, do these products or services pose?

9. How do banks currently consider the impacts of climate-related financial risk mitigation strategies and financial products on households and communities, specifically LMI and other disadvantaged communities?

Data, Disclosures, and Reporting

10. What, if any, specific climate-related data, metrics, tools, and models from borrowers and other counterparties do banks need to identify, measure, monitor, and control their own climate-related financial risks? How do banks currently obtain this information? What gaps and other concerns are there with respect to these data, metrics, tools, or models?

11. How could existing regulatory reporting requirements be augmented to better capture banks' exposure to climate-related financial risks?

[4] "Green bonds" refer to fixed-income securities, the proceeds of which are earmarked for environmentally beneficial investment.

Scenario Analysis

12. Scenario analysis is an important component of climate risk management that requires assumptions about plausible future states of the world. How do banks use climate scenario models, analysis, or tools and what challenges do they face?

13. What factors are most salient for the OCC to consider when designing and executing scenario analysis exercises?

FEDS Notes

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Climate Change and Financial Stability

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Financial regulators, international organizations, market participants and others have directed significant attention in recent years towards developing an understanding of the implications of climate change for the financial sector and financial stability.[1] Climate change-related financial risks pose both micro- and macroprudential concerns, but analysis and research is at an early stage.[2] This Note describes an approach to understanding how risks arising from climate change may affect financial stability, and connects this discussion to the financial stability monitoring framework described in the Federal Reserve's Financial Stability Reports.[3] That framework distinguishes between shocks to the financial system and economy, which are difficult to predict, and vulnerabilities, which are underlying features of an economic or financial system that can amplify the negative effects of shocks. We describe how climate-related risks may emerge both as shocks and as vulnerabilities that could amplify the effects of climate-change related shocks or other shocks.[4]

This analysis offers a way to assess the financial stability impact of risks resulting from climate change as information on the nature, extent, and timing of those risks improves. Our approach to describing climate-related financial stability risks is complementary to, though both simpler and broader than, the existing international typology described in Carney (2015).

We offer three main conclusions. First, the Federal Reserve's financial stability monitoring framework is flexible enough to broadly incorporate many key elements of climate-related risks. Second, although we believe that climate change increases financial stability risks, more research and analysis is needed to incorporate these risks fully into financial stability monitoring, including substantial improvements in data and models. Third, domestic and international transparency efforts around climate-related financial exposures may help clarify the nature and scope of financial stability risks related to climate change.

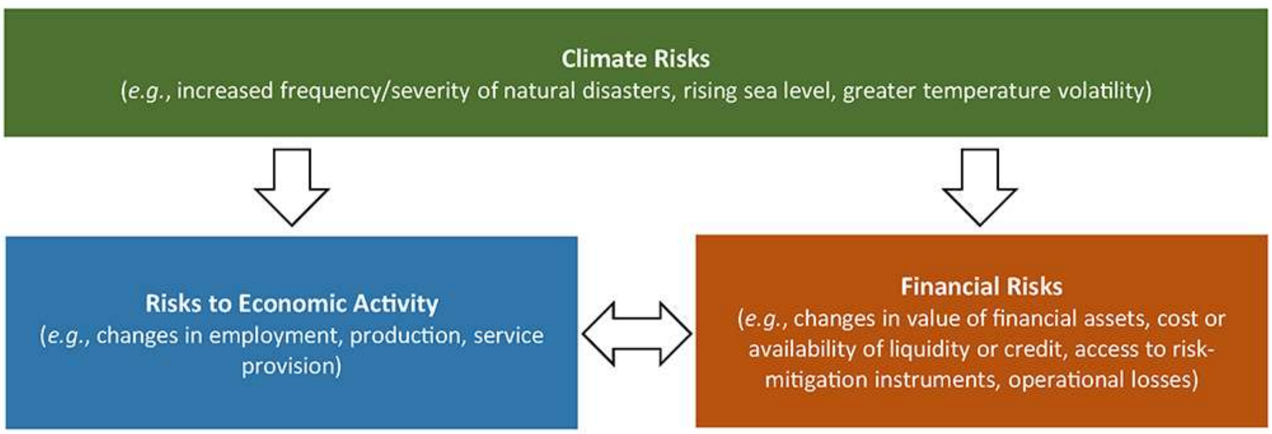
From Climate Change to Financial Risks

At a broad level, *climate change* refers to changes in the usual conditions of nature of the Earth's oceans, fresh water, and atmosphere.[5] These changes include, for example, increases in average global temperatures, the frequency and severity of major storms, and the level or acidity of oceans, among many other effects. There is a strong scientific consensus that the global climate has already changed substantially over the past century and that future changes should be expected as human-caused emissions of greenhouse gases continue. Greenhouse gases in the Earth's atmosphere, such as carbon dioxide and methane, block solar radiation reflected from the Earth's surface, thereby raising global temperatures. The higher the concentration of these gases, the greater their effect on climate.

Despite the scientific consensus on trends in and causes of climate change, the exact timing and precise magnitudes of future climate outcomes remain uncertain.[6] We refer to this range of possible future physical outcomes arising from climate change as *climate risks*. Researchers continue to further develop and refine climate and econometric models that forecast the path of climate change, but much uncertainty remains.

Projections of economic activity and the accompanying greenhouse gas emissions have long been an input into climate models that estimate these climate risks.[7] However, since the early work of Nordhaus in the 1970s, a growing body of research also treats economic activity as an output of these models, recognizing the effect that the climate has on economic and financial outcomes.[8] These effects occur through a climate damage function, which reflects deteriorating public health, labor productivity, and agricultural yields, failing public infrastructure, rising mortality rates, and weather-related property destruction among other impacts.[9] Such adverse effects can result in direct *financial risks*, prompting a reassessment of asset values, changing the cost or availability of credit, or affecting the timing or reliability of cash flows. They can also create *risks to economic activity*, which can themselves create or amplify financial risks. Economic and financial risks can also amplify one another—for example, weather-related property destruction can lead to bank losses, leading to less lending, leading to reduced investment, and so on. (See Fig. 1.)

Figure 1. Stylized Relationships between Climate, Economic, and Financial Risks



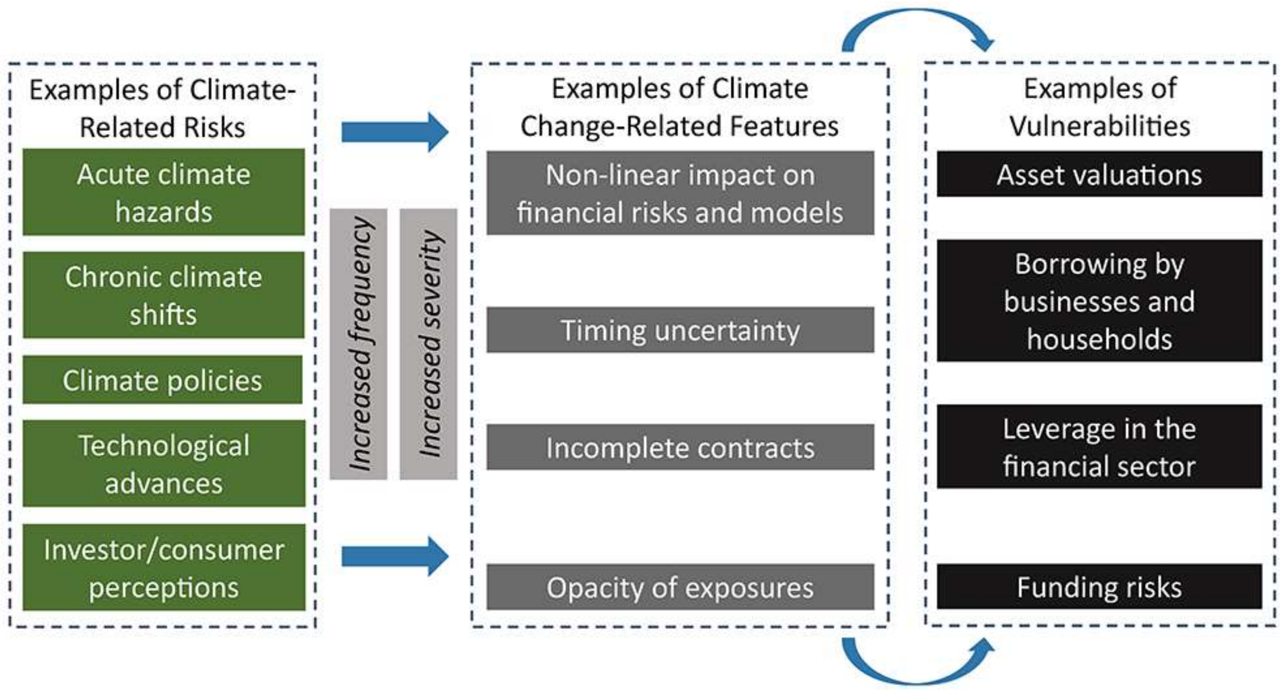
Accessible version

Climate Risks and Financial Stability

By themselves, climate-related economic or financial risks need not affect financial stability; the economy can experience a decline in output, and investors can experience losses, without these effects being amplified by the financial system. Under some conditions, however, these risks could increase financial-system vulnerabilities through losses to levered financial intermediaries, disruption in financial market functioning, or sudden repricing of large classes of assets.

This cascade of consequences fits within the Federal Reserve's financial stability monitoring framework in two ways (*see* Fig. 2). First, climate risks can manifest as shocks to the financial system.[10] Acute hazards, such as storms, floods, or wildfires, can quickly change or reveal new information about future economic conditions or the value of real or financial assets.[11] With the potential for sudden large shifts in perceptions of risk, chronic hazards (like a slow increase in mean temperatures, or rising sea levels) could produce abrupt repricing events, if investor expectations or sentiment about the physical risks change abruptly. While these examples focus on physical risks, shocks to the financial system may emerge from a broader set of climate risks. These additional risks include the emergence of climate-related liability risks or future changes in climate policies. Like all financial shocks, it is difficult to predict how and when these broader set of climate risks may be realized as financial shocks.

Figure 2. Possible Transmission from Climate-Related Risks to Financial System Vulnerabilities



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Second, climate risks can also increase financial system *vulnerabilities* that could transmit and amplify shocks. The examples below illustrate features of climate change that increase the probability of asset mispricing and higher nonfinancial and financial leverage, which interconnectedness and reduced diversification could amplify:

- **Opacity of exposures:** Investors currently have limited information on the range of climate-related exposures among financial and non-financial companies.[12] Information like the geographic location of collateral or the geospatial distribution of supply chains are generally neither disclosed nor tracked in standardized ways. Accounting standards for climate-related risks are in development, and model disclosure frameworks from the international community have not seen widespread adoption.[13,14] Weak institutional knowledge of how climate change could affect exposures can mask underlying risks. This relative opacity could also lead to broad repricing after a shock resulting from direct exposures and through fire sales or contagion. Thus, a lack of transparency around climate-related risks can increase vulnerabilities related to asset valuations, financial and non-financial leverage, and contagion risk.
- **Mispricing:** Some studies suggest that even well-informed investors may underestimate the likelihood of large shocks related to climate, particularly physical risks.[15] Such pervasive underestimation could lead to excessive levels of effective leverage, and combined with the uncertain timing of climate change itself, could create asset price bubbles.
- **Correlated aggregate exposures:** An important feature of the predicted path of climate change is the possibility of non-linearities or tipping points in climate conditions.[16] Changes in climate such as risk of fire, floods, and sea level rise can happen rapidly, and historical data may be of limited use to forecast future climate scenarios. This feature implies that climate-related economic and financial models would have unavoidable limitations over longer time horizons, so that risks may be systematically correlated across participants in the economy and financial system. In particular, the potential for correlated shocks could reduce the accuracy of models that estimate risks at levered financial intermediaries.

Illustrative Examples of Climate Risk Transmission

Table 1 shows some illustrative examples of links between climate risks and financial stability risks. The risks described below may appear as combinations of vulnerabilities and shocks.

Real estate: Under many climate projections, climate change leads to a further rise in sea levels and increase in storm surge.[17] These effects, in turn, lead to increased inundation of coastal land parcels, which could either damage existing structures on those parcels, or require investment and adaptation for their continued productive use.[18] As this inundation occurs, the expected value of coastal real estate may decrease—which may, in turn, pose risks to real estate loans, mortgage-backed securities, the profitability of firms using the inundated property, and the finances of state and local governments facing declining property tax revenues and rising remediation costs.

With perfect information and no externalities, the price of real estate-linked assets might already reflect these climate-related risks. However, given the uncertainty of climate and financial models and the potential opacity of climate-related exposures – a financial system vulnerability – investors in such real estate-linked assets may react abruptly to new information about a region's exposure to climate-related risks.[19] A sharp repricing shock, in turn, could create risks to financial stability through losses to leveraged financial intermediaries.[20]

Table 1: Illustrative Examples of Transmission Channel Framework

	Climate Risks	Economic Risks	Financial Risks	Financial Stability Risks
Real Estate	Rising sea levels, frequency of storm surges	Increased inundation of coastal parcels	Decreased value of coastal real estate	Abrupt repricing of mortgage lending markets
Insurance	More frequent and severe hurricanes, wildfires, etc.	Greater disruption to local economic activity	Pressure for higher rates, lower supply of insurance and reinsurance	Greater uninsured losses, spillover effects

Insurance markets: Under many scenarios, climate change also increases the frequency and severity of natural disasters such as wildfires and major storms.[21] These disasters, in turn, could damage physical assets and create growing disruptions to local economic activity, raising the cost of insuring highly exposed properties and businesses. As a result, the price of that coverage would rise, and insurers' willingness to offer policies on some properties would fall. The risk of business defaults following natural disasters could increase as firms tend towards lower levels of insurance coverage. This pullback in insurance coverage could be a financial system vulnerability with a variety of second-order effects, many of which are beginning to be visible in the property and casualty insurance markets of some states.[22]

If states cap rate increases at levels insurers believe are too low, insurers may threaten to withdraw from those states entirely, leading those insurance markets to break down. If businesses are unable to secure coverage for critical functions, they could potentially cease certain services, with implications for the broader local economy. Similarly, households may be unable to obtain insurance on properties at reasonable cost, which could result in household migration to other locations.

With less private insurance and the potential for broader negative impacts on local economies, state and local governments could face pressure to provide coverage or absorb losses for areas affected by natural disasters. Coupled with a potential reduction in the tax base from emigration, governments could face increasing fiscal pressures and become less able to service their debt. This reduced ability to service debt could result in a higher probability of municipal bond defaults and knock-on consequences for municipal debt markets broadly.[23]

Uncertainty also presents the possibility that insurance and reinsurance models will underestimate risk, another potential financial system vulnerability. As many insurers use standardized catastrophe models to help price risks, there is the potential for correlated losses if these models fail to reflect new patterns of weather and disasters. This could lead to a sudden repricing of many insurance products, leading to externalities for businesses and households that need to purchase coverage.

Challenges to Understanding Climate-Related Risks

In principle, quantifying climate-related risks should be similar to quantifying other financial stability risks. In practice, however, climate-related risks face several challenges to measurement beyond those associated with conventional financial system vulnerabilities and potential shocks, and which will require investment to address. These climate-related features impair not only estimation and modeling at the level of the overall economy, but also the analysis of region-, sector-, asset-, institution-, and investor-level exposures. Investment in data procurement, and careful analysis of climate-related data to describe specific economic and financial risks, is critical to addressing these challenges and producing high-quality research on climate-related outcomes.

A fundamental challenge relates to merging and cleaning climate-related data for use in economic models.[24] Availability of sufficiently granular spatiotemporal and climate-related financial data is limited, including information on exposure to physical hazards or the emission levels of activities associated with particular investments or financial institutions. Investors or researchers hoping to assess the financial impacts of climate-related risks must often use proxies involving spatiotemporal weather data. Weather data collection is uneven across countries, making comparable assessments of climate-related risks from one data set alone difficult. Because these data sources are often partial, multiple data sources are often necessary to examine a specific climate-related financial risk.

Models that seek to link climate directly to economic output involve a separate set of challenges. Climate models typically simulate the interaction of a wide range of variables over many decades. In addition, the effects of climate change on economic activity may involve heterogeneous local or regional effects. These factors introduce uncertainty into even short- and medium-term projections, making aggregate climate models an imprecise source of information for near-term economic estimates and risk assessment.[25, 26]

Other modelling challenges include estimation of the effects of efforts to mitigate the physical effects of climate change. Mitigation efforts to reduce physical risks may have a long delay between implementation and the full effects; governments incur mitigation costs up front, but realize the benefits from mitigation gradually over time. Different economies, geographies, and sectors are also likely to face distinct risks from climate change, each taking actions that affect one another. Climate models can be insufficiently granular to support conclusions about these jurisdiction-specific impacts and their interactions, and historical weather data may not accurately reflect economic impacts under a new climate regime.

A final set of challenges are essentially logistical. Although the public sector generates a range of weather and climate data, much of that data resides across agencies and jurisdictions, leaving researchers to clean, process, and merge the data separately and independently. Once a data set is complete, analysis may be especially computationally intensive, requiring expertise and resources beyond the reach of many smaller research institutions. Several private firms have launched services to fill this gap, focusing on geographic exposures to more severe weather events, but generally remain available only to those who purchase them.

These challenges impede understanding of the linkages among climate, economic, financial, and financial stability risks described above (see also Fig. 1 and Fig. 2). They also have consequences for financial markets, as investors and institutions seek to incorporate climate change into pricing, investment, and risk management decisions.

Conclusion

This Note describes examples of financial stability risks arising from climate change, and how these risks can emerge as either shocks or vulnerabilities in the Federal Reserve's financial stability monitoring framework used in the Federal Reserve's Financial Stability Reports. Research to better understand the financial and financial stability risks of climate change continues to grow rapidly. More specifically, deeper analysis of the specific channels by which climate-related risks create hidden vulnerabilities in the financial sector will be an especially important topic for exploration. Continued research investments in this area will require a broad range of research and modelling approaches and tools and new sources of data. We believe these investments over time will increase policymakers' ability to monitor the relationship between climate change and financial stability.

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1. Among public organizations, this includes efforts by the Financial Stability Board, Basel Committee on Banking Supervision, International Association of Insurance Supervisors, International Organization of Securities Commissioners, United Nations Environment Programme, Network for Greening the Financial System, and Commodity Futures Trading Commission, as well as central banks, including recently the Federal Reserve Board (see Board of Governors (2020)). In addition, there has been substantial private sector, nongovernmental organization (NGO), think tank, Congressional, media, and research attention. Return to text

2. See, e.g., Rudebusch (2019) and (2021). Return to text

3. See Board of Governors (2020) and Adrian, Covitz, and Liang (2015). Return to text

4. A related box on the financial stability implications of climate change appears in the Federal Reserve Board's November 2020 Financial Stability Report. Return to text

5. Material in this section is adapted from Hsiang and Kopp (2018). Return to text

6. See, e.g., Intergovernmental Panel on Climate Change (2015a,b); Anderegg et al. (2010). Return to text

7. See also Hsiang et al. (2017) on the role of economic projections as a main source of uncertainty in climate models. Return to text

8. See, e.g., Nordhaus (1977), (1991), and (1992). Return to text

9. See, e.g., U.S. Global Change Research Program (2017), chapters 10, 11, 12 (PDF), and 14 (PDF). Return to text

10. See Adrian et al. (2015). Return to text

11. See, e.g., Rhodium Group (2019) and (2020). Return to text

12. See Adrian et al. (2015), pp. 388-89 (relating vulnerabilities and systemic risk to "data collections" and "accounting standards"). Return to text

13. The Big Four U.S. accounting firms and the World Economic Forum recently released a reporting framework for environmental, social and governance (ESG) standards; see Tett (2020). Return to text

14. See, e.g., FSB Task Force on Climate-Related Financial Disclosures (2020), p. 8 ("Disclosure [of climate-related financial information] increased, on average, across the 11 recommended disclosures by six percentage points between 2017 and 2019. However, companies' disclosure of the potential financial impact of climate change on their businesses, strategies, and financial planning is low"). In September 2020, the International Financial Reporting Standards (IFRS) Trustees published a consultation paper on sustainability reporting to determine whether there is a need for global sustainability standards, whether the IFRS Foundation should play a role, and what the scope of that role could be; comments were due by December 31, 2020. Return to text

15. Hong et al. (2019) find long-run stock market inefficiency with respect to pricing of drought severity. Return to text

16. See Cai and Lontzek (2019), who note that the integrated assessment models (IAM) literature has recently studied the importance of climate tipping points, which refer to 'a critical threshold at which a tiny perturbation can qualitatively alter the state or development of [the climate] system,' and tipping elements, which are 'large-scale components of the Earth system that may pass a tipping point' (definitions from Lenton et al. 2008, p. 1786). A key feature of a tipping element is that current temperature affects the likelihood of a tipping event that results in a transition to an irreversible "tipping process." Examples of tipping processes include the melting of the Greenland or West Antarctic ice sheets. See also IPCC 2018, section 3.5. Return to text

17. See, e.g., Sweet et al. (2017); Amante (2019). Return to text

18. See, e.g., Rodziewicz et al. (2020). Return to text

19. See, e.g., Alok et al. (2020). Return to text

20. See, e.g., Ouazad and Kahn (2019). Return to text

21. See Intergovernmental Panel on Climate Change (2015a) ("A changing climate leads to changes in the frequency, intensity, spatial extent, duration, and timing of weather and climate extremes, and can result in unprecedented extremes"). Return to text

22. See, e.g., Flavelle (August 2019) and Sheehan (2020). Return to text

23. See, e.g., Norton (2019). Return to text

24. Where not otherwise cited in this section, see Auffhammer et al. (2013); Auffhammer (2018); Network for Greening the Financial System (2019). Return to text

25. For a summary of estimates of the effects of climate change on economic growth, see, e.g., Network for Greening the Financial System (2019) and Hsiang et al. (2017). For estimates of social cost of carbon emissions, see, e.g., Nordhaus (2017), van den Bergh and Botzen (2014), and Moore and Diaz (2015). Return to text

26. For an overview of the current limitations of climate models for use in financial risk assessments performed at spatial and temporal scales smaller than continental or multi-decadal, see, e.g., Fiedler et al. (2021). Return to text

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Balancing Buyer and Supplier Responsibilities

Model Contract Clauses to Protect Workers in International Supply Chains, Version 2.0

*By the Working Group to Draft Model Contract Clauses to Protect Human Rights in International Supply Chains, ABA Business Law Section**

*David V. Snyder, Chair,*** Susan A. Maslow, Vice Chair,*** and Principled Purchasing Project led by Sarah Dadush*†

INTRODUCTION

This project was born of challenge, frustration, and hope. There is little doubt that workers in international supply chains are being abused, in the most

* This report is the product of the Working Group and reflects its rough (and sometimes hotly debated) consensus. While produced under the auspices of the Uniform Commercial Code Committee of the American Bar Association Business Law Section, the report has not been approved or endorsed by the Committee, the Section, or the Association. Accordingly, the report should not be construed to be the action of either the American Bar Association or the Business Law Section. Nothing contained herein, including the clauses to be considered for adoption, is intended, nor should it be considered, as the rendering of legal advice for specific cases or particular situations, and readers are responsible for obtaining such advice from their own legal counsel. This report and the clauses and other materials herein are intended for educational and informational purposes only. The lawyer who advises on the use of these clauses must take responsibility for the legal advice offered.

** David Snyder as chair and Susan Maslow as vice chair served as principal drafters of this report, particularly the introductory text and Version 1.0 of the MCCs, which served as the groundwork for this Version 2.0. Much of the drafting of the new contract clauses in Version 2.0 was undertaken *pro bono publico* by a team at Linklaters LLP, although the ultimate drafting was done (and ultimate drafting decisions made) by Snyder and Maslow with the support or at least acquiescence of the Working Group. David Snyder is Professor of Law and Director of the Business Law Program at American University, Washington College of Law, in Washington, D.C., and would like to acknowledge grant funding from the law school as well as travel funding from the American Bar Association. During the final stages of this project he served as a Fernand Braudel Senior Fellow at the European University Institute (Florence), whose grant support is gratefully acknowledged. He would also like to thank Katherine Borchert, Philip Killeen, Sophie Lin, and Alexandra Finocchio for excellent research assistance. Susan Maslow is a semi-retired partner at Antheil Maslow & MacMinn, LLP, in Bucks County, Pennsylvania. She is also chair of the Corporate Social Responsibility Subcommittee to Implement the ABA Model Principles on Labor Trafficking and Child Labor. Special thanks are due to Aditi Bagchi, Omri Ben-Shahar, Robert Hillman, Jonathan Lipson, Trang Nguyen, Kish Parella, and Salli Swartz.

† Sarah Dadush, Professor of Law at Rutgers Law School, led the Principled Purchasing Project to move the MCCs toward a more balanced allocation of responsibility for the human rights performance of supply contracts between buyers and suppliers. Specifically, the Project team produced MCCs that articulate the buyer's obligations to behave responsibly in relation to its supplier in order to better protect workers' human rights; the Project team also produced the Responsible Purchasing Code of Conduct, referred to as Schedule Q throughout the MCCs. The team is made up of Olivia Windham-Stewart, John F. Sherman III, and a team of lawyers acting *pro bono publico* from Linklaters LLP, and the Project benefited from a generous grant by the Laudes Foundation.

horrifying ways, even as they work to produce the staples of our everyday lives and indeed support much of our economy. Young children and enslaved people pick and process cocoa and coffee beans; they pick and process cotton; they sew clothes, weld steel, and assemble sporting goods; they mine rare minerals and extract valuable sources of energy. Many workers find themselves in injurious and even deadly working conditions, with people hurt and killed by the hundreds.[1] Supply chains can be riddled with modern forms of slavery, particularly debt-bonded labor.[2] Much has been invested in ameliorating these conditions but not enough. They continue,[3] and they are now sharpened and heightened by the enveloping crisis of the COVID-19 pandemic.

One of the crucial tools for addressing these problems is the contractual governance of supply chains. The Model Contract Clauses (MCCs) offered here seek to help companies implement healthy corporate policies in their supply chains in a way that is both legally effective and operationally likely. In general, the MCCs do not state the human rights performance standards themselves. The MCCs do not state what the working conditions must be like, how many fire exits are necessary, or what measures must safeguard against conflict minerals. The MCCs are designed for use across sectors, so the substantive standards will vary (clothing brands need no standards on conflict minerals, and electronics makers are not concerned with cotton sourcing). The human rights standards that the supplier must follow are assumed to be stated in what is here called Schedule P (P for Policy), and the standards that the buyer must follow are assumed to be stated

1. *See, e.g.*, Steve Henn, *Factory Audits and Safety Don't Always Go Hand in Hand*, NPR (May 1, 2013), http://www.npr.org/2013/05/01/180103898/foreignfactory-audits-profitable-but-flawed-business; Matt Stiles, *Documents: Wal-Mart Auditors Inspect Bangladesh Factory, Find Safety Flaws*, NPR (Apr. 30, 2013), http://www.npr.org/2013/04/30/180123158/documents-wal-mart-auditors-inspectbangladeshi-factory-find-safety-flaws.

2. The International Labour Organisation estimates that around 50 percent of victims of forced labor in the private economy are affected by debt bondage—around eight million people worldwide. *See Global Estimates of Modern Slavery: Forced Labour and Forced Marriage*, ILO (2017), https://www.ilo.org/wcmsp5/groups/public/@dgreports/@dcomm/documents/publication/wcms_575479.pdf; https://antislavery.org/slavery-today/bonded-labour.

3. *See, e.g.*, Annie Kelly, *Nestlé Admits Slavery in Thailand While Fighting Child Labour Lawsuit in Ivory Coast*, Guardian (Feb. 1, 2016), https://www.theguardian.com/sustainable-business/2016/feb/01/nestle-slavery-thailand-fighting-child-labour-lawsuit-ivory-coast (presenting Nestlé's instances of forced labor within its supply chains); Daniela Penha, *Slave Labor Found at Starbucks-Certified Brazil Coffee Plantation*, Mongabay (Sept. 18, 2018), https://news.mongabay.com/2018/09/slave-labor-found-at-starbucks-certified-brazil-coffee-plantation/ (finding slave labor in a Starbucks coffee bean supplier); Michael Sainato, *Accidents at Amazon: Workers Left to Suffer After Warehouse Injuries*, Guardian (July 18, 2018), https://www.theguardian.com/technology/2018/jul/30/accidents-at-amazon-workers-left-to-suffer-after-warehouse-injuries (revealing numerous instances of workplace injuries in Amazon's factories); Martje Theuws & Pauline Overeem, *Flawed Fabrics: The Abuse of Girls and Women Workers in the South Indian Textile Industry*, SOMO Ctr. Res. Multinational Corps. 17–30 (2014), http://www.indianet.nl/pdf/FlawedFabrics.pdf (reporting on women's labor conditions in five spinning mills: Best Cotton Mills, Jeyavishnu Spintex, Premier Mills, Sulochana Cotton Spinning Mills, and Super Spinning Mills); Pauline Overeem & Martje Theuws, *Case Closed, Problems Persist: Grievance Mechanisms of ETI and SAI Fail to Benefit Young Women and Girls in the South Indian Textile Industry,* SOMO Ctr Res. Multinational Corps. 21–23 (2018), http://www.indianet.nl/pdf/CaseClosedProblemsPersist.pdf (finding the grievance mechanisms for spinning mills did not provide remedy to affected workers and did not meet the requirements of the United Nations Guiding Principles).

in Schedule Q. Both Schedules P and Q are likely to take the form of codes of conduct, one for the supplier and one for the buyer. They are outside the scope of the MCCs themselves. This practice is typical. A purchase agreement consists largely, if not entirely, of legal obligations; the specifications for the goods themselves are often contained in separate schedules or in other documents. Although the Working Group cannot offer a model Schedule P because of the wide variation across industries, we do provide the building blocks for Schedule P for buyers that are starting to consider or are revising their expectations of their contracting partners. Because it is less industry-specific, a standard Schedule Q is offered, enumerating and explaining the responsible purchasing practices that buyers may be expected to follow.

The Model Contract Clauses offered below (MCCs 2.0) are designed as an improvement on and an alternative to those published three years ago (MCCs 1.0).[4] MCCs 1.0 were intended to harness supply contracts as one critical tool—among many—to put human rights policies into operation while managing company risk. Although many corporations have admirable human rights policies, mere policies can languish if they are not integrated into the operational and legal life of the company and particularly into the company's supply chains. MCCs 1.0 were drafted to give counsel a model to follow in operationalizing their companies' human rights policies, easing the task for overburdened corporate counsel, and giving the benefit of extensive research conducted by the Working Group.

MCCs 1.0 met with considerable interest and enthusiasm, and the Working Group received extensive feedback that was often supportive, sometimes critical, and sometimes both. The great interest in the project also led to the informal augmentation of the Working Group with many voices from outside the Business Law Section, which is the official location of the Working Group (under the auspices of the Uniform Commercial Code [U.C.C.] Committee). With that feedback, the Working Group embarked on a new version of the MCCs. Version 1.0 envisioned a business model where buyers were confronted with troublesome suppliers who would violate the human rights of workers; the buyers would need to manage this problem through contractual control of their suppliers, and the MCCs could help them do so. Additional research reveals, however, that human rights violations at the supplier level are often rooted in the buyers' own purchasing practices, particularly by timing demands, pricing pressures, and last-minute order modifications, as well as a lack of due diligence—turning a blind eye—to human rights issues. MCCs 2.0 accordingly assign contractual responsibility for human rights in the supply chain to the buyers as well as the suppliers. In these revised clauses, buyers commit to responsible purchasing practices while suppliers commit to responsible and ethical management of their

4. David V. Snyder & Susan A. Maslow, *Human Rights Protections in International Supply Chains—Protecting Workers and Managing Company Risk: 2018 Report and Model Contract Clauses from the Working Group to Draft Human Rights Protections in International Supply Contracts*, 73 Bus. Law. 1093 (2018) [hereinafter MCCs 1.0].

workforce and their subsuppliers. Crucially, both buyers and suppliers are required to engage in "human rights due diligence." These responsibilities are enforceable, although the legal remedies are not facile. MCCs 2.0 now include extensive provisions on human rights remediation as well as more standard contract remedies.

To many lawyers, the addition of buyer responsibilities is the most significant change from MCCs 1.0, but the shift from a regime of representations and warranties in MCCs 1.0 to a regime of human rights due diligence in MCCs 2.0 is at least as important. Several strong forces motivated this move. In any case, large multinational enterprises (MNEs) will likely find themselves subject to mandatory human rights due diligence. Human rights due diligence is already mandatory for companies meeting certain criteria under French law,[5] and regulatory efforts in a similar direction are well underway in European Union law.[6] Small and medium enterprises (SMEs) will benefit from a more realistic regime of due diligence rather than the strict liability of representations and warranties that, as a practical matter, will often be untrue and therefore routinely breached. In other words, MCCs 2.0 move from a demand that the supplier make a number of representations and warranties that both parties will perhaps know to be false, or doubtful, to a contractual expectation that all parties in the supply chain, from the buyer itself to its top-tier suppliers to the lowest level subcontractors, will all be duly diligent about human rights impacts. In some ways, due diligence is familiar as it is a constant in corporate practice. Still, many lawyers will find it new in two ways. Obviously, it is a move away from more

5. French Corporate Duty of Vigilance Law, Loi 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre [Law 2017-399 of March 27, 2017 relating to the duty of care of parent companies and sponsoring undertakings], JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE [J.O.] [Official Gazette of France], Mar. 28, 2017, https://www.legifrance.gouv.fr/eli/jo/2017/3/28; *see also* Wet zorgplicht kinderarbeid [Dutch Child Labor Due Diligence Act], Wet van 24 oktober 2019, Stb., 2019, https://zoek.officielebekendmakingen.nl/stb-2019-401.html. While this piece was being prepared for the press, two new relevant acts were passed, one in Germany and another in Norway: Act on Corporate Due Diligence in Supply Chains, Federal Ministry of Labour and Social Affairs (Aug. 18, 2021), https://www.bmas.de/SharedDocs/Downloads/DE/Internationales/act-corporate-due-diligence-obligations-supply-chains.pdf;jsessionid=A74A78EA8F08BAFCFE51BB8CDB1741AD.delivery1-replication?__blob=publicationFile&v=3 (providing an English translation of the German Act); Norwegian Transparency Act of 2021, https://stortinget.no/globalassets/pdf/lovvedtak/2020-2021/vedtak-202021-176.pdf (last accessed Nov. 20, 2021).

6. The announcement was made in April 2020 by EU Commissioner for Justice Didier Reynders that the European Commission will introduce legislation on mandatory human rights due diligence as part of the European Green Deal and the COVID-19 recovery package. *See generally* Eur. Parl. Comm. on Legal Affairs, *Draft Report with Recommendations to the Commission on Corporate Due Diligence and Corporate Accountability* (2020/2129(INL)) (Sept. 11, 2020); Eur. Parl. Subcomm. on Human Rights, *Briefings on Human Rights Due Diligence Legislation—Options for the EU* (PE 603.495) (June 2020). For an update on EU developments, see Jonathan Drimmer et al., *Pre-Draft of the EU Mandatory Corporate Due Diligence and Corporate Accountability Initiative: 10 Questions Businesses Need to Know*, PAUL HASTINGS (Oct. 5, 2020), https://www.paulhastings.com/publications-items/details/?id=da731c70-2334-6428-811c-ff00004cbded. On March 10, 2021, the EU Parliament adopted the Draft Directive on Corporate Due Diligence and Corporate Accountability [hereinafter Draft Directive]. The Draft Directive was previously expected to be finalized and to come into force in 2021 but has encountered several legislative delays. If finalized, all Member States will have twenty-four months to adopt laws, regulations, and administrative provisions necessary to comply with the directive.

traditional contract drafting that centers on standard "reps and warranties." More fundamentally, human rights due diligence is not simply about assessment of corporate risk and assuring legal compliance but instead requires a consideration of stakeholders' (including workers') interests that are not identical to those of the contracting parties.

More broadly, MCCs 2.0 seek to align much more closely with the 2011 UN Guiding Principles on Business and Human Rights (UNGPs)[7] and with the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises as well as the OECD Due Diligence Guidance for Responsible Business Conduct.[8] The UNGPs and OECD Guidelines and Guidance have enjoyed wide uptake by many businesses already, and the ABA itself has officially endorsed the UNGPs, as have numerous other bar organizations.[9] Aside from human rights due diligence, the UNGPs and the Guidelines drove several significant changes in MCCs 2.0. Human rights remediation is generally prioritized over typical contract remedies (like money damages), and issues like pricing, changes of circumstances (such as COVID-19), timing, and modifications are addressed expressly. In addition, the Working Group discovered that while many companies already have committed to respect human rights in their corporate codes of conduct, many are looking for help in doing so in their supply chains. Accordingly, we are offering guidance with respect to what buyers may require of their suppliers in the form of "Building Blocks for Schedule P" as well as guidance in the form of a Schedule Q that states the buyer's responsibilities. Schedule Q fills a gap in the supply chain governance arena because most codes of conduct apply to suppliers, not buyers. As there are few, if any, examples of buyer codes, Schedule Q is specific and detailed.

Some of these changes are path-breaking but necessary. As detailed below, the legislative move to mandatory human rights due diligence has already started. France led the way, with other countries considering similar legislation, and the European Union has announced that it will be moving in this direction. Large MNEs may already be subject to such rules because of their business in France or the Netherlands, and others may soon find themselves in a like

7. *See* Special Representative of the Secretary-General on the Issue of Human Rights and Transnational Corporations and Other Business Enterprises, Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework, Human Rights Council, annex, U.N. Doc. A/HRC/RES/17/31 (Mar. 21, 2011) (accessible at https://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf) [hereinafter UNGPs].

8. *See* OECD Guidelines for Multinational Enterprises (2011), http://www.oecd.org/daf/inv/mne/48004323.pdf; OECD Due Diligence Guidance for Responsible Business Conduct (2018), http://mneguidelines.oecd.org/OECD-Due-Diligence-Guidance-for-Responsible-Business-Conduct.pdf.

9. The ABA House of Delegates endorsed the UNGPs in 2011 and has since been followed by the International Bar Association, the Law Society for England and Wales, the Japan Federation of Bar Associations, and the European Bars Federation [Fédération des Barreaux d'Europe (FBE)]. For a concise history of the background, content, and uptake of the UNGPs, see John F. Sherman III, *Beyond CSR: The Story of the UN Guiding Principles on Business and Human Rights*, *in* Corporate Social Responsibility—Sustainable Business: Environmental, Social and Governance Frameworks for the 21st Century ch. 20, § 20.04 (Rae Lindsay and Roger Martella eds., 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3561206.

position. That said, many companies find themselves very differently situated, and this project has always been intended for a broad range of companies, including SMEs. Further, different companies are in different places with respect to the commitments they want to make and the responsibilities they can undertake. For these reasons, the MCCs 2.0 *retain a fully modular approach so that companies can choose the commitments that best reflect their positions, their goals, and their sector of activity*. This is not a certification document; it is not a prix fixe menu. Companies are fully free to order their contractual provisions à la carte, choosing the clauses and the commitments that are right for them.

Version 1.0, the Chief Issues Addressed, and the Resolutions Retained in Version 2.0

This project was originally conceived as an effort in legal problem-solving, careful drafting, and research in order to move corporate commitments from mere policy statements to the legal and operational side of companies. It was instigated by a previous ABA project: after much effort and negotiation, the ABA adopted model principles against labor trafficking and child labor.[10] The Business Law Section had achieved some success in convincing companies to adopt these principles, but there was considerable concern that they were ineffective as mere policy statements. The Working Group was formed to operationalize them, in corporate parlance. The Working Group saw its mission as making corporate human rights policies legally effective and operationally likely. These twin goals remain our mantra.

The main challenge at the initial stage of the work was to solve the mismatch between commercial law rules and human rights law and standards. The problem is that goods made in unacceptable conditions might fully conform to product specifications. As we said then, "The background law does not deal easily with the problem of soccer balls that are perfectly stitched but that were sewn by child slaves."[11] The problem manifests itself primarily with respect to conformity and remedies, and MCCs 1.0 took on the task of resolving those issues. The first version of the MCCs was geared to solve a commercial law problem and to assure that the clauses would be likely to work with typical purchasing documents. They were designed as a helpful resource for companies' counsel.

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10. There are both ABA Model Business and Supplier Principles on Labor Trafficking and Child Labor (ABA Model Principles) and ABA Model Business and Supplier Policies on Labor Trafficking and Child Labor (Model Policies). The ABA Model Principles are the high-level articulation of the detailed material in the Model Policies. The ABA Model Principles also form Part II of the Model Policies. Only the ABA Model Principles were adopted by the ABA House of Delegates, so only the ABA Model Principles represent the official position of the American Bar Association. For a detailed discussion, see E. Christopher Johnson Jr., *Business Lawyers Are in a Unique Position to Help Their Clients Identify Supply-Chain Risks Involving Labor Trafficking and Child Labor*, 70 Bus. Law. 1083 (2015). For more information on the Model Principles Task Force, see ABA Model Business and Supplier Policies on Labor Trafficking and Child Labor, http://www.americanbar.org/groups/business_law/initiatives_awards/child_labor.html (last accessed Nov. 20, 2021).

11. MCCs 1.0, *supra* note 4, at 1095. *See generally* Douglas A. Kysar, *Preferences for Processes: The Process/Product Distinction and the Regulation of Consumer Choice*, 118 Harv. L. Rev. 526 (2004).

The chief issues were making supplier obligations flow through the entire supply chain; allowing for traditional contract remedies along with human rights remediation even if suppliers' defaults did not lead to defective goods (e.g., perfect shirts that were made in extremely dangerous conditions); conceiving of mitigation as something other than resale at market prices (because the goods may be "perfect" but nevertheless tainted by their reprehensible provenance); allowing a full range of remedies in a less-than-promising international transaction; and structuring the relationship through the use of disclaimers to limit the liability of buyers. MCCs 1.0 offered solutions to these issues, and for the most part they remain in MCCs 2.0, although no solution is ideal. They were (and are) as follows.

- All responsibilities flow through the entire supply chain under broad definitions of subcontractors, employees, and representatives, and duties are imposed on all of them. See MCCs 2.0 ¶ 1.2.
- In MCCs 1.0, goods are nonconforming and the buyer has a right of rejection and cancellation or avoidance if the supplier has violated Schedule P. See MCCs 1.0 ¶ 2. This right remains in MCCs 2.0 unless the buyer failed to engage in responsible purchasing practices. See MCCs 2.0 ¶ 3. If the buyer did contribute to the problem, the situation is more complex. See MCCs 2.0 ¶¶ 2.3(e), 6.2(f), 6.5(b).
- Mitigation is reconceived (as is "acceptance" under U.C.C. § 2-606) in recognition of the possibility that reselling tainted goods might actually increase damages (e.g., through reputational harm and other consequential damage). Alternative mitigation could include donating the tainted goods to charity, for instance, unless other action is required by law, as when the U.S. trafficking statutes are implicated. See MCCs 2.0 ¶ 6.4.
- Remedies are still specified in detail, taking into account the particular problems of tainted but otherwise conforming goods, reputational harm, informational issues, and so on. See MCCs 2.0 ¶ 6. Nevertheless, MCCs 2.0 make clear that neither party should profit from breaches of ethical practice. See MCCs 2.0 ¶ 6.3(a). Further, remedies in MCCs 2.0 must be understood in conjunction with the commitment to human rights remediation of the problem (see ¶ 2) rather than termination of the relationship. This shift is discussed further below.
- Although some who have worked on the project have pushed hard to remove them, the disclaimers have been retained in modified form. Compare MCCs 1.0 ¶ 5.7, with MCCs 2.0 ¶ 7.

The treatment of disclaimers deserves further consideration. The problem is that a variety of legal doctrines may perversely discourage buyers from taking affirmative steps to identify and address human rights abuses in their supply chains. Typically, buyers have no enforceable duties to workers who are legally separated from the buyers, and in most international supply chains, the workers are legally remote from the ultimate buyers (although buyers are prohibited under U.S. law from importing goods made with forced labor). If the buyer takes affirmative steps, however, it may become liable to workers for failing to use reasonable care in an undertaking that it willingly undertook. Further, some types of control by buyers over suppliers may sacrifice the suppliers' independent contractor status, which can be so important in shielding buyers from liability.[12] For these reasons, the disclaimers in MCCs 1.0 sought to maintain the legal independence of the suppliers, even though the buyer was imposing duties on its suppliers to keep the supply chain clean. For example, while a buyer might monitor its suppliers, MCCs 1.0 provide that the buyer assumes no *duty* to do so.[13]

Some buyers, of course, may have noncontractual legal duties to monitor, to disclose information, and so on; for instance, buyers who are federal contractors and therefore bound by the Federal Acquisition Regulation must "monitor, detect, and terminate the contract with a subcontractor or agent engaging in prohibited activities."[14] And all buyers may have a duty to disclose the discovery of forced labor in their supply chains under some circumstances.[15] Further, buyers who commit to abide by the UNGPs or other norms may be under their own corporate duty to do just that, which will involve considerable involvement in keeping their supply chains clean.[16] Such buyers will monitor their suppliers on an ongoing basis to determine whether they are in compliance with Schedule P, and they must map their supply chains to determine whether their products are produced with human rights abuse at more remote links in the chain, below those suppliers with whom they have a direct contractual relationship. Such monitoring and mapping are fundamental to human rights due diligence under the UNGPs. None of this, however, means that contractual disclaimers are inappropriate. That buyers may have a regulatory or statutory duty, enforceable by the government, or their own corporate commitments to the UNGPs or other norms, does not mean that buyers will also want to incur

12. Consider the case law reviewed in Ramona Lampley, *Mitigating Risk, Eradicating Slavery*, 68 Am. U. L. Rev. 1707 (2019); David V. Snyder, *The New Social Contracts in International Supply Chains*, 68 Am. U. L. Rev. 1869, 1902–03 (2019). Note the "trenchant observation of Judge Johnston that current tort doctrine encourages Western buyers to divorce themselves from the supply chain as much as possible and to 'ignore[] workplace safety' as a means to 'escape liability.'" Rahaman v. J.C. Penney Corp., No. N15C-07-174 MMJ, 2016 WL 2616375, at *9 n.68 (Del. Super. Ct. May 4, 2016). The complaint was originally filed in the United States District Court for the District of Columbia, naming Bangladesh as a defendant (No. 15-CV-00619-KBJ (D.D.C. filed Apr. 23, 2015)).

13. MCCs 1.0, *supra* note 4, ¶ 5.7.a.

14. FAR, 48 C.F.R. §§ 52.222-56, 22.1703(c)(1)(ii)(A) (2021).

15. *See, e.g.*, 18 U.S.C. § 541 (2018); 19 C.F.R. § 12.42(b) (2021). Foreign laws may also impose similar legal duties on U.S. companies doing business in or with their countries. *See supra* note 5.

16. *See generally* John Gerard Ruggie & John F. Sherman III, *Adding Human Rights Punch to the New Lex Mercatoria: The Impact of the UN Guiding Principles on Business and Human Rights on Commercial Legal Practice,* 6 J. Int'l Dispute Settlement 455 (2015), https://scholar.harvard.edu/files/john-ruggie/files/adding_human_rights_punch_to_the_new_lex_mercatoria.pdf.

parallel contractual (or tort) liability, enforceable by their contracting counterparties or other private plaintiffs, except as stated explicitly in the contract.

Buyer reluctance to take on additional liability to private plaintiffs should come as no surprise; millions of dollars are spent in litigation over implied private rights of action. The disclaimers simply say that the buyer takes on no contractual duties beyond those explicitly stated; the buyer may or may not owe duties for some other reason, but the disclaimer expressly rejects private contractual enforcement of such duties. The disclaimers thus do important work in protecting buyers who choose to become more involved in managing their supply chains rather than burying their heads in the sand. In short, they help companies manage their risk while they comply with their duties, being clear that some companies may wish to limit who can sue under the contract for alleged breaches of those duties. And to be clear, as just noted, the buyer in MCCs 2.0 does take on some explicitly stated contractual duties, as discussed in the next section. The disclaimers as drafted in MCCs 1.0 are flat, but in Version 2.0 the disclaimers are necessarily qualified: it would not be true to say that the buyer is taking on no obligation to monitor its supply chain, for instance. The buyer is taking on that and other responsibilities as part of its human rights due diligence in Article 1. Thus, the disclaimers remain in MCCs 2.0, but with exceptions for the obligations that the buyer takes on elsewhere in the agreement.[17]

The Move to Buyers Sharing Responsibility with Suppliers

A number of reasons have motivated the addition of buyer responsibilities, but two are compelling: protection for workers cannot happen successfully without buyer responsibility, and many buyers are now or will soon be legally required to take on this responsibility. These twin reasons are all the stronger because they are intertwined.

Buyers' purchasing practices can play a key role both in protecting and in harming workers. Version 1.0 of the MCCs was conceived on the notion that problems in the supply chain are caused by irresponsible suppliers, not by the ultimate buyer. This is in tension with the UNGPs, the research that supports them, and more recent research in conjunction with the drafting of MCCs 2.0.[18] In short, if the MCCs are to be successful, buyers need to follow responsible purchasing practices.

17. MCCs 2.0 ¶ 7.1(a)–(b) ("Buyer does not assume a duty under this Agreement . . . except as stated in Article 1 and 2".).

18. Sarah Dadush, *Contracting for Human Rights: Looking to Version 2.0 of the ABA Model Contract Clauses*, 68 Am. U. L. Rev. 1519, 1537–40 (2019) (citing Vijay Padmanabhan et al., The Hidden Price of Low Cost: Subcontracting in Bangladesh's Garment Industry (2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2659202); John F. Sherman III, *The Contractual Balance Between 'Can I?' and 'Should I?' Mapping the ABA's Model Supply Chain Contract Clauses to the UN Guiding Principles on Business and Human Rights*, Harv. Kennedy Sch. Working Paper No. 73 (Apr. 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3574811.

Extensive research has shed light on the realities of international supply chain contracting and the role of buyers' purchasing practices. The leaders of the Principled Purchasing Project, which is part of the Working Group, put together an extraordinary set of consultations during the summer of 2020. It is not necessarily the kind of rigorous empirical research from which findings may be generalized, but we did hear from many people in many sectors. Consultations were held with representatives of large Western buyers (including three companies that are certainly household names), with a third party that is often involved in remediation, with nongovernmental organizations and others from civil society, with investors committed to ESG values,[19] with representatives of multilateral international organizations, with standard setters and auditors, with union and labor advocates, with industry associations, and with suppliers from several countries in East and South Asia.[20] After these consultations and other research, the Working Group has no doubt that buyer demands, typically related to production times, price requirements, or change orders, can often cause or contribute to human rights violations. It has become clear that improving buyers' purchasing practices is central to protecting workers from human rights abuses. To be effective, the MCCs must provide mechanisms for buyers to share responsibility with suppliers.

To the business-minded lawyer, effectiveness must always be the ultimate goal, but any lawyer's mind is trained to home in on legal risks; developing legal requirements on human rights due diligence and increased legal enforcement of existing regulations heighten the need for buyers to focus on their responsibility. It is still true that policing supply chains carries risks,[21] and candid lawyers must acknowledge as much to their clients.[22] But the countervailing risks have been heavy for some time, and they are becoming even weightier now. When MCCs 1.0 were published, companies were already concerned with a variety of compliance obligations, particularly around federal trafficking, forced labor, and child labor statutes, as well as disclosure obligations under some state and foreign laws.[23] Many of these may have seemed like paper obligations, and companies seldom if ever felt the brunt of any enforcement. That

19. That is, environmental, social, and governance values.

20. The consultations were held under Chatham House rules, so identifying information cannot be disclosed here. In all, over fifty people were consulted, representing roughly forty to fifty organizations.

21. *See supra* note 12 and accompanying text.

22. *See* Model Rules Prof'l Conduct 2.1 (2021) (duty to provide candid advice to clients).

23. MCCs 1.0, *supra* note 4, at 1095 (citing Trafficking Victims Protection Act of 2000, 22 U.S.C. §§ 7101–7114 (2018); 18 U.S.C. §§ 1589–1592 (2018) (criminal sanctions for forced labor, trafficking, and peonage); Trafficking Victims Protection Reauthorization Act of 2013 (TVPRA) (Title XII of the Violence Against Women Reauthorization Act of 2013, Pub. L. No. 113-04, 127 Stat. 54); Trade Facilitation and Trade Enforcement Act of 2015 (TFTEA), Pub. L. No. 114-125, 130 Stat. 122 (2016); Cal. Civ. Code Ann. § 1714.43 (2021); Federal Acquisition Regulation, 48 C.F.R. §§ 52.222–50 to 52.223-7 (2021); UK Modern Slavery Act 2015, c. 30; French Corporate Duty of Vigilance Law, *supra* note 5; Directive 2014/95/EU, of the European Parliament and of the Council of 22 October 2014 Amending Directive 2013/34/EU as Regards Disclosure of Non-Financial and Diversity Information by Certain Large Undertakings and Groups, 2014 O.J. (L 330) 1); *see also* Australian Modern Slavery Act 2018 (Cth) No. 153 part 2; Dutch Child Labor Due Diligence Act, *supra* note 5.

has changed, and U.S. Customs and Border Protection has now seized numerous cargoes under withhold release orders issued pursuant to antitrafficking laws.[24] Corporate boards and officers can no longer afford attractive but ineffective corporate policies. Few current risk assessments will be able to justify turning a blind eye to the problems.

And if U.S. Customs enforcement were not enough to spur action, new legislation has also begun to require companies to be responsible for their supply chains, and not just concerning child labor, forced labor, and conflict minerals, but also with respect to working conditions and workers' health and safety. For many years, admittedly, companies had few seriously enforced legal incentives to clean their supply chains. That landscape changed when France passed its duty of vigilance law in 2017 and the Netherlands passed a similar Child Labor Diligence Act in 2019.[25] The EU is now showing every sign of following suit.[26] These changes are discussed in the next section, but the point for now is that both operational effectiveness and legal obligation, in practice and on paper, require buyers to take responsibility for their supply chains. MCCs 2.0 help them to do that.

The Move from Representations and Warranties to Human Rights Due Diligence

The same two reasons—operational effectiveness and enforced legal requirements—that compel the addition of buyer responsibilities within MCCs 2.0 also require the move from representations and warranties to human rights due diligence. For many MNEs there is not much of a risk calculus on this score; simply put, human rights due diligence is currently required by French law and Dutch law and will likely be required very soon by EU law.[27] Even for MNEs that are not subject to French and Dutch law and that will not be subject to EU law, and for SMEs in similar circumstances, the move still makes sense. The regime of representations and warranties, with their accompanying strict liability—if they are not true, there is breach—is unrealistic and ineffective, and often so much so as to be downright fictitious. Frequently, this regime is thought to lead to what is called a "tickbox" or "checkbox" approach to supply chain management in which buyers require a laundry list of representations of compliance from their suppliers. Suppliers mechanistically provide them by checking the boxes, and everyone

24. *See, e.g.*, Press Release, U.S. Customs & Border Protection, CBP Issues Detention Order on Palm Oil Produced with Forced Labor in Malaysia (Sept. 30, 2020), https://www.cbp.gov/newsroom/national-media-release/cbp-issues-detention-order-palm-oil-produced-forced-labor-malaysia. After a long period when enforcement was rare, U.S. CBP has issued roughly eighteen "withhold release orders" (WROs) in the last twelve months (as of Oct. 11, 2020). Some link this surge in enforcement to multimillion dollar settlements by buyers. *See* Andy Hall, *Statement on Top Glove's Estimated US$40m Reimbursement of Migrant Worker Recruitment Related Fees and Costs*, Facebook (Oct. 5, 2020), https://m.facebook.com/story.php?story_fbid=10157620591885677&id=675065676.

25. *See supra* note 5.

26. *See supra* note 6.

27. *See supra* notes 5–6 and accompanying text. Although it is narrower because it is limited to child labor, the Dutch statute of 2019 similarly imposes a due diligence regime. *See supra* note 5.

goes home happy (although they may be more than a little resentful of time wasted filling forms). Little is achieved.[28]

The move from representation-and-warranty to due diligence is eminently practical, then, and should be reassuring to the parties. The participants in the supply chain are no longer being asked, unrealistically and fictitiously, to literally guarantee perfect compliance with the human rights and safety standards in Schedule P and the principled purchasing practices in Schedule Q. Instead, they are being required to be duly diligent, on an ongoing basis, about achieving those goals. This is not mere aspiration; the parties are contractually obligated to use reasonable means to achieve the goal. But there is no longer strict liability for failure of perfect compliance. And there is no longer the knowledge, certain to both parties, that the human rights obligations of the contract are breached the moment it is signed.

Although warranty rather than due diligence is the usual style of contract drafting in common law countries, diligence obligations are no stranger to the common law. Notions of good faith efforts or best efforts are standard in many contracts for sales of goods,[29] and due diligence accords well with the *obligation de moyens*, which is sometimes even called an *obligation de diligence*, in the civil law.[30] To some, the switch may seem surprising; after all, if human rights are so crucial, should the parties not be expected to be strictly liable rather than merely to use appropriate efforts? Yet, given the size and complexity of many supply chains, the varying capabilities of different companies, from the largest MNEs to the most modest SMEs, due diligence is the better regime. These inescapable facts are recognized in the UNGPs. Under Guiding Principle 24, businesses are entitled to prioritize and focus their attention on the most severe human rights harms or on harms that would become irremediable in the event of a delayed response. Not everything can be made perfect, ever, much less all at once. Perfection is not and cannot be the standard. Priorities are necessary, as is reflected in MCCs 2.0, particularly sections 2.3(c) and 2.5.

Human rights due diligence is a prospective, retrospective, and ongoing risk management process that enables businesses to respect human rights by identifying, preventing, mitigating, and accounting for how they address the impacts of their activities on human rights.[31] To be effective, it requires understanding

28. D. A. Baden et al., *The Effect of Buyer Pressure on Suppliers in SMEs to Demonstrate CSR Practices: An Added Incentive or Counter Productive?*, 27 Eur. Mgmt. J. 429, 435 (2009); *see also* James Harrison, *Establishing a Meaningful Human Rights Due Diligence Process for Corporations: Learning from Experience of Human Rights Impact Assessment*, 2 Impact Assessment & Project Appraisal 107, 111, 115 (2013), https://www.tandfonline.com/doi/full/10.1080/146155 (explaining that due diligence "could degenerate into a 'tick-box' exercise designed for public relations purposes rather than a serious integral part of corporate decision-making"); *see also* Ruggie & Sherman, *supra* note 16, at 460.

29. *See, e.g.*, U.C.C. § 2-306 (2011).

30. For basic explanations of the *obligation de moyens* or *de diligence* and its relation to other kinds of obligations with stricter liability, such as the *obligation de résultat* or the *obligation déterminée*, see Martin Davies & David V. Snyder, International Transactions in Goods: Global Sales in Comparative Context 437–41 (2014).

31. See the UNGPs, *supra* note 7, especially Principles 11, 17–22, 29, and 31.

the perspective of potentially affected individuals or "stakeholders," and engagement with stakeholders pervades each stage of the process. It is understood within the context of the UNGPs and the subsequent OECD Guidelines and Guidance.[32] The OECD Due Diligence Guidance provides enterprises with the flexibility to adapt due diligence to their circumstances, recognizing that the nature and extent of diligence will be affected by the size of the enterprise, the context of its operations, and other factors. Specific guidance for SMEs seeking to implement effective human rights due diligence processes can also be found in the Guidance.[33] In addition, the OECD has produced sector-specific due diligence guidance for the minerals, extractives, agriculture, garment and footwear, and financial sectors, as well as guidance that applies across sectors. Like the Guiding Principles, a key aspect of the OECD Due Diligence Guidance is to carry out and improve the diligence process on an ongoing basis. Although the language is not well suited for contract clauses, the following list provides a good, though not exhaustive, understanding of the concept. Human rights due diligence includes:

(i) embedding responsible business conduct into the culture of the company through leadership, incentives, policies, and management systems;

(ii) identifying and assessing actual and potential adverse human rights impacts, throughout the supply chain, that the contract-related activities may cause or contribute to, or that may be directly linked to the operations, products, or services contemplated by the contract;

(iii) ceasing, preventing, and mitigating such adverse impacts;

(iv) tracking and monitoring, in consultation and collaboration with internal and external stakeholders, the success of mitigation or prevention;

(v) communicating how adverse impacts are addressed, mitigated, or avoided; and

(vi) providing for or cooperating in remediation where appropriate.[34]

As can be appreciated from this list, while due diligence is familiar to corporations and their counsel, human rights due diligence is not coterminous with the kind of due diligence undertaken for a merger or a public offering. Human rights due diligence goes beyond technical legal compliance and includes the need to look at risks through the perspective of the stakeholder, as learned through engagement with the stakeholder; the prioritization of responsive action by severity of impact on the stakeholder; the need to search on an ongoing basis for human rights risks throughout the entire supply chain, and not just the first few tiers; the

32. OECD Due Diligence Guidance, *supra* note 8.
33. *See* OECD Due Diligence Guidance, *supra* note 8, at 9, 18, Annex Questions 6, 7, and Table 4.
34. See the introduction to Section II of the OECD Due Diligence Guidance, *supra* note 8.

development of leverage to influence contractual parties to refrain from, mitigate, or remediate harm to human rights; and the need to go beyond the limits of local law. In other words, human rights due diligence is a necessary part of ongoing supply chain management; it is proactive, forward and backward looking, responsive to actual or potential impacts, and requires meaningful and regular engagement with stakeholders. Under the present law, to some degree, and under the law as it is developing, those impacts are part of the inescapable responsibility of the contracting parties, and that is why they are the focus of the first obligation stated in MCCs 2.0.

Express Treatment of Human Rights Remediation

Human rights remediation receives extensive treatment in MCCs 2.0. In contrast, MCCs 1.0 provide for termination on breach but assume the parties would not actually move to termination except in the rarest and most egregious circumstances. Instead, the parties would work to remediate the problem by taking measures to stop and correct the harm and to address any grievances. Termination, generally speaking, is in no one's interest. The buyer does not want to suffer the disruption and incur the delay or switching costs to transfer its business to new suppliers. The supplier certainly does not want to lose business. And except in the most extreme circumstances, the workers do not want to lose their jobs and their livelihood, such as it is. MCCs 1.0 give the buyer a termination right, which would increase the buyer's leverage, as contemplated by the UNGPs and OECD Guidelines,[35] in order to require human rights remediation by the supplier. In this way MCCs 1.0 are similar to many loan documents that allow a lender to call a loan upon default, accelerating all amounts due and requiring immediate payment, even though in most circumstances everyone expects the loan to be sent to "workouts" where efforts can be made to salvage the loan. Of course, not all loan documentation works this way, and similarly, MCCs 1.0 provide an alternative for notice and cure if the parties want to provide contractually for human rights remediation.[36]

Because everyone should contemplate remediation in almost all circumstances, MCCs 2.0 flip the position of MCCs 1.0 and provide for remediation expressly and extensively.[37] In addition, remediation is not solely the responsibility of

35. *See* UNGPs, *supra* note 7, Commentary to Principle 19; OECD Guidelines, *supra* note 8, § II, art. 3.2.

36. *See* MCCs 1.0, *supra* note 4, ¶¶ 2.3 (cancellation and avoidance), 2.5 (no right to cure), at 1099–1100 & n.30 (suggesting in a footnote an alternative clause for notice and cure to allow remediation).

37. MCCs 2.0 ¶ 2 (remediation); *see also id.* ¶ 2.4 (right to cure). It is an interesting question of contract design to decide whether a contractual termination right, like that in ¶ 2.3 of MCCs 1.0, *supra* note 4, should be included in transactions that do not contemplate its use but instead contemplate remediation (or in commercial practice, a workout). A termination right that will seldom be used might be conceived as a supracompensatory remedy that in a competitive market will be undesirable. *See generally* Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 Yale L.J. 369 (1990). For that reason, the switch to the scheme in MCCs 2.0 is perhaps desirable. The relevant market may not be competitive, however, and for that

the supplier; the buyer must participate if it has caused or contributed to the problem.[38] These provisions are not only in keeping with the shared responsibility of buyers and suppliers but also seem especially appropriate in cases where the buyer has caused or contributed to the harm. On the other hand, and perhaps just as obviously, cases may arise where the conduct is so egregious that immediate termination is required, with no opportunity for remediation, and MCCs 2.0 provide expressly for this as well.[39] These cases involve what are often called zero-tolerance activities.

Force Majeure, Responsible Exit, COVID-19, and Other Disruptions

The radical disruptions of COVID have caused new problems in supply chains and exacerbated old ones. MCCs 2.0 address these problems with two innovative provisions.[40] MCCs 2.0 acknowledge that the intervention of an event like COVID, or a particularly vicious monsoon, or political unrest, or countless other events, could upset the supply chain in a way that the goods could only be produced in violation of the commitments in Schedule P. Often these violations occur because of unauthorized subcontracting. In the case of COVID, lack of personal protective equipment could make production unsafe. These events may or may not constitute a force majeure, and the outcomes of judicial decisions on this issue are notoriously unpredictable under the U.C.C. and international sales law.[41] Judicial resolution of disputes in international supply chains is often impractical anyway. For these reasons, the clauses themselves provide guidance.

Notably, they apply to any "reasonably unforeseeable, industry-wide or geographically specific, material change" regardless of whether the change constitutes a force majeure. A supplier may exit the relationship without default if staying in the relationship would force it to breach Schedule P. When it comes to buyers wanting to exit the relationship, for whatever reason, including a force majeure event or something similar, the clauses impose on the buyer a duty to "consider the potential adverse human rights impacts and employ commercially reasonable efforts to avoid or mitigate them," regardless of the reason for exit. In light of claims that many buyers abandoned their suppliers when the COVID-19 lockdowns set in without compensating them—even for completely manufactured goods, and, in some cases, even for goods that had already been

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reason a buyer with bargaining power may prefer the termination right. The greater buyer leverage might arguably increase the chance of forcing remediation as well, but this will depend on the particular facts of the market and the parties' place in it, and even if so, overweening buyer power to terminate may undermine valuable cooperation and be counterproductive for that reason. These issues arise from holdup problems in supply chain contracting generally, and the Working Group fully admits that it has not solved those problems (and further believes that whoever does solve those problems will probably get a Nobel Prize in economics to show for it).

38. MCCs 2.0 ¶ 2.3(e).

39. *Id.* ¶ 2.4.

40. MCCs 2.0 ¶¶ 1.3(e)–1.3(f).

41. *See* U.C.C. §§ 2-613, 2-615 (2011); CISG art. 79. *See generally* Davies & Snyder, *supra* note 30, at 326–27.

shipped[42]—MCCs 2.0 add that "[t]ermination of this Agreement shall be without prejudice to any rights or obligations accrued prior to the date of termination, including, without limitation, payment that is due for goods."

These clauses hardly solve all the problems of force majeure, COVID, and similar events. Nothing can. But they bring human rights into the equation and may help the parties reach resolutions that take into account a broad view of the interests involved.

The Addition of Dispute Resolution in MCCs 2.0

Because the MCCs are drafted as an addition to a primary sales agreement, Version 1.0 contains no provision for dispute resolution. Presumably choice of law, choice of forum, arbitration, or the like would be treated in the main agreement. After publication of MCCs 1.0, the Working Group learned more about the special context of dispute resolution that involves human rights, and for that reason MCCs 2.0 add two relevant provisions.

Most prominently, clauses on nonjudicial dispute resolution have been added. For companies that prefer to litigate rather than arbitrate, litigation remains an option. (Alternative drafting is offered in MCCs 2.0 ¶ 8.6, so companies can choose arbitration or litigation.) Still, even companies that want judicial resolution of ultimate disputes may benefit from pre-litigation efforts at amicable resolution, and these mechanisms are set up in this new version. This kind of collaborative resolution is consonant with the more cooperative approach now taken in much cutting-edge supply chain management. Many companies will find the "up the line" scheme to be consistent with their management practices in many other business contexts.[43]

In addition, as MCCs 2.0 align more closely with the UNGPs, an "operational level grievance mechanism" is set up to address problems as they arise.[44] This mechanism is informal, but it is nevertheless required, and it must be fully functional. Again, its purpose—to be "legitimate, accessible, predictable, equitable, transparent, rights-compatible, a source of continuous learning and based on engagement and dialogue with affected stakeholders, including workers"—will

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42. *See* Jeffrey Vogt et al., Farce Majeure: How Global Apparel Brands Are Using the COVID-19 Pandemic to Stiff Suppliers and Abandon Workers, https://www.ecchr.eu/en/publication/die-ausrede-der-hoeheren-gewalt (last accessed Nov. 20, 2021).

43. *See* Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 Colum. L. Rev. 1377, 1404 (2010); Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 Colum. L. Rev. 431, 442 (2009); Susan Helper, John Paul MacDuffie, & Charles F. Sabel, *Pragmatic Collaborations: Advancing Knowledge While Controlling Opportunism* 9 Indus. & Corp. Change 443, 449 (2000). In addition, governments adhering to the OECD Guidelines set up a National Contact Point (NCP) to further the effectiveness of the OECD Guidelines by, among other activities, helping to resolve disputes. The NCP in the United States provides a nonjudicial grievance mechanism with a mediation and conciliation platform.

44. MCCs 2.0 ¶ 1.4.

align with many companies' efforts toward collaborative supply chain management. Further, it is required for consistency with the UNGPs.[45]

Conclusion: Companies Can Choose the Commitments that Suit Their Needs and Goals

A modular approach is the central drafting strategy of the MCCs in both versions. The Working Group fully recognizes that not all companies are in the same place. Not only do they possess differing capabilities and face varying contexts, they are simply in different positions in their approach to human rights. Some companies—often those that have been involved in the worst problems—have advanced far in taking responsibility for the effects of their business on human rights. Other companies have taken only a few steps, and many have not yet started on the path. The MCCs are drafted for all of these companies and are designed so that counsel, with a minimum of effort, can adapt them to the particular circumstances of each company.

The Working Group has faced calls to require buyers to agree to all of the clauses, to prohibit "cherry-picking," and to mandate a particular allocation of responsibility. And the Working Group has faced criticism for failing to do so, or for rejecting goals that can only be aspirational. These calls and criticisms misconceive the place of the Working Group. We cannot impose duties or mandate compliance. Nor have we chosen an aspirational mission. We are a creature of the Uniform Commercial Code Committee of the ABA Business Law Section, and we see ourselves as practical lawyers. The original and ongoing goal to draft clauses that are "legally effective and operationally likely" can only be achieved if companies adopt the clauses. Otherwise the MCCs will be relegated to even greater irrelevance than the corporate policies that languish, unused, in the minute books of board meetings. Accordingly, the MCCs are drafted so that companies can eliminate clauses that do not fit their goals; they can use MCCs

45. UNGP 29, *supra* note 7. MCCs 2.0 have been very much influenced by the groundbreaking work in the Hague Rules on Business and Human Rights Arbitration (2019). At the same time, it should be noted that many are skeptical of arbitration in the context of human rights, particularly because of experiences in investment arbitration. Arbitration can be seen as favoring corporate interests over human rights, with biased arbitrators and confidentiality provisions that protect wrongdoers and hamstring balanced advocacy. For some of the leading discussion, see generally Kyle D. Dickson-Smith & Bryan Mercurio, *Australia's Position on Investor-State Dispute Settlement: Fruit of a Poisonous Tree or a Few Rotten Apples?*, 40 Sydney L. Rev. 213, 219–20 (2018); Duy Vu, *Reasons Not to Exit? A Survey of the Effectiveness and Spillover Effects of International Investment Arbitration*, 47 Eur. J. L. & Econ. 291, 307 (2019); Alessandra Arcuri & Francesco Montanaro, *Justice for All? Protecting the Public Interest in Investment Treaties*, 59 B.C. L. Rev. 2791, 2792 (2018); Luke E. Peterson & Kevin R. Gray, International Human Rights in Bilateral Investment Treaties and in Investment Treaty Arbitration 12–13, 27 (2003). Much of the criticism, however, is based on investor-state dispute resolution, and there are significant distinctions between investor-state disputes and supply chain disputes. The former generally involve states and investors; the latter are generally disputes between two sets of businesses. The numerous international arbitrations between business entities should speak favorably about the positive aspects of arbitration. Article 8 of MCCs 2.0 gives parties both arbitration and litigation options, and the annotations provide further discussion of the issues involved.

1.0 if MCCs 2.0 are too much; they can adapt everything[46] to meet their needs. For many companies, the most critical step is the first one—to start taking measures to improve their contracts. If the Working Group can make it easier to take that first step, we will have accomplished one of our most important objectives. That is not our only objective, however. We hope to provide guidance for companies that would like to move into a leadership position. We have tried to achieve balance while understanding that different companies walk on different tightropes in different tents.

We began with the confession that challenge, frustration, and hope were the catalysts for this project, and their powerful combustion continues to move the project forward. After publication of MCCs 1.0, it became clear that an ambitious effort toward revision would be needed to meet the goals of the project, which at its center is focused on improving the human rights of workers and other stakeholders, practically and immediately, through contracts—one of the most potent tools available. At the same time, we know that more needs to be learned, that new methods of supply chain management are coming into use, that new laws are in the offing, and that more work will need to be done. For now, we believe MCCs 2.0 offer a practical tool for companies that want to commit to protecting workers and other stakeholders in their international supply chains. It is not an easy task. The problem is spread across the world and results from countless factors, including basic economic realities. It will not be fixed soon, and it will not be fixed by supply chain reform alone or by contract clauses standing by themselves. This is the challenge. And it is sometimes frustrating that the problem can seem intractable, particularly since so many people, with different missions, different incentives, and different perspectives, contend for so many different solutions. Still, we believe that every effort can help and that practical solutions offered for even the most complex problems can result in real improvements in the lives of real people. That is our ultimate objective.

Contents

46. In this introduction, we have not tried to catalog all of the changes, or even all of the significant changes, from MCCs 1.0 to 2.0, but we are confident that counsel will readily identify problematic clauses in any case.

CLAUSES TO BE INSERTED INTO SUPPLY CONTRACTS, PURCHASE ORDERS, OR SIMILAR DOCUMENTS FOR THE SALE OF GOODS

The text proposed assumes that buyers are located in the United States and that the applicable law is either (a) U.S. state law that implements the Uniform Commercial Code without material nonuniform amendment or (b) the United Nations Convention on Contracts for the International Sale of Goods (the CISG, a treaty to which the United States is a party and which applies to many international sales of goods under CISG article 1(1)(a)).

For the most part, substantive human rights standards and ethical purchasing practices are not contained in these clauses and are instead assumed to be specified in Schedule P and Schedule Q, respectively. For companies that do not already have substantive human rights requirements for their suppliers, "Building Blocks for Schedule P" is included separately to provide guidance. A pro forma Schedule Q is also provided separately. In the clauses below, please refer to the footnotes for explanations of risks, statutory and case law, and human rights guidance from the UN Guiding Principles on Business and Human Rights (the Guiding Principles or UNGPs) and the 2011 OECD Guidelines for Multinational Enterprises (the OECD Guidelines) as well as the 2018 OECD Due Diligence Guidance for Responsible Business Conduct (the OECD Due Diligence Guidance).

1 ***Mutual Obligations with Respect to Combatting Abusive Practices in Supply Chains***. As of the Effective Date[47] of this Agreement, Buyer and Supplier each agree:

1.1 *Human Rights Due Diligence.*[48]

(a) Buyer and Supplier each covenants to establish and maintain a human rights due diligence process appropriate to its size and circumstances to identify, prevent, mitigate, and account for how each of Buyer and Supplier addresses the impacts of its activities on the human rights of individuals directly or indirectly affected by their supply chains, consistent with the 2011 United Nations Guiding Principles on Business and Human Rights.[49] Such human rights due diligence shall be consistent with guidance from the Organisation for Economic Co-operation and Development for the applicable party's sector (or, if no such sector-specific guidance exists, shall be consistent with the 2018 OECD Due Diligence Guidance for Responsible Business Conduct (the OECD Due Diligence Guidance)).[50]

(b) [Buyer and Supplier each] [Supplier] shall and shall cause each of its [shareholders/partners, officers, directors, employees,] agents and all subcontractors, consultants and any other person providing staffing for Goods[51] or services required by this Agreement (collectively, such party's "Representatives") to disclose information on all matters

47. An effective date may not be necessary, but the parties may prefer an "Effective Date" to be either the date of this Agreement or the date when all conditions precedent are satisfied. Alternatively, parties may want to set a period during which certain, but not all, obligations under this Agreement are effective. Presumably a certain level of human rights due diligence [hereinafter HRDD] will have been done by Buyer before engaging in extensive negotiations with prospective suppliers. Note that the HRDD contemplated in the following clauses goes beyond the customary know-your-customer, anti-money laundering, and other due diligences that companies may otherwise employ, as explained more fully in the introduction. *See supra* notes 27–34 and accompanying text. Note further that the Effective Date is referenced in Section 1.1(d) to include pre-signing remediation plans.

48. *See supra* notes 27–34 and accompanying text (on HRDD under the UNGPs and OECD).

49. *See* UNGPs 15–19, *supra* note 7.

50. *See supra* note 8.

51. "Goods" is assumed to be defined earlier in the Agreement (and not defined in Schedule P). *See also infra* Section 3.2 (on the definition of "Nonconforming Goods").

relevant to the human rights due diligence process in a timely and accurate fashion to [the other party] [Buyer].

(c) For the avoidance of doubt, each party is independently responsible for upholding its obligations under this Section 1.1, and a breach by one party of its obligations under this Section 1.1 shall not relieve the other party of its obligations under this Agreement.

(d) Human rights due diligence hereunder may include implementation and monitoring of a remediation plan to address issues identified by due diligence that was conducted before the Effective Date.

1.2 *Schedule P Compliance Throughout the Supply Chain.*[52] Supplier shall ensure that each of its Representatives acting in connection with this Agreement shall engage with Supplier and any other Representative in due diligence in accordance with Section 1.1 to ensure compliance with Schedule P. Such relationships shall be formalized in written contracts that secure from the parties terms [in compliance with] [equivalent to those imposed by] [at least as protective as those imposed by] Schedule P.[53] Supplier shall keep records of such written contracts to demonstrate compliance with its obligations under this Agreement and shall deliver such records to Buyer as reasonably requested.[54]

1.3 *Buyer's Commitment to Support Supplier Compliance with Schedule P.*[55]

(a) *Commitment to Responsible Purchasing Practices*. Buyer commits to support Supplier's compliance with Schedule P by engaging in responsible purchasing practices [in accordance with Schedule Q].

(b) *Reasonable Assistance*. If Buyer's due diligence determines Supplier requires assistance to comply with Schedule P, Buyer, if it elects not to terminate this Agreement under Section 2.5, shall employ

52. Guiding Principle 13 requires that businesses avoid causing or contributing to human rights harms through their own activities, address such impacts where they occur, and seek to prevent or mitigate adverse human rights impacts that are directly linked to their operations, products, or services by their business relationships. Accordingly, this clause seeks to embed obligations to comply with human rights through the entire supply chain. In keeping with the modular approach of these clauses, businesses may want to circumscribe their responsibility in line with the degree to which they are connected to the activities of the business.

53. The content of Schedule P is beyond the scope of this document. Note, however, that some suggest the best practice is to avoid reference to specific laws in favor of a general reference because legislative initiatives are broader in some countries than in others. In the event that the drafter nevertheless wishes to require that Supplier specifically represent compliance with antitrafficking and similar legislation, consider avoiding the term *applicable*, which will limit required adherence by companies that do not meet the size or revenue requirements of certain legislation. This might present a problem where the law applies to Buyer, because of its size, but not Supplier, because of its (relatively small) size.

54. UNGP 21, *supra* note 7, requires businesses to communicate externally, particularly where concerns are raised by affected stakeholders, and sets out standards for the form, frequency, adequacy, and confidentiality of such human rights reporting. *See also* UK Modern Slavery Act, *supra* note 23, § 54.

55. See *supra* note 49 on UNGPs 15–19.

commercially reasonable efforts to provide such assistance],[56] which may include Supplier training, upgrading facilities, and strengthening management systems.[57]] Buyer's assistance shall not be deemed a waiver by Buyer of any of its rights, claims or defenses under this Agreement or under applicable law.

(c) [*Pricing*. Buyer shall collaborate with Supplier to agree on a contract price that accommodates costs associated with upholding responsible business conduct, [including, for the avoidance of doubt, minimum wage and health and safety costs, at a standard at least as high as required by applicable law [and International Labour Organisation norms]].[58]]

(d) *Modifications*. For any material modification (including, but not limited to, change orders, quantity increases or decreases, or changes to design specifications) requested by Buyer or Supplier, Buyer and Supplier shall consider the potential human rights impacts of such modification and take action to avoid or mitigate any adverse impacts, including by amending the modification [consistent with Schedule Q]. If Buyer and Supplier fail to agree upon modifications and/or amendments that would avoid a Schedule P breach, then either party may initiate dispute resolution in accordance with Article 8.

(e) *Excused Non-Performance*. If (i) Supplier provides notice and reasonably satisfactory evidence to Buyer that a Schedule P breach is reasonably likely to occur because of a requested modification or because of a

56. As market standards are unlikely to provide adequate measures for what constitutes "reasonable assistance," Buyer's obligations are articulated in Schedule Q.

57. Parties may consider deeming the cost of reasonable assistance to be a setup or mobilization expense associated with Supplier's preparing to provide goods to Buyer. For example, if Schedule P obligations effectively require that Supplier make capital improvements to meet Schedule P targets that may go beyond the minimum requirements of applicable law, Supplier's costs for such compliance may qualify for reasonable assistance from Buyer. Depending on the circumstances, Buyer and Supplier may determine that such assistance should be provided as a single payment at the beginning of the term of the Agreement or the parties may decide to spread assistance over time, over units delivered, or otherwise. Where assistance is provided over time, the parties should clearly state when such assistance might be suspended or whether such assistance would be accelerated on early termination.

58. In cases where the parties want to support a "living wage" under the Agreement, they are encouraged to review their costing using established methodologies, such as Fair Wear's labor-minute costing tools, and living wage estimates found at https://www.fairwear.org/programmes/lw-tools-and-benchmarks and to consult definitions such as that provided by the Global Living Wage Coalition, which defines a living wage as "[t]he remuneration received for a standard workweek by a worker in a particular place sufficient to afford a decent standard of living for the worker and her or his family. Elements of a decent standard of living include food, water, housing, education, health care, transportation, clothing, and other essential needs including provision for unexpected events," and the ACT-endorsed definition, which is, "The minimum income necessary for a worker to meet the basic needs of himself/herself and his/her family, including some discretionary income." This should be earned during legal working hour limits (i.e., without overtime). *What Is a Living Wage?*, Glob. Living Wage Coal., https://www.globallivingwage.org/about/what-is-a-living-wage/ (last visited Jan. 30, 2021); *How Does ACT Define a Living Wage?*, ACT, https://actonlivingwages.com/living-wages/ (last visited Jan. 30, 2021).

reasonably unforeseeable, industry-wide or geographically specific, material change to a condition affecting Supplier;[59] (ii) the parties cannot agree on a solution that avoids breach of Schedule P; and (iii) Supplier elects not to perform in order to avoid breaching Schedule P, then the parties hereby agree that this Agreement or a specific purchase order hereunder may be terminated in whole or in part by Supplier and that Supplier shall not be in default of its obligations under this Agreement as a result of such non-performance.[60]

(f) *Responsible Exit*. In any termination of this Agreement by Buyer, whether due to a failure by Supplier to comply with this Agreement or for any other reason (including the occurrence of a force majeure event or any other event that lies beyond the control of the parties),[61] Buyer shall (i) consider the potential adverse human rights impacts and employ commercially reasonable efforts to avoid or mitigate them; and (ii) provide reasonable notice to Supplier of its intent to terminate this Agreement. Termination of this Agreement shall be without prejudice to any rights or obligations accrued prior to the date of termination, including, without limitation, payment that is due for acceptable goods produced by Supplier pursuant to Buyer's purchase orders before termination.[62]

1.4 *Operational-Level Grievance Mechanism*.[63] During the term of this Agreement, Supplier shall maintain an adequately funded and governed nonjudicial Operational-Level Grievance Mechanism ("OLGM") in order to effectively address, prevent, and remedy any adverse human rights impacts that may occur in connection with this Agreement. Supplier shall ensure that the OLGM is legitimate, accessible, predictable, equitable, transparent, rights-compatible, a source of continuous learning, and based on engagement and dialogue with affected stakeholders,

59. For example, if a supplier lacks sufficient personal protective equipment (PPE) to protect its workers in a pandemic to allow for normal operations, it should not be found in breach.

60. This provision is intended to address not only change orders but force-majeure-like events that go beyond a simple change in conditions affecting a single supplier.

61. This phrasing should be adapted to the phrasing of any force majeure clause in the main supply contract to be sure the provision can harmonize with the parties' agreed approach to and definition of a force majeure event.

62. It is not uncommon for buyers to exert their leverage—such as threats of termination—to require discounts or other benefits from suppliers. However, this type of behavior is unlikely to be upheld in courts, and this provision is meant to allow Supplier to enforce its rights despite any superior leverage that Buyer may have. Buyer is required to satisfy all obligations accrued prior to termination, including payment in full for goods produced without violation of Schedule P.

63. Guiding Principle 29 provides that all businesses must have in place an OLGM to resolve human rights disputes early and directly through engagement and dialogue with stakeholders. It is part of the businesses' ongoing HRDD responsibility. Guiding Principle 22 expects that businesses should cooperate with or participate in legitimate remedial processes when the businesses recognize that they have caused or contributed to an adverse impact. Legitimate processes can include state judicial and nonjudicial dispute resolution mechanisms, as well as nonstate nonjudicial mechanisms. Under Guiding Principle 31, all nonjudicial dispute resolution mechanisms, state and nonstate, should meet the effectiveness criteria enumerated in the text of the clause. *See* UNGPs, *supra* note 7.

including workers. Supplier shall maintain open channels of communication with those individuals or groups of stakeholders that are likely to be adversely impacted by potential or actual human rights violations so that the occurrence or likelihood of adverse impacts may be reported without fear of retaliation. Supplier shall demonstrate that the OLGM is functioning by providing [monthly] [quarterly] [semi-annual] written reports to Buyer on the OLGM's activities, describing, at a minimum, the number of grievances received and processed over the reporting period, documentary evidence of consultations with affected stakeholders, and all actions taken to address such grievances.

2 ***Remediating Adverse Human Rights Impacts Linked to Contractual Activity***.

2.1 *Notice of Potential or Actual Violations.*

(a) Within _____days of (i) Supplier having reason to believe there is any potential or actual violation of Schedule P (a "Schedule P Breach"), or (ii) Buyer's receipt of any oral or written notice of any potential or actual Schedule P Breach, Supplier shall provide to Buyer a detailed summary of (1) the factual circumstances surrounding such violation; (2) the specific provisions of Schedule P implicated; (3) the investigation and remediation that has been conducted and/or that is planned as informed by implementation of the OLGM process set forth in Section 1.4; and (4) support for Supplier's determination that the investigation and remediation has been or will be effective, adequate, and proportionate to the violation.

(b) If Supplier reasonably believes that Buyer's breach of Buyer's obligations under Section 1.3 caused or contributed to the Schedule P Breach and that remediation of the Schedule P Breach requires Buyer's participation under Section 2.3(e), Supplier shall notify Buyer and provide details supporting its claim. If Buyer rejects Supplier's allegation, Buyer shall provide Supplier with its written explanation rejecting Supplier's position. In such case, the Dispute (hereinafter defined) shall be resolved under Article 8.

(c) Supplier hereby designates (name) (title) at (email address) and Buyer designates (name) (title) at (email address) to send/receive all notices provided under this Section 2.1 [and in addition notices shall be given as specified in Section ____ for general notices under this Agreement].

2.2 *Investigation.*

(a) Upon receipt of a notice under Section 2.1, Buyer and Supplier shall fully cooperate with any investigation by the other party or their representatives. Without limitation, such cooperation shall include, upon request of a party, working with governmental authorities to enable both Supplier and Buyer or their agents to enter the country, to be issued appropriate visas, and to investigate fully.

(b) Each party shall provide the other with a report on the results of any investigation carried out under this Section; provided that any such cooperation in the investigation does not require Buyer or Supplier to waive attorney-client privilege, nor does it limit the defenses Supplier or Buyer may raise.

2.3 *Remediation Plan.*[64]

(a) If Buyer becomes aware of a Schedule P Breach[65] that has not been effectively remediated, Buyer shall, in collaboration with Supplier's other buyers where legally appropriate,[66] require Supplier to prepare a remediation plan (a "Remediation Plan").

(b) The purpose of the Remediation Plan shall be to restore, to the extent commercially practical, the affected persons to the situation they would have been in had the adverse human rights impacts not occurred. [The Remediation Plan shall enable remediation that is proportionate to the adverse impact and may include apologies, restitution, rehabilitation, financial and non-financial compensation, as well as prevention of additional adverse impacts resulting from future Schedule P violations.][67]

(c) The Remediation Plan shall include a timeline and objective milestones for remediation, including objective standards for determining

64. Remediation is both retrospective and prospective. It is retrospective because it attempts to make people whole for the harm they have suffered. It is prospective because it seeks to prevent recurrence. In this way, remediation is embedded within HRDD. The forms of remediation in the clause are based on the commentary to UNGP 25, *supra* note 7.

65. Under UNGP 24, *supra* note 7, businesses are entitled to prioritize and focus their attention on the most severe human rights harms or harms that become irremediable if there is a delayed response. A "severe harm" is characterized by its gravity, the number of people affected, and the ability to make people whole. *See id.* UNGP 14 (defining in commentary what contributes to the severity of harm).

66. Research suggests that cooperation among buyers who all purchase from the same troubled supplier can be especially effective, but buyers should keep in mind any applicable antitrust or competition laws. Counsel should consider, for example, FTC v. Super. Ct. Trial Lawyers Ass'n, 493 U.S. 411 (1990); Letter from A. Douglas Melamed, Acting Ass't Att'y Gen., U.S. Dep't of Just., to Kenneth A. Letzler, Arnold & Porter (Oct. 31, 1996) (Business Review Letter on Apparel Industry Partnership development of standards for manufacturing under humane conditions). The context of these authorities is different, however, and buyers should consider concerted efforts with the benefit of research and advice of counsel. Note that ethical and safety concerns do not necessarily allow activities otherwise proscribed by the antitrust laws. *See* Nat'l Soc'y of Prof'l Engineers v. United States, 435 U.S. 679 (1978) (association's refusal to bid on price due to concerns about safety was per se an unlawful boycott). In response to the COVID-19 pandemic, the Department of Justice Antitrust Division issued a number of expedited Business Review Letters to provide requested guidance on permissible cooperation among competitors. At the time of writing, it is not known whether similar Business Review Letters may be available to facilitate human rights remediation if the parties implement appropriate safeguards to mitigate the risks of anticompetitive behavior.

67. The bracketed language comes from the commentary to UNGP 25, *supra* note 7; companies committed to the UNGPs will likely want to retain the language for that reason.

when such remediation is completed and the breach cured.[68] Supplier shall demonstrate to Buyer that affected stakeholders and/or their representatives [and/or a third party acting on behalf of such stakeholders][69] have participated in the development of the Remediation Plan.[70] [The Remediation Plan may contemplate recourse to the dispute resolution mechanisms set forth in Article 8, as appropriate.]

(d) Supplier shall provide [reasonably satisfactory] evidence to Buyer of the implementation of the Remediation Plan and shall demonstrate that participating affected stakeholders and/or their representatives are being regularly consulted. Before the Remediation Plan can be deemed fully implemented, evidence shall be provided to show that affected stakeholders and/or their representatives have participated in determining that the Remediation Plan has met the standards developed under this Section.

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68. "Cured" may have different meanings in other contexts. In this case, a "completed" remediation or "cured" breach may include an ongoing activity (e.g., periodic monthly reports on compliance).

69. Ideally, all adversely impacted stakeholders would be granted enforcement rights under this Agreement, but there are significant commercial and practical obstacles to granting such third-party beneficiary rights. For that reason, Section 7.2 disclaims third-party rights under the contract. If parties wish to include such rights, however, they may consider the language proposed in Corporate Accountability Lab, Towards Operationalizing Human Rights and Environmental Protection in Supply Chains: Worker-Enforceable Codes of Conduct (Feb. 2021), https://static1.squarespace.com/static/5810dda3e3df28ce37b58357/t/6026fd326aa9cd4f88697a20/1613167923256/Towards+Operationalizing+Human+Rights+and+Environmental+Protection+in+Supply+Chains.pdf (last accessed Feb. 23, 2021):

> 1.1. The Parties to this [Purchase Order/Agreement] acknowledge and agree that the terms of [Schedule P/Schedule Q] are intended to benefit and protect not only the Parties but also persons directly impacted by (1) Supplier's activities performed under this [Purchase Order/Agreement] and (2) activities by subsuppliers that the Supplier contracts with to perform under this [Purchase Order/Agreement]. Such persons include but are not limited to workers, land owners, property owners, those residing, working, and/or recreating in proximity to supply chain activities who are injured or suffer damages due to breach of [Schedule P/Schedule Q], including survivors of those killed or disabled. Such persons are intended third-party beneficiaries to [Schedule P/Schedule Q].
>
> 1.2. All intended third-party beneficiaries of [Schedule P/Schedule Q] have the right to enforce [Schedule P/Schedule Q] against Parties in any court or tribunal that has jurisdiction over the [Buyer/Supplier or Purchase Order/Agreement].
>
> 1.3. Third-party beneficiaries may assign their rights to a labor union, nongovernmental organization, or other organizations providing legal assistance they select.

Parties adopting this language will need to consider its relation to other dispute resolution mechanisms and should note in particular the clause (¶ 1.2) on jurisdiction.

70. The OECD Due Diligence Guidance recommends that remediation be risk based, prioritizing the most severe risks for corrective action. OECD Due Diligence Guidance, *supra* note 8, at 34–35, Annex Questions 41–45 and 48–54. The appropriate remediation will depend on the nature and extent of the harm and the prioritization of risk. For example, many buyers choose to rate forced labor and child labor as high risk or Zero Tolerance; *see* Section 2.5. Buyer may refuse Goods originating from a factory where such Zero Tolerance breaches have taken place and may require rigorous comprehensive remediation of that factory while maintaining the contract with other factories operated by Supplier when appropriate.

(e) If Buyer's breach of Section 1.3 has caused or contributed[71] to the Schedule P Breach or the resulting adverse human rights impact, Buyer shall participate in the preparation and implementation of the Remediation Plan, including by providing assistance [which may include in-kind contributions, capacity-building[72] and technical or financial assistance] that is proportionate to Buyer's contribution to the Schedule P Breach and the resulting adverse impact.

(f) A Remediation Plan under this Article 2 or under Section 1.1(d) shall be a fully binding part of this Agreement.

2.4 *Right to Cure.*[73]

(a) In the event of a breach by Supplier of its obligations under Schedule P, Buyer shall give notice under Section 2.1(a), which shall trigger a [commercially reasonable] cure period [as set forth under this Agreement] [as agreed by the mutual written agreement of the parties (each acting in good faith and in a commercially reasonable manner)].[74] Such breach shall be considered cured when Supplier has met the standards set out in Sections 1.4 and 2.3.

(b) If such breach is not cured within the period designated under Section 2.4(a), or is incapable of being cured, Buyer may [cancel]

71. The OECD Guidelines (as well as the UNGPs) concern those adverse impacts that are either caused or contributed to by the enterprise, or are directly linked to their operations, products, or services by their business relationships. See OECD Guidelines, *supra* note 8, at 20; UNGP 13, *supra* note 7. The OECD Guidelines further provide that an enterprise "contributes to" an adverse impact or harm "if its activities, in combination with the activities of other entities cause the impact, or if the activities of the enterprise cause, facilitate or incentivise another entity to cause an adverse impact"; however, the "contribution must be substantial, meaning that it does not include minor or trivial contributions." *Id.* at Annex Question 29. Furthermore, the term "business relationship" is broad and "includes relationships with business partners," including franchisees, licensees, joint ventures, investors, clients, contractors, customers, consultants," advisers, entities in the supply chain, and "other non-State or State entities directly linked to its business operations, products or services." *Id.* at 10, 23. The OECD Guidelines further provide that where a harm is directly linked to the operations, products, or services of a business, the business must use its leverage to influence the entity causing the harm to prevent or mitigate it. *See id.* at 24. Under UNGP 22, *supra* note 7, businesses are responsible for providing remediation where they caused human rights harm directly through their own operations and where they contributed to harm caused by others. As under the OECD Guidelines, where a business is only linked to an adverse impact, it must use its leverage to influence the parties that caused or contributed to the impact to remediate. Thus, where Buyer fails to take reasonable action to address a Schedule P Breach promptly after becoming aware of it, Buyer may be deemed to have contributed to any ongoing harm.

72. The term *capacity building* is found in the OECD glossary of statistical terms as the "[m]eans by which skills, experience, technical and management capacity are developed within an organizational structure (contractors, consultants or contracting agencies)—often through the provision of technical assistance, short or long term training, and specialist inputs (e.g., computer systems). The process may involve the development of human, material and financial resources." *Glossary of Statistical Terms: Capacity Building*, OECD (Aug. 22, 2002), https://stats.oecd.org/glossary/detail.asp?id=5103.

73. A right to cure is essential to the ability of Supplier to avoid the human rights harms to workers and others that may result from the termination by Buyer of the Agreement.

74. Section 2.4 has been drafted broadly to provide Buyer and Supplier flexibility in crafting an appropriate industry-specific protocol for addressing Schedule P breaches by Supplier.

[avoid][75] this Agreement under Section 6.2(e) and, with or without such [cancellation] [avoidance], may exercise any of its remedies under Article 6 or applicable law.

2.5 *Right to Immediate Termination*. Notwithstanding any other provision of this Agreement, this Agreement may be immediately [canceled] [avoided] by Buyer under Section 6.2(e), without providing a cure period, if Supplier has engaged in a Zero Tolerance Activity. A "Zero Tolerance Activity" shall be any of the following activities if they were not disclosed promptly by Supplier to Buyer during due diligence under Section 1.1: (a) activities that would cause Buyer to be the subject of prosecution or sanction under civil or commercial laws whether national, regional or international; (b) activities that would expose Buyer to criminal liability; (c) activities prohibited by the Foreign Corrupt Practices Act of 1977 (as amended); (d) instances where it becomes apparent that Supplier cannot, in the absence of assistance from Buyer under Section 1.3(b), perform this Agreement without material or repeated violation of Schedule P; and (e) others specified in Schedule P.[76] Such termination shall be effectuated in compliance with Section 1.3(f) on responsible exit.

3 ***Rejection of Goods and [Cancellation] [Avoidance] of Agreement.***

3.1 *[Strict Compliance*. It is a material term of this Agreement that Buyer, Supplier, and Representatives shall engage in due diligence in accordance with Sections 1.1 and 1.2 so as to ensure compliance with Schedule P.]

3.2 *Rejection of Nonconforming Goods*. In the event of a Schedule P Breach by Supplier that renders the Goods Nonconforming Goods, Buyer shall have the right to reject them[77] unless Buyer's breach of its obligations under Section 1.3 [and/or Schedule Q] materially caused or contributed to the Schedule P Breach. Goods are Nonconforming

75. "Cancel" for contracts governed by the U.C.C.; "avoid" for those governed by the CISG. Both terms imply that the Agreement is being ended because of a breach. The agreement may be "terminated" even without a breach. *See* U.C.C. § 2-106(3) (2011). The drafting here follows the U.C.C. loosely in this regard but not strictly; the U.C.C. distinguishes between cancellation for breach of the agreement and termination "otherwise than for its breach." In the drafting of this Agreement, "termination" may or may not be for breach of the Agreement.

76. *See supra* note 70 (discussing risk prioritization). This clause attempts to balance the fact that certain violations of human rights are ultimately better addressed through the Remediation Plan process set forth above, as compared to other violations that cannot be tolerated even for an instant, the Zero Tolerance Activities. This is a difficult line to draw at times, and there is some divergence in practice and across legislation as to what may be tolerated and what is absolutely prohibited. Where these lines are drawn and what may or may not be permissible are issues for each Buyer and Supplier to address based on applicable laws and policies. Note also the Supplier's right to immediate termination without default under *supra* Section 1.3(e).

77. See U.C.C. §§ 2-601, 2-602 (2011).

Goods if the Buyer cannot resell them in the ordinary course of business or if the goods cannot pass without objection in trade or if the Goods are associated with a Zero Tolerance Activity.[78]

3.3 *[Cancellation.] [Avoidance.]* The following shall be deemed to [substantially impair the value of this Agreement to Buyer][79] [constitute a fundamental breach of the entire Agreement][80] and Buyer may [cancel] [avoid][81] this entire Agreement with immediate effect and without penalty and/or may exercise its right to indemnification and all other remedies: (a) a breach by Supplier of Schedule P that relates to a Zero Tolerance Activity, or (b) Supplier's failure to timely complete its obligations under a Remediation Plan. Buyer shall have no liability to Supplier for such [cancellation] [avoidance] but shall employ commercially reasonable efforts to comply with Section 1.3(f).

3.4 *Timely Notice.* Notwithstanding any provision of this Agreement or applicable law (including without limitation [the Inspection Period in Section ____ of this Agreement and] [Articles 38 to 40 of the CISG] [and U.C.C. §§ 2-607 and 2-608]),[82] Buyer's rejection of any Goods[83] as a result of noncompliance with Schedule P shall

78. Nonconforming Goods are presumably defined elsewhere in the Agreement, for example, with respect to conformity to product specifications. This section clarifies that goods that conform to product specifications may nevertheless be rejected in the circumstances specified in the text. The U.S. Customs and Border Protection (CBP) has the authority to detain merchandise at a port of entry if information reasonably, even if not conclusively, indicates that it is mined, manufactured, or produced, wholly or in part, by forced labor, including convict labor, forced child labor, or indentured labor under WROs issued under 19 U.S.C. § 1307 (2018). If CBP issues a WRO against a Supplier or Representative, as it has done eighteen times between September 2019 and October 2020, importers of detained shipments are provided an opportunity to export their shipments or submit proof to CBP that the merchandise was not produced by forced labor. If the goods cannot be released into U.S. markets because of a WRO or otherwise sold where and when Buyer intended, Buyer must have the right to reject the Goods as Nonconforming Goods. Similarly, if Buyer cannot sell the goods in the ordinary course of business, it should have the right to reject the Goods unless Buyer's own actions caused or contributed to the problem in a material way.

79. Because the perfect tender rule of U.C.C. § 2-601 does not apply to installment contracts, installment contracts governed by the U.C.C. should include the phrase within the first bracket.

80. The phrase within the second bracket is applicable for agreements to which the CISG applies, whether for a single delivery or an installment contract, under article 49.

81. *Cancellation* occurs when a "party puts an end to the contract for breach by the other" under U.C.C. § 2-106(4). *Avoidance* is the appropriate term under CISG article 49.

82. Articles 38–40 of the CISG require that Buyer examine the goods or cause them to be examined within as short a period as is practicable. Buyer loses the right to rely on a lack of conformity if Buyer does not give Supplier notice within a reasonable time after Buyer discovers or ought to have discovered a defect and, at the latest, within two years of the date of delivery (or other contractual period) unless Supplier knew or could not have been unaware of the defect. Because U.C.C. § 2-607(3)(a) provides a similar argument that Buyer's failure to notify Supplier of a breach within a reasonable time bars any remedy, this contractual text is included to limit disputes about what constitutes a reasonable time. If the U.C.C. is referenced in the text, the applicable state version should be cited.

83. "Nonconforming Goods" and "Inspection Period" are assumed to be defined earlier in the Agreement. Nevertheless, Nonconforming Goods are defined specifically for purposes related to human rights policies in Section 3.2.

be deemed timely if Buyer gives notice to Supplier within a reasonable time after Buyer's discovery of same.

4 [***Revocation of Acceptance.***[84]

4.1 *Notice of Buyer's Discovery.* Buyer may revoke its acceptance, in whole or in part, upon notice sent [in accordance with Section ___] of Buyer's discovery that the Goods are Nonconforming Goods unless Buyer's breach of its obligations under Section 1.3 materially caused or contributed to the Schedule P Breach. Such notice shall specify the nonconformity or nonconformities that Buyer has discovered at that point, without prejudice to Buyer's right to specify nonconformities that it discovers later.

4.2 *Same Rights and Duties as Rejection.* [Upon revocation of acceptance, Buyer shall have the same rights and duties as if it had rejected the Goods before acceptance.]

4.3 *Timeliness.* Notwithstanding any provision of this Agreement (including without limitation [the Inspection Period in Section ____ of this Agreement and] U.C.C. § 2-608), Buyer's revocation of acceptance of any Goods under this Article 4 shall be deemed timely if Buyer gives notice to Supplier within a reasonable time after Buyer's discovery of same.]

5 ***Nonvariation of Matters Related to Schedule P.***

5.1 *Course of Performance, Established Practices, and Customs.* Course of performance and course of dealing (including, without limitation, any failure by Buyer to effectively exercise any audit rights) shall *not* be construed as a waiver and shall *not* be a factor in Buyer's right to reject Nonconforming Goods, [cancel] [avoid][85] this Agreement, or exercise any other remedy. Supplier acknowledges that with respect to the matters in Schedule P, any reliance by Supplier on course of performance, course of dealing, or similar conduct would be unreasonable. Supplier acknowledges the fundamental importance to Buyer of the matters in Schedule P and understands that no usage or practice established between the parties should be understood otherwise, and any apparent conduct or statement to the contrary should not be relied upon.[86]

84. The clauses on revocation of acceptance are designed for use in contracts governed by the U.C.C. and are drafted with U.C.C. § 2-608 in mind. They should be omitted in contracts governed by the CISG. For this reason, Article 4 is bracketed.

85. *Cancel* for agreements under the U.C.C., *avoid* for the CISG. *See supra* note 81.

86. The first phrase uses the terminology of U.C.C. section 1-303, and the second phrase uses the terminology of CISG article 9(1).

5.2 *No Waiver of Remedy*. Buyer's acceptance of any Goods in whole or in part will not be deemed a waiver of any right or remedy[87] nor will it otherwise limit Supplier's obligations, including, without limitation, those obligations with respect to indemnification.

6 ***Buyer Remedies.***

6.1 *Breach and Notice of Breach*. Upon breach by Supplier, Buyer may exercise remedies to the extent provided in this Article 6. Prior to the exercise of any remedies pursuant to Section 6.2, Buyer shall notify Supplier in accordance with Section 2.1. Such notice, if with respect to an actual violation, constitutes notice of default under this Agreement.[88]

6.2 *Exercise of Remedies*. Remedies shall be cumulative. Remedies shall not be exclusive of, and shall be without prejudice to, any other remedies provided hereunder or at law or in equity. Buyer's exercise of remedies and the timing thereof shall not be construed in any circumstance as constituting a waiver of its rights under this Agreement. Buyer's remedies include, without limitation[89]:

(a) Demanding adequate assurances from Supplier of due performance in conformity with Schedule P [after Buyer makes similar assurances to Supplier of its due performance under Section 1.3 [and/or Schedule Q]].

(b) Obtaining an injunction with respect to Supplier's noncompliance with Schedule P (in which case, the parties represent to each other and agree that noncompliance with Schedule P causes Buyer great and irreparable harm for which Buyer has no adequate remedy at law and that the public interest would be served by injunctive and other equitable relief).

87. U.C.C. § 2-601 (2011).

88. U.C.C. § 2-607(3)(a) requires notice of a breach within a reasonable time after constructive discovery of the breach. A buyer who fails to give such notice will find its claims barred, with many courts holding that pre-suit notice is required.

89. This section reflects the remedies provided in the FAR, 48 C.F.R. § 52.222-50, relative to combating trafficking in persons. Additionally, the clause adds an insecurity provision under U.C.C. § 2-609. The clause also clarifies that injunctive relief may be necessary. In addition, while Buyer may want to work with a Supplier toward full compliance, Buyer should be prepared to face waiver arguments. The timing of the exercise of remedies is sensitive, and the exercise of remedies and any requests for damages may themselves have adverse impacts on human rights. This provision expressly recognizes that such careful consideration of the exercise of remedies by Buyer does not constitute a waiver. Note also that the remedies provisions here do not mention setoff. *See* 11 U.S.C. §§ 506(a)(1), 553 (2018) (setoff is a secured claim in bankruptcy). If setoff, recoupment, claw back, or similar remedies are not already provided elsewhere in the Agreement, counsel may wish to consider making such rights explicit in this clause.

(c) Requiring Supplier to terminate an agreement or affiliation with a specific factory, terminate a subcontract or remove an employee or employees and/or other Representatives.[90]

(d) Suspending payments, whether under this Agreement or other agreements, until Buyer determines, in Buyer's reasonable discretion, that Supplier has taken appropriate remedial action following the expiration of the cure period indicated in Section 2.4(a).[91]

(e) [Avoiding] [Canceling] this Agreement if permitted by Sections 2.4(b), 2.5, or 3.3.

(f) Obtaining damages, including all direct and consequential damages caused by the breach; *provided, however*, that damages shall be reduced proportionately to the degree that Buyer's breach of Section 1.3 [and/or Schedule Q] caused or contributed to Supplier's breach of Schedule P.

6.3 *Damages*. Buyer and Supplier acknowledge:

(a) Neither Buyer nor Supplier should benefit from a Schedule P violation or any human rights violation occurring in relation to this Agreement.

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90. Buyer's ability to direct its supplier's operations or require the removal of an employee or employees can give rise to claims of undertaking liability or liability under the peculiar risk doctrine. *See* Rahaman v. J.C. Penney Corp., No. N15C-07-174MMJ, 2016 WL 2616375, at *9 (Del. Super. Ct. May 4, 2016). There is also concern about becoming a joint employer and thereby opening exposure or liability. Counsel should consider very carefully whether it is better to have the power to make such demands (e.g., require that Supplier fire employees or other Representatives, or terminate or suspend a relationship with a particular factory) or whether it is more important to forego this power in an effort to maintain independent status and concomitant lower risk of liability.

91. Some supply contracts will call for payment by letter of credit, which will complicate the right to suspend payment. When a documentary credit is involved, the supply contract and letter of credit should require presentation of a certificate of compliance with Schedule P. Under U.S. law, a false beneficiary's certificate could allow an injunction against payment on grounds of "material fraud by the beneficiary on the issuer or applicant." *See* U.C.C. § 5-109(b) (2011). Purposeful falsity of the certificate might perhaps be helpful even if suit must be in London or in a jurisdiction following English law, which requires fraud on the documents. The leading case from the House of Lords is United City Merchs. (Invs.) Ltd. v. Royal Bank of Can., [1983] AC 168, 183 (HL) (referring to "documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue"); *see also* Inflatable Toy Co. Pty. Ltd. v. State Bank of NSW Ltd., [1994] 34 NSWLR 243 (Austl.) (applying Australian law). If the violation of Schedule P constitutes an illegal act, the illegality theory may also be useful in a suit governed by English law. In any case, the certificate should be required to be dated within a reasonably short time of the draw. Many banks probably will not object to the requirement of an additional certificate as certificates (e.g., by SGS) are commonplace in such transactions, and environmental certificates are similar to (and in some cases may be the same as) a certificate of compliance with Schedule P. While some banks may resist the requirement of such a certificate because of fear of injunction actions and the concomitant extension of the credit risk if the injunction is ultimately denied, most banks seem unlikely to be concerned by the requirement of one more certificate, and any additional credit risk from an injunction may be mitigated by a bond or other credit support as contemplated by U.C.C. § 5-109(b)(2) and comment 7, or by the civil procedure laws or rules of certain jurisdictions requiring posting of a bond, or by collateralization or bonding provisions in the reimbursement agreement itself. Still, despite all of these efforts, suspension of payment may be impossible in cross-border documentary credit transactions because frequently a foreign bank will have honored before the injunction can issue. Once one bank honors in good faith, the commitments along the chain become firm and cannot be enjoined. *See* U.C.C. § 5-109 (2011).

If damages are owed that would result in a benefit to Buyer or Supplier, such amounts should go toward supporting the remediation processes set out in Section 1.4 and Article 2. A "benefit" is here understood to mean being put in a better position than if this Agreement had been performed without a Schedule P Breach. Nothing herein limits the right of a party to be put in the position it would have been in had this Agreement been performed without a Schedule P Breach.

(b) [If there are insufficient funds to pay damages and complete the remediation processes set out in Section 1.4 and Article 2, remediation shall take priority.]

(c) [It may be difficult for the parties to fix damages for injury to business, prospects, and reputation with respect to Nonconforming Goods produced in violation of Schedule P, and in such case, liquidated damages must be paid by Supplier to Buyer as follows: [insert amount or formula for calculation.]][92]

6.4 *Return, Destruction or Donation*[93] *of Goods; Nonacceptance of Goods.*

(a) Buyer may, in its sole discretion, store the rejected Nonconforming Goods for Supplier's account, ship them back to Supplier or export them or, if permitted under applicable law, destroy or donate the Nonconforming Goods, all at Supplier's sole cost, expense, and risk, except to the extent that Buyer has caused or contributed to the nonconformity by breach of Section 1.3 [and/or Schedule Q].

(b) Buyer is under no duty to resell any Nonconforming Goods produced by or associated with Supplier or its Representative who Buyer has reasonable grounds to believe has not complied with Schedule P, whether or not such noncompliance was involved in the production of the specific Nonconforming Goods. Buyer is entitled to discard, destroy, export or donate any such Nonconforming Goods. Notwithstanding anything contained herein to the contrary or instructions otherwise provided by

92. U.C.C. § 2-718(1) on liquidated damages prohibits penalties, providing that "unreasonably large liquidated damages [are] void as a penalty." The ultimate enforceability of these provisions will turn on whether the exercise of the remedy in the contractual clause was reasonable. Particular care should be exercised if Buyer demands liquidated damages in addition to other damages. These provisions are bracketed so that counsel can consider the most appropriate damages provisions in the relationship.

93. Donation of goods manufactured or otherwise delivered with the use of forced labor may not be permitted by the U.S. Customs and Border Protection, Cargo Security, Carriers and Restricted Merchandise Branch, Office of Trade. Buyer's only option as an importer may be to return or export the goods. Other countries may have similar restrictions on the possession and ownership of merchandise mined, produced, or manufactured in any part with the use of a prohibited class of labor, and such laws, restricting taking title to, or possession of, tainted goods, are beyond the scope of this document. These restrictions must be examined before donations are made.

Supplier, destruction or donation of Nonconforming Goods rejected [or as to which acceptance was revoked],[94] and any conduct by Buyer required by law that would otherwise constitute acceptance, shall not be deemed acceptance and will not trigger a duty to pay for such Nonconforming Goods.[95] Buyer and Supplier represent and agree that this Section and any related Sections are an effort to mitigate damages, as selling, profiting from, and being associated with tainted goods or Nonconforming Goods is likely to be damaging to Buyer, including to Buyer's reputation.

6.5 *Indemnification; Comparative Fault Calculation.*

(a) Supplier shall indemnify, defend and hold harmless Buyer and its officers, directors, employees, agents, affiliates, successors and assigns (collectively, "Indemnified Party") against any and all losses, damages, liabilities, deficiencies, claims, actions, judgments, settlements, interest, penalties, fines, costs or expenses of whatever kind, including, without limitation, the cost of storage, return, export or destruction of Goods, the difference in cost between Buyer's purchase of Supplier's Goods and replacement Goods, reasonable attorneys' fees, audit fees that would not have been incurred but for Supplier's Schedule P Breach, and the costs of enforcing any right under this Agreement or applicable law, in each case, that arise out of the violation of Schedule P by Supplier or any of its Representatives. This Section shall apply, without limitation, regardless of whether claimants are contractual counterparties, investors, or any other person, entity, or governmental unit whatsoever.

(b) Notwithstanding Section 6.5(a), Supplier's obligation to indemnify Buyer shall be reduced proportionately to the degree that Buyer's breach of Section 1.3 [and/or Schedule Q] caused or contributed to Supplier's breach of Schedule P; in other words, for the avoidance of doubt, damages shall be borne by Buyer directly to the extent Buyer has materially caused or contributed to the breach of Schedule P.[96]

94. *See supra* note 84 (on revocation of acceptance).

95. This section is drafted to address concerns that might be raised with respect to the U.C.C. § 1-305 mandate to place the aggrieved party in the position of its expectation, without award of consequential or penal damages unless specifically allowed, particularly with respect to minimizing damages. *See also* U.C.C. § 2-715 (2011) (consequential damages cannot be recovered if they could have been prevented). An attempt by Buyer to avoid mitigation might be seen as a lack of good faith. Nevertheless, reselling goods that are produced in violation of a human rights policy may be understood as increasing Buyer's damages, rather than reducing them. Accordingly, Buyer should be entitled to discard, destroy, export, or donate to a charity any goods produced in violation of a human rights policy as an attempt toward mitigation, rather than against it.

96. For example, if Supplier agrees to a change order requested by Buyer and the parties should know that Supplier will be unable to perform without violating Schedule P, indemnification to Buyer must be reduced to the extent, pro rata, that Buyer caused or contributed to the harm. This clause sets up a mechanism akin to a comparative fault regime.

7 ***Disclaimers.***

7.1 *Negation of Buyer's Contractual Duties Except as Stated.* Notwithstanding any other provision of this Agreement:

(a) Buyer does not assume a duty under this Agreement to monitor Supplier or its Representatives, including, without limitation, for compliance with laws or standards regarding working conditions, pay, hours, discrimination, forced labor, child labor, or the like, except as stated in Articles 1 and 2.[97]

(b) Buyer does not assume a duty under this Agreement to monitor or inspect the safety of any workplace of Supplier or its Representatives nor to monitor any labor practices of Supplier or its Representatives, except as stated in Articles 1 and 2.[98]

(c) Buyer does not have the authority and disclaims any obligation to control (i) the manner and method of work done by Supplier or its Representatives, (ii) implementation of safety measures by Supplier or its Representatives, or (iii) employment or engagement of employees and contractors or subcontractors by Supplier or its Representatives. The efforts contemplated by this Agreement do not constitute any authority or obligation of control. They are efforts at cooperation that leave Buyer and Supplier each responsible for its own policies, decisions, and operations. Buyer and Supplier and Representatives remain independent and are independent contractors. Nor are they joint employers, and they should not be considered as such.[99]

(d) Buyer assumes no duty to disclose the results of any audit, questionnaire, or information gained pursuant to this Agreement other than as required by applicable law, except to the extent Buyer must disclose information to Supplier as expressly provided in this Agreement.[100]

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97. Federal contractors should note the FAR, 48 C.F.R. §§ 52.222-56, 22.1703(c), which requires contractors, within threshold limits, to "monitor, detect, and terminate the contract with a subcontractor or agent engaging in prohibited activities." This disclaimer does not negate a duty arising under the FAR or any other regulation or law; it simply disclaims any such *contractual* duty by Buyer. As discussed in the introduction, buyers may have duties under applicable laws, regulations, and their own corporate commitments; the purpose of these disclaimers is to negate liability based on this Agreement, except as stated in Articles 1 and 2.

98. Again, note the FAR, *see* 48 C.F.R. §§ 52.222-56, 22.1703(c), and again, note that buyers may be subject to duties that do not arise by contract, as explained in *supra* note 97.

99. *Note the possible conflict here with Buyer's remedies under Section 6.2(c). See also supra* note 90. This disclaimer is included to help negate claims of undertaking liability or liability under the peculiar risk doctrine. It could conflict, however, with some legislative efforts currently being considered and debated in the European Union.

100. This provision emphasizes that Buyer is assuming a limited contractual duty to disclose, although Buyer may have duties to disclose under other standards (legal or nonlegal). For example, Buyer must determine if it provided false or misleading information to Customs and Border

7.2 *Third-Party Beneficiaries.* [All buyers and suppliers in the supply chain have the right to enforce the relevant provisions relating to the human rights protections set forth herein and in Schedule P [and Schedule Q] and privity of contract is hereby waived as a defense by Buyer and Supplier provided, however, that there are otherwise no third-party beneficiaries to this Agreement. Individuals or entities, including but not limited to associations, workers, land owners, property owners, those residing, working and/or recreating in proximity to supply chain activities and any individual who is injured or suffers damages due to a violation of human rights have no rights, claims, causes of action or entitlements against Buyer or Supplier arising out of or relating to this Agreement, Schedule P, [Schedule Q] or any provision hereunder.] [There are no third-party beneficiaries to this Agreement].[101]

8 ***Dispute Resolution.***[102]

8.1 *Dispute Resolution Procedures.* The parties agree that the procedures set forth in this Article shall be the sole and exclusive remedy in connection with any dispute arising in whole or in part from or relating to

Protection and other officials in the event that goods are initially accepted and removed from the dock but are later determined to be tainted by forced or child labor. If the original information provided to CBP is false, a duty to amend may arise. *See, e.g.,* 18 U.S.C. § 541 (2018); 19 C.F.R. § 12.42(b) (2021). As another example, under the FAR, contractors and subcontractors must disclose to the government contracting officer and agency inspector general "information sufficient to identify the nature and extent of an offense and the individuals responsible for the conduct." 48 C.F.R. § 22.1703(d) (2021).

101. Third-party beneficiaries are a controversial issue. Two alternatives are given here. When licensing is involved, those parties choosing the first bracketed option will want to consider giving enforcement rights to licensors and/or licensees and not only buyers and suppliers. See also *supra* note 69 for a third alternative affirmatively granting third-party beneficiary status to stakeholders. The ultimate decision may be affected by the outcome of discussions with respect to a possible mandatory treaty on business and human rights. *See* The Second Revised Draft of a Treaty on Business and Human Rights by the Open-Ended Intergovernmental Working Group on Transnational Corporations and Other Business Enterprises with Respect to Human Rights (OEIGWG), established by U.N. Human Rights Council Resolution 26/9 (Aug. 6, 2020). It could also be affected by legislative developments in the European Union.

102. These dispute resolution options should be considered in light of the dispute resolution clauses in the sales contract. Article 8 may or may not be suitable for all applications and should be considered in the context of Buyer's existing internal policies and Buyer's customary contractual terms regarding the resolution of disputes and claims, including Buyer's standard form and template procurement agreements; the standard terms and conditions of Buyer's purchase orders; and the Buyer's supplier codes of conduct (Schedule P) or analogous documents that include, *inter alia,* administrative, operational, remedial and/or corrective action procedures, processes, sanctions, and penalties. Dialogue, settlement, and remediation of any controversy arising from a human rights abuse offer victims the most favorable and expeditious resolution, but it is also possible that both human rights abuse and other contractual breaches could be involved. The corporate culture of a company will likely determine whether arbitration or litigation is the preferred route to follow for breaches unrelated to Schedule P [or Schedule Q], provided that under no likely circumstance would a party agree to bifurcate its chosen resolution of such multiple disputes. A mediation-during-the-pendency-of litigation clause is therefore included here.

Articles 1 through 7 or Schedule P [or Schedule Q], whether such dispute involves Buyer, Supplier, or a Representative[103] (a "Dispute"). Buyer and Supplier irrevocably waive any right to commence any action in or before any court or governmental authority, except as expressly provided in this Article 8. Notwithstanding anything contained herein to the contrary, however, at any point in the proceedings under this Article 8, the parties may agree to engage the services of a neutral facilitator to assist in resolving any Dispute.

8.2 [*Confidentiality.*[104] All documents and information concerning the Dispute, including all submissions of the parties, all evidence submitted in connection with any proceedings, all transcripts or other recordings of hearings, all orders, decisions and awards of the arbitral tribunal and any documents produced as a result of any informal resolution of a dispute, shall be confidential, except with the consent of both parties or where, and to the extent, disclosure is required of a party (a) by legal duty, (b) to protect or pursue a legal right, or (c) in relation to legal proceedings before a court or other competent authority.]

8.3 *Joinder of Multiple Parties.* If one or more other disputes arise between or among parties to other contracts that are sufficiently related to the same or similar actual or threatened human rights violations, the

103. This Agreement explicitly provides that every supplier and buyer in the chain is bound to Schedule P [and Schedule Q] and the Agreement provisions relating to human rights protections. Involvement of Representatives is therefore contemplated in this clause. *See generally* Int'l Chamber of Commerce Rules of Arbitration art. 7 (2017) ("Joinder of Additional Parties"); GE Energy Power Conversion Fr. SAS, Corp. v. Outokumpu Stainless USA, LLC, 140 S. Ct. 1637, 1645–45, 1648 (2020) (finding that in certain circumstances, nonsignatories may compel arbitration of international disputes and equitable estoppel may apply).

104. Confidentiality is usually perceived as among the advantages of arbitration, including international commercial arbitration, over litigation and public filings. Confidentiality comes with drawbacks, however, particularly where the proceeding affects the public interest, as is likely true when a dispute relates to human rights. This provision is bracketed, and the parties should carefully negotiate and omit or adapt the text to reflect the form of confidentiality or transparency that best suits their efforts to mediate or arbitrate. Note that the UNGPs do not require full transparency. UNGP 31(e), *supra* note 7, expects that nonjudicial grievance mechanisms will keep parties informed and "provid[e] sufficient information about the mechanism's performance to build confidence in its effectiveness and meet any public interest at stake." The commentary states, "Communicating regularly with parties about the progress of individual grievances can be essential to retaining confidence in the process. Providing transparency about the mechanism's performance to wider stakeholders, through statistics, case studies or more detailed information about the handling of certain cases, can be important to demonstrate its legitimacy and retain broad trust. At the same time, confidentiality of the dialogue between parties and of individuals' identities should be provided where necessary." *Id.* (quoting commentary). The Hague Rules on Business and Human Rights (BHR) Arbitration, *supra* note 45, call for total transparency of all proceedings. The Hague BHR Rules aim to fill the judicial remedy gap in the UNGPs and should be considered by those companies committed to the UNGPs. In any case, those who are not legally required to disclose discovered human rights abuses and who hope to protect any Dispute from public dissemination, especially before cure or remediation is in place, must verify the applicable chosen rules regarding confidentiality or should include express provisions in the arbitration provisions that deal with confidentiality. This section requires total confidentiality unless otherwise required. The bracketed portion of Section 8.8 below, however, allows for an agreed-upon release of redacted final orders and awards.

parties shall use their best efforts to consolidate any such related disputes for resolution under this Article 8.

8.4 *Informal Good Faith Negotiations Up the Line*. The parties shall try to settle their Dispute amicably between themselves by good faith negotiations, initially in the normal course of business at the operational level. If a Dispute is not resolved at the operational level, the parties shall attempt in good faith to resolve the Dispute by negotiation between executives who hold, at a minimum, the office(s) of [TITLE(S)]. Either party may initiate the executive negotiation process at any time and from time to time by providing notice [in accordance with Section 2.1(c)] (the "Dispute Notice"). Within no more than five (5) days[105] after the Dispute Notice has been given, the receiving party shall submit to the other a written response (the "Response"). The Dispute Notice and the Response shall include (a) a statement of the Dispute, together with a recital of the alleged underlying facts, and of the respective parties' positions and (b) the name and title of the executive who will represent that party and of any other person who will accompany the executive. The parties agree that such executives shall have full and complete authority to resolve the Dispute. All reasonable requests for information made by one party to the other will be honored. If such executives do not resolve such dispute within [twenty (20)] days of receipt of the Dispute Notice for any reason, the parties shall have an additional [ten (10)] days thereafter to reach agreement as to whether to seek to resolve the Dispute through mediation under Section 8.5.[106]

8.5 *Mediation*. If the parties do not resolve any Dispute within the periods specified in Section 8.4, either party may, by notice given in accordance with Section 2.1(c) (the "Mediation Notice"), invite the other to resolve the Dispute under the [insert name of rules] as in effect on the date of this Agreement (the "Mediation Rules"). The language to be used in the mediation shall be [language]. If such invitation is

105. The number of days appropriate for good faith negotiations may vary based on the severity or breadth of the Schedule P Breach as well as Buyer's ability to find another source for the products at issue.

106. A commitment to enter into mediation need not be complex, and these Model Clauses use the short and simple clauses recommended by such institutions as the PCA and UNCITRAL. Other institutions that provide mediation services may not accept clauses such as these, and the drafter should consult with such other institutions to determine what text to employ. Reference should be made to Model Arbitration Clauses for the Resolution of Disputes Under Enforceable Brand Agreements at https://laborrights.org/sites/default/files/publications/%20Model%20Arbitration%20Clauses%20for%20the%20Resolution%20of%20Disputes%20under%20Enforceable%20Brand%20Agreements.pdf. *See also* Clean Clothes Campaign et al., *Model Arbitration Clauses for the Resolution of Disputes Under Enforceable Brand Agreements*, INT'L LAB. RTS. F. (June 24, 2020), https://laborrights.org/publications/model-arbitration-clauses-resolution-disputes-under-enforceable-brand-agreements.

accepted, a single mediator shall be chosen by the Parties. If, within [______] days following the delivery of the Mediation Notice, the invitation to mediate is not accepted, the parties shall resolve the Dispute through [arbitration][litigation] under Section 8.6. [If the parties are unable to agree upon the appointment of a mediator, then one shall be appointed by the [insert title of official at the named institution].]

8.6 *[In this clause, companies choose between arbitration (Alternative A) and litigation (Alternative B).] [Arbitration] [Litigation].* If and only if the parties (a) have chosen not to make use of Mediation under Section 8.5 to resolve the Dispute, or (b) have not, within [____] days following the delivery of the Dispute Notice, resolved the Dispute using such Mediation, then the Dispute shall be settled

[Alternative A for arbitration.] [by arbitration in accordance with the [name of rules of the arbitration institution] (the "Arbitration Rules") in effect on the date of this Agreement.[107] The number of arbitrators shall be [one] [three]. The seat of arbitration shall be [seat] and the place shall be [place]. The language of the proceedings shall be [language]. [The provisions for expedited procedures contained in [section or article] of the Arbitration Rules shall apply irrespective of the amount in dispute. The parties further agree that following the commencement of arbitration, they will continue to attempt in good faith to reach a negotiated resolution of the Dispute.[108]]

[Alternative B for litigation.] [in accordance with ____ [here refer to the choice of forum and related clauses of the main supply contract].[109] Notwithstanding the commencement of litigation, if the parties are subsequently able to resolve the Dispute through negotiations or mediation,

107. In selecting the applicable Arbitration Rules, the parties must be sure the scope of discovery and the cost allocation are acceptable and can add text deviating from what is provided within such provisions if not.

108. *Singapore Arb-Med-Arb Clause*, SING. INT'L ARB. CTR., siac.org.sg/model-clauses/the-singapore-arb-med-arb-clause (last visited Feb. 15, 2021) ("Arb-Med-Arb is a process where a dispute is first referred to arbitration before mediation is attempted. If parties are able to settle their dispute through mediation, their mediated settlement may be recorded as a consent award. The consent award is generally accepted as an arbitral award, and, subject to any local legislation and/or requirements, is generally enforceable in approximately 150 countries under the New York Convention. If parties are unable to settle their dispute through mediation, they may continue with the arbitration proceedings.").

109. If the parties do not wish to include mediation and/or arbitration provisions, the Model Clauses assume somewhere in the underlying master agreement they have included standard text addressing litigation issues such as the choice of law and choice of forum, consent to jurisdiction and service of process, and any desired waivers (e.g., of objection, of defense, of jury trial); these litigation provisions are not included in these Model Clauses.

any resultant resolution may be made a consent judgment on agreed terms.]

8.7 [Only for use with Alternative A for arbitration.] *[Emergency Measures.* Notwithstanding any provision of this Agreement or any applicable institutional rules, any party may obtain emergency measures at any time to address a Zero Tolerance Activity or any other imminent threat to health, safety, or physical liberty (including without limitation the holding of workers in locked barracks or the unavailability of accessible and unlocked emergency exits). In addition, a party may make an application for emergency relief to the [name of institution] (the "Arbitration Institution") for emergency measures under the arbitration rules of the Arbitration Institution as in effect on the date of this Agreement.[110] If and only if the arbitral tribunal does not have the power to grant effective emergency measures or other specific relief may a party apply for relief to a court of competent jurisdiction that possesses the power to grant effective emergency measures.]

8.8 [Only for use with Alternative A for arbitration.] [*Arbitration Award.* The arbitrator(s) may grant any remedy or relief set forth in Article 6 or elsewhere in this Agreement that a court of competent jurisdiction could grant, except that the arbitrators may not grant any relief or remedy greater than that sought by the parties, nor any punitive damages. The award shall include compliance with a Remediation Plan as contemplated by Article 2 above. [The arbitration tribunal shall send a copy of each final order, decision and award to [title of official and name of institution] so that the public may have access to such documents, provided that, prior to sending any such document to such repository, such arbitration tribunal, in consultation with each of the parties, shall redact any information from such document that (a) would reveal the identity of any party that wishes to remain anonymous; or (b) disclose any other information (including without limitation the amount of any award, any proprietary information or any trade secrets) that a party wishes to remain confidential.]]

110. Several standard arbitration systems contemplate a financial harm ceiling for the application of expedited procedures, which will not be applicable in the context of the discovery of human rights abuses where the harm is not necessarily or primarily a financial harm to be suffered by one of the parties. The following alternate wording could be added: "The provisions for expedited procedures contained in the Arbitration Rules shall apply, provided the discovered harm is ongoing and steps to immediately address and cure are possible but not being voluntarily implemented."

Schedule P Building Blocks

The development of an enterprise-wide culture to address human rights violations in the workplace is essential. These violations include not only modern slavery and child labor but also recruitment fees, confiscation of travel documents, travel permits, or room and board fees, insufficient pay, harassment, brutal hourly demands, restrictions on freedom of association, toxic exposure on the job site, and dangerous facility conditions. Only such a pervasive culture can identify the risks of a company's involvement in potential human rights harms that could violate both current and emerging global regulations.[1] A generalized reference in Schedule P to observance by the supplier of all international human rights or a boilerplate reference to supplier codes cannot yield an effective tool to identify and manage the appropriate response to very real and ongoing threats to human rights given "salient risks" within a supply chain.[2]

Overview

The UN Guiding Principles on Business and Human Rights ("UNGPs") were unanimously adopted by the UN Human Rights Council in June 2011. The Organisation for Economic Co-operation and Development Guidelines for Multinational Enterprises ("OECD MNE Guidelines") were revised to include a new human rights chapter that was consistent with the UNGPs that same year. Since 2011, the UNGPs and the OECD MNE Guidelines have enjoyed ever-growing recognition in the international business community across sectors as documents that define responsible business conduct ("RBC"), notwithstanding characterization as voluntary standards and therefore "soft law."

1. *See* Elise Groulx Diggs, Mitt Regan & Beatrice Parance, *Business and Human Rights as a Galaxy of Norms*, 50 Geo. J. Int'l L. 309, 312 (2019) (articulating a "Galaxy of Norms" that supports the mapping of liability and the rings of responsibility arising from the rapidly evolving discussion of business and human rights (BHR) that includes both hard law and soft law norms).

2. *See* Special Representative of the Secretary-General on the Issue of Human Rights and Transnational Corporations and Other Business Enterprises, Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework, Human Rights Council, annex, U.N. Doc. A/HRC/RES/17/31, Principle 24 (Mar. 21, 2011) [hereinafter UNGPs]. The UNGPs expect businesses to prioritize their attention to salient risks of harm. A salient risk is a likely risk of *severe harm* to individuals, as seen from the perspective of the affected person. Greater weight is given to severity than to likelihood; a severe human rights harm has three attributes: (i) scale (the gravity of the harm, e.g., death, rape, or torture); (ii) scope (a large number of people harmed, e.g., poisoning of a community water supply, a factory collapse); and (iii) irremediability (the harmed person cannot be restored to the same position ex ante). To be considered severe, harm need not have all three attributes. *See* Office of the High Comm'r for Human Rights, The Corporate Responsibility to Respect Human Rights: An Interpretive Guide 8 (2012), https://www.ohchr.org/Documents/Publications/HR.PUB12.2 En.pdf [hereinafter Interpretive Guide].

The UNGPs consist of thirty-one principles grounded in recognition of the following three pillars: (1) states' existing obligations to respect, protect, and fulfill human rights and fundamental freedoms (UNGPs 1–10); (2) the role of business enterprises as specialized organs of society performing specialized functions, required to comply with all applicable laws and to respect human rights (UNGPs 11–24); and (3) the need to match rights and obligations to appropriate and effective remedies (UNGPs 25–31).

Schedule P must focus on the second of the three mutually supporting pillars of the "Protect, Respect, and Remedy" framework from the UNGPs: corporate responsibility to respect human rights. The UNGPs insist that corporate responsibility to respect human rights is a global standard of expected conduct for all business enterprises wherever they operate and independently of any states' abilities and/or willingness to fulfill their own human rights obligations. The UNGPs further explain that such corporate responsibility also exists over and above compliance with national laws and regulations. To protect human rights and address adverse human rights impacts, companies must take adequate measures for the prevention, mitigation, and, where appropriate, remediation of adverse impacts. Businesses are expected to (1) publicize a high-level commitment to respect human rights and embed it in the organization; (2) conduct human rights due diligence ("HRDD"); and (3) remedy harm that it caused or contributed to through a business relationship or through its own actions in tandem with another actor or harm linked to its operations, products, or services.

To comply with the UNGPs, a company must conduct due diligence to measure its human rights impacts according to substantive human rights benchmarks expressed in the International Bill of Human Rights ("IBHR") and International Labour Organization ("ILO") Declaration on Fundamental Principles and Rights at Work.[3]

Identifying a need to promote a common understanding of the meaning and scope of due diligence for RBC, the OECD developed OECD Due Diligence Guidance for Responsible Business Conduct ("Guidance") in 2018 to provide practical support to enterprises on implementation of the OECD Guidelines, with explanations of its due diligence recommendations. The Guidance seeks to align with the UNGPs, the ILO Declaration on Fundamental Principles and

3. ILO, ILO Declaration on Fundamental Principles and Rights at Work and Its Follow-up (2010), https://www.ilo.org/wcmsp5/groups/public/—ed_norm/—declaration/documents/publication/wcms_467653.pdf [hereinafter ILO Declaration]. The ILO published ILO Indicators of Forced Labour in October 2012, which presents the most common signs or "clues" that point to the possible existence of forced labor, in an effort intended to help "frontline" criminal law enforcement officials, labor inspectors, trade union officers, NGO workers, and others who need to identify persons who are trapped in forced labor and who may require urgent assistance. In addition, companies must be aware of the International Recruitment Integrity System (IRIS) Standard created by ILO and IOM, which provides that labor recruiters comply with all applicable legislation, regulations, multilateral and bilateral agreements on labor migration, and policies related to the recruitment of migrant workers in the jurisdictions of origin, transit, and destination, including those pertaining to the immigration or emigration of migrant workers.

Rights at Work, the ILO Conventions and Recommendations referenced with the OECD MNE Guidelines, and the ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy. Note that the OECD has also developed sector-specific due diligence guidance for the minerals, agriculture, and garment and footwear supply chains and good practice papers for the extractives and financial sectors.[4]

The Guidance explains that enterprises should carry out due diligence to identify, prevent, mitigate, and account for how they address actual and potential adverse impacts in their own operations, their supply chain, and other business relationships as recommended in the OECD MNE Guidelines. Effective HRDD should, per the Guidance, be supported by efforts to embed RBC into policies and management systems to enable enterprises to remediate adverse impacts that they cause or to which they contribute. HRDD is an ongoing process that should commence prior to contracting and must continue during the life cycle of the contract, including its end. It should be designed to assess and govern a business enterprise's impact on human rights and not the impact of human rights on a business enterprise. After properly diagnosing risks, ongoing HRDD should ensure that corporate responses are fit to context and provide individuals with the type of support they need, actually mitigating and preventing further harm and producing positive human rights outcomes.

Schedule P should refer specifically to the salient risks that the business discovers in its supply chain after extensive HRDD, including not only the possibility of modern slavery and child labor but also, for example, environmental catastrophe, violence from company security forces, compromised workplace safety, or discrimination and harassment. Schedule P should be as clear as possible when defining salient risks within the supply chain.

Such clarity is not possible without comprehensive HRDD. Due diligence is mandatory in some European countries, and many other countries are now considering similar bills.[5] On April 29, 2020, the European Commissioner of Justice, Didier Reynders, announced that the European Union would propose new mandatory HRDD legislation. Whether that legislation or regulations promulgated under it will identify specific HRDD acts or a safe harbor process is yet to be seen.

4. *See* OECD, OECD Due Diligence Guidance for Responsible Business Conduct (OECD Publishing, 3d ed. 2018), https://mneguidelines.oecd.org/OECD-Due-Diligence-Guidance-for-Responsible-Business-Conduct.pdf; for more information on sector-specific publications, see *Due Diligence Guidance for Responsible Business Conduct*, OECD, https://www.oecd.org/investment/due-diligence-guidance-for-responsible-business-conduct.htm (last accessed Nov. 21, 2021).

5. The French law on the Duty of Vigilance, the Swiss Responsible Business Initiative, and the German Supply Chain campaign embed the UNGPs and OECD due diligence standards into law. Mandatory due diligence laws require companies to "identify, prevent, mitigate, and account for the negative human rights impacts of their activities or those linked to their business relationships." Eur. Coal. for Corporate Just., Key Features of Mandatory Human Rights Due Diligence Legislation (2018), https://corporatejustice.org/eccj-position-paper-mhrdd-final_june2018_3.pdf. Find the latest news on mandatory HRDD at www.business-humanrights.org/en/mandatory-due-diligence. As these materials were being prepared for press, legislative developments continued. Some updates as of that time can be found in *supra* notes 5 and 6.

The ETI Base Code,[6] founded on ILO conventions[7] and used widely across sectors, is an "internationally recognized code of good labor practice . . . used as a benchmark against which to conduct social audits and develop ethical trade action plans."[8] "The provisions of the Base Code constitute minimum and not maximum standards" but nevertheless include nine categories, as follows: "1. Employment is freely chosen [i.e., no forced labor]; 2. Freedom of association and the right to collective bargaining are respected; 3. Working conditions are safe and hygienic; 4. Child labor shall not be used;[9] 5. Living wages are paid; 6. Working hours are not excessive; 7. No discrimination is practiced; 8. Regular employment is provided; and 9. No harsh or inhumane treatment is allowed."[10] Some codes expand on these categories to include community-wide impact, environmental issues, and land rights. SMETA[11] is an audit methodology providing a compilation of what are recognized as practical and ethical techniques.[12] It includes a rating system for the severity of non-compliance when evaluating any one of the nine categories above, from "[b]usiness critical non-compliance" being the most severe to "[c]ritical non-compliance," "[m]ajor non-compliance," or "[m]inor non-compliance," the last-named being the least severe.[13] The corresponding timescales for remediation range from zero to ninety days, with "business critical issues" requiring an immediate response (i.e., zero days) to correct the issue.[14] Once a customer begins or takes corrective action, an auditor verifies the adequacy of the business's actions either remotely or onsite.[15] SMETA should be used to supplement a business's systems, as it is not "intended as a standalone document."[16]

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6. The Ethical Trading Initiative (ETI) is an "alliance of companies, trade unions, and NGOs that promotes respect for workers' rights around the globe." *About ETI*, ETHICAL TRADING INITIATIVE, https://www.ethicaltrade.org/about-eti (last visited Feb. 2, 2021).

7. *See* ILO Declaration, *supra* note 3.

8. *See* ETHICAL TRADING INITIATIVE, THE ETI BASE CODE (2018), https://www.ethical trade.org/sites/default/files/shared_resources/ETI%20Base%20Code%20%28English%29_0.pdf (introduction).

9. The UN Convention on the Rights of the Child (1989) provides: "For the purposes of the present Convention, a child means every human being below the age of eighteen years unless under the law applicable to the child, majority is attained earlier." Convention on the Rights of the Child art. 1, Nov. 20, 1989, 1577 U.N.T.S. 3. "In Spanish-speaking countries in Latin America, it is usual practice to distinguish between the boys and girls, on the one hand, and older adolescents, thereby recognizing that adolescents are more mature and can take on more responsibilities than younger children." ETI BASE CODE, *supra* note 8, at 12.

10. ETI BASE CODE, *supra* note 8, at 1.

11. The Sedex Members Ethical Trade Audit (SMETA) "is designed to help auditors conduct high quality audits that encompass all aspects of responsible business practice," including "labor, health and safety, environment and business ethics." *SMETA Audit*, SEDEX, https://www.sedex.com/our-services/smeta-audit/ (last visited Feb. 2, 2021); *SMETA*, SEDEX, https://www.sedex.com/wp-content/uploads/2021/01/SMETA-flyer-1-1.pdf (last visited Feb. 2, 2021) (referencing general flyer about SMETA).

12. *See SMETA*, SGS (Apr. 1, 2019), https://www.sgs.com/en/news/2019/04/safeguards-03619-smeta-audits-an-introduction#:~:text=SMETA%20is%20an%20audit%20methodology,%2C%20environment%2C%20and%20business%20ethics.

13. SEDEX, SEDEX MEMBERS ETHICAL TRADE AUDIT (SMETA) NON-COMPLIANCE GUIDANCE 3 (2018), http://www.sipascr-peru.com/wp-content/uploads/2018/09/Sedex-Members-Non-Compliance-Guidance-v.2-2018.pdf

14. *Id.* at 4.

15. *See id.* at 5.

16. *Id.* at 1.

Almost all codes adopt a similar approach, with varying emphasis and different levels of tolerance for certain non-compliances. The drafters of a company's Schedule P could use the ETI Base Code and SMETA audit framework as a starting point to identify and map risks determined in the company's essential, pre-contract due diligence. Schedule P should define what the buyer and supplier agreed will constitute important terms, such as "severity," "salient risks," and "child labor." Schedule P also should include a process for handling discovered non-compliances that prioritizes attention to salient risks and expects buyer and/or supplier to respond based on their level of involvement depending on findings of "cause," "contribution," and "linkage." A finding of "cause" should trigger a need to fix, remedy, and prevent, while a finding of "contribution" triggers a need to fix, remedy, and prevent through leverage and possible contract suspension and even termination. A finding of "linkage" should trigger efforts to prevent through leverage and possible contract suspension or termination.

Moving Beyond Abstract to the Concrete

The contents of each company's Schedule P policy statement will vary depending on the parties, the contract, and the salient risks at different tiers of the chain. Schedule P should be the result of extensive, ongoing HRDD. UN Guiding Principles 17 through 21 enumerate the due diligence process: (1) identify risks of harm to people and their environment; (2) respond to risk in an integrated fashion (which varies according to the mode of involvement; that is, cause, contribution, or linkage); (3) monitor and track performance; and (4) disclose risks and impacts to affected stakeholders.[17] This same process can be broken down to include: (a) risk mapping; (b) regular assessment; (c) actions to mitigate; (d) alert mechanisms; and (e) monitoring and evaluating for specific issues and possible routes to address those issues.[18] For example, there may be pollution of drinking water at one tier, security force violence at a second tier, and dangerous working conditions at a third. Boilerplate text to cover all potential risks will not result in the parties' clear understanding of what needs to be done and may be useful only to identify a breach rather than guide conduct. Schedule P should not consist solely of a list of possible internationally recognized human rights that the supplier reviews and checks off as an assurance of current and ongoing compliance without true investigation. Rather, it should specify in practical and concrete terms the types of conduct by the parties that would constitute human rights abuse and identify which abuses justify suspension or even termination of the contract. Schedule P must also acknowledge the potential existence of other risks or abuses in the supply chain identified later or inadequately during the initial due diligence processes that may have to be

17. *See* Interpretive Guide, *supra* note 2, at 31–63 (discussing UNGPs 17–21).
18. *See Our Solutions*, Sedex, https://www.sedex.com/our-services/ (last visited Feb. 2, 2021) (linking to categories).

addressed with a response other than, or including, suspension or termination.[19] Sector- and conduct-specific multi-stakeholder human rights standards, such as the Voluntary Principles on Security and Human Rights[20] and the Fair Labor Association's revised Principles of Fair Labor and Responsible Supply Chains of Minerals from Conflict-Affected and High Risk Areas, as supplemented, might be incorporated or referenced where appropriate. A meaningful Schedule P is the result of extensive and ongoing due diligence and a history of dialogue between buyer and supplier that establishes clear and enforceable standards preserved in a written and understood action plan.

Critical Components of a Compliance Program

At a minimum, the content of a Schedule P, which is consistent with international standards, should:

(1) specify and define clearly the salient human rights risks that the parties have identified in HRDD, the manifestation of which will constitute a breach of Schedule P, leaving flexibility for salient risks that were missed in any precontract HRDD;

(2) specify relevant statutes and regulations that the parties and all subcontractors or other agents are expected to comply with during the course of the contract or other relationship;

(3) specify the parties' internal codes that all those in the supply chain are expected to know and honor;

(4) specify any multi-stakeholder standards that are relevant; and

(5) specify any relevant auditing protocols.

For companies looking for a more comprehensive list of Schedule P building blocks, a number of concrete tools are available to assist a company in designing an effective Schedule P statement that articulates its human rights policies. Schedule P should address precontract due diligence at length, and a concrete remediation plan should be derived therefrom. This seems logical: buyer and supplier should both be reluctant to enter into agreements without knowing in advance whether they might, and how they might, address hypothetical, let alone known, existing problems. Hence, Schedule P is expected to lead to some form of "remediation plan" that exists at the outset or that the parties agree to develop soon after signing. This plan would articulate long-term goals

19. *See* OECD, OECD Due Diligence Guidance for Responsible Business Conduct 74–81 (2018), http://mneguidelines.oecd.org/OECD-Due-Diligence-Guidance-for-Responsible-Business-Conduct.pdf (recommending training, implementing new policies, or "linking business incentives" to prevent and mitigate risks and ongoing human rights abuses).

20. Voluntary Principles Initiative, Voluntary Principles on Security and Human Rights (2000), http://www.voluntaryprinciples.org/wp-content/uploads/2019/12/TheVoluntaryPrinciples.pdf.

(on a prioritized basis) and interim steps that each party will take, either alone or in conjunction with others, as well as dates for achieving these steps and reporting and monitoring requirements.

One highly useful practical tool is the 2016 report, *Doing Business with Respect for Human Rights: A Guidance Tool for Companies*,[21] a collaboration between the Global Compact Network Netherlands, Oxfam, and Shift. The report provides practical guidance on how a company can set the overall tone on human rights through its policy commitments, how it can embed those commitments into the company's DNA, how it can move from reactively to proactively assessing its impacts, how it can integrate its human rights policy into its interactions with business partners and act in response to discovered human rights risks, how it can evaluate its successes and failures, how it can make the stated commitments meaningful by engaging with stakeholders, and how to respond promptly and effectively to solve human rights problems.[22] Appendix B to the report provides a detailed summary of what should go into a policy commitment, including types of general and specific statements, implementation processes, and who is responsible for implementation, evaluation, and updates to the policy.[23]

Another widely used resource is the 2017 UN Guiding Principles Reporting Framework,[24] a collaboration between the Shift Project and international accounting firm, Mazars LLP. It consists of a short list of targeted questions designed to increase internal and external understanding of a company's human rights policies and practices by assessing the quality of how the company identifies and manages each of its salient human rights risks.[25]

To be effective, the human rights expectations of Buyer in the Model Clauses have to be articulated and then enforced at every level of the supply chain. Supplier, as well as every lower tier supplier, must certify that it is fully familiar with all of the terms of the agreed upon Schedule P and the conditions under which the services are to be performed. Each tier supplier must enter into its agreement based on its own ongoing investigation of all human rights matters within the scope of its operations and cannot rely on the opinions or representations of other suppliers. Schedule P must, therefore, include a "perpetual clause" such that each supplier binds its lower tier supplier(s) to all of the performance obligations and responsibilities that Supplier assumes toward Buyer under Schedule P.

In this manner, Schedule P would be incorporated into every subsequent agreement or arrangement in the supply chain, insofar as it relates in any way,

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21. Shift et al., Doing Business with Respect for Human Rights: A Guidance Tool for Companies (2d ed. 2016), https://shiftproject.org/wp-content/uploads/2020/01/business_respect_human_rights_full-1.pdf.

22. *See id.* at 4–5.

23. *See id.* at 123–29.

24. Shift Project Ltd. & Mazars LLP, UN Guiding Principles Reporting Framework (2015), https://www.ungpreporting.org/; *see also* Shift Project Ltd. & Mazars LLP, UN Guiding Principles Reporting Framework with Implementation Guidance (2015), https://www.ungpreporting.org/wp-content/uploads/UNGPReportingFramework_withguidance2017.pdf.

25. *See* UN Guiding Principles Reporting Framework, *supra* note 24, at 2–3.

directly or indirectly, to the services or products in the chain. Each supplier agrees to be bound to the supplier that engaged its services in the same manner and to the same extent as the Supplier who contracted with Buyer in the master agreement. Where, in Schedule P and the Model Clauses, reference is made to Supplier and the work or specifications pertain to Supplier's trade, craft, or type of work, such work or specifications shall be primarily interpreted to apply to the next tier supplier. To be precise, there would be a general reference to a requirement, say, for example, no forced labor, and a more specific section prohibiting the use of conflict minerals in a contract for electronics or, in a contract for garments, no cotton from particular named places.

It is the Working Group's intention that Supplier shall have the benefit of all rights, remedies, and redress against a subsequent tier supplier that Buyer has against Supplier under the prime contract, and each lower tier supplier shall have the benefit of all rights, remedies, and redress against Supplier that Supplier has against Buyer under the prime contract, subject to the restrictions and limitations of the Model Clauses and only insofar as any of the foregoing is applicable to Schedule P. If deemed desirable and appropriate, both Schedule P and the Model Clauses can make it clear that Buyer has the direct right to claim a human rights breach by a supplier within the chain below the Supplier that is a party to the master agreement and that Supplier and each lower tier supplier has the same right in its role as a lower tier buyer vis-à-vis the lower tier supplier.

Even if Schedule P goes beyond traditional privity and applies up and down the chain, many insist that there is little likely enforcement of the Model Clauses or Schedule P that effectively addresses human rights representations without the inclusion of impacted stakeholders. "Next Generation Supplier Codes," a phrase adopted by the Corporate Accountability Lab, include provisions and enforcement mechanisms that:

- allow workers, survivors of deceased workers, land owners and impacted community members to enforce Schedule P [or Schedule Q], that is, provide third-party beneficiary language, and grant these third-party beneficiaries the ability to assign their rights to a labor union, nongovernmental organization, or other organizations providing legal assistance;
- require notification and education of workers with respect to their rights;
- require the supplier to disclose all its production factories so that the buyer may access and facilitate compliance monitoring; and
- require the supplier to commit to refraining from retaliation against stakeholders who bring or consider bringing enforcement actions.

Sample third-party beneficiary clauses to be added to a buyer-supplier agreement can be found at Corporate Accountability Lab, "Towards Operationalizing Human Rights and Environmental Protection in Supply Chains:

Worker-Enforceable Codes of Conduct" (Feb. 2021), https://corpaccountabilitylab.org/publications.

A. Organizational Standards

1. UN Guiding Principles on Business and Human Rights (2011)

a. Sponsor Organization: United Nations

b. Link:
https://www.ohchr.org/documents/publications/guidingprinciplesbusinesshr_en.pdf

c. Description: The UNGPs are the authoritative global standard on business and human rights, and resulted from a six-year process of multi-stakeholder consultations, research, and pilot projects, under the direction of their author, Harvard Kennedy School Professor John Ruggie, then the Special Representative of the UN Secretary-General on Business and Human Rights (SRSG). The UNGPs rest on three interrelated pillars: "the state duty to protect human rights, the business responsibility to respect human rights, and the need for greater access to remedy for victims of business-related abuse."

d. Supplementary/Interpretive Documents:

i. The Corporate Responsibility to Respect Human Rights (2012) (https://www.ohchr.org?Documents/Publications/HR.PUB.12.2_En.pdf).

The UN Office of the High Commissioner on Human Rights (OHCHR) drafted this document with the full approval of the SRSG, providing a comprehensive guide to the understanding and application of the second pillar of the UNGPs.

2. OECD Guidelines for Multinational Enterprises (2011 edition)

a. Sponsor Organization: Organisation for Economic Co-operation and Development (OECD)

b. Link:
https://www.mnguidelines.oecd.org/mneguidelines

c. Description: The OECD MNE Guidelines "provide non-binding principles and standards for responsible business conduct in a global context consistent with applicable standards." They were revised in 2011 to substantially augment their human rights section, in order to align with the UNGPs. In doing so, the OECD imported virtually intact the HRDD process of the UNGPs. The OECD has continued to play an important role in providing concrete guidance to companies that do business in or with the OECD and resolves business and human rights disputes through its nonjudicial National Contact Process dispute resolution system.

d. Supplementary/Interpretive Documents:

   i. OECD Due Diligence Guidance for Responsible Business Conduct (2018) (https://www.mneguildelines.oecd.org/OECD-Due-Diligence-Guildance-for-Responsible-Business-Conduct.pdf).

3. Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy (MNE Declaration) (1977, amended 2017)

a. Sponsor Organization: International Labour Organization (ILO)

b. Link:
https://www.ilo.org/empent/Publications/WCMS_094386/lan–en/index.htm

c. Description: The MNE Declaration is the ILO instrument influencing and guiding a number of international and regional organizations, national governments, and employers' and workers' organizations around the world. It provides direct guidance on social policy and inclusive, responsible, and sustainable workplace training and practices and includes international labor standards and principles addressing specific work issues relating to forced labor, transition from the informal to formal economy, wages, safety and health, access to remedy, and compensation of victims.

4. ILO Declaration on Fundamental Principles and Rights at Work (1998)

a. Sponsor Organization: ILO

b. Link:
https://www.ilo/declaration/thedeclaration/textdeclaration/lang–en/index.htm

c. Description: The ILO Declaration commits member states to respect and promote principles and rights in four categories, whether or not they have ratified the relevant Conventions. These categories are: "freedom of association and the effective recognition of the right to collective bargaining; the elimination of forced or compulsory labor; the abolition of child labor; and the elimination of discrimination in respect of employment and occupation." Member states that have not ratified one or more of the core Conventions are asked each year to report on the status of the relevant rights and principles within their borders, noting impediments to ratification and areas where assistance may be required. These reports are used to create a compilation of baseline tables, by country, and periodic global reports relating to the promotion of the fundamental principles and rights at work.

d. Supplementary/Interpretive Documents:

   i. ILO Indicators of Forced Labour (2012) (https://www.ilo.org/global/topics/forced-labour/publications/WCMS_203832/lang–en/index).

5. IRIS Standard (Version 1.1, 2019)

a. Sponsor Organization: International Organization for Migration (IOM)

b. Link:
https://www.iris.iom.int/iris-standard

c. Description: The International Recruitment Integrity System (IRIS) is the IOM's global, multi-stakeholder initiative to promote ethical recruitment of migrant workers. IRIS is referred to under Objective 6 of the Global Compact for Safe, Orderly and Regular Migration and other intergovernmental frameworks. The IRIS Standard articulates what ethical recruitment means in practice and how labor recruiters can demonstrate compliance. The IRIS Standard and corresponding guidelines serve as a reference point for labor recruiters, employers, and state actors on how to integrate ethical recruitment principles into recruitment-related management systems, policies, regulations, processes, and procedures. To achieve this integration, the IRIS Standard defines operational indicators against which labor recruiters can be measured to assess compliance.

6. Human Rights Principles for Companies (January 1998)

a. Sponsor Organization: Amnesty International

b. Link:
https://www.amnesty.org/download/Documents/148000/act700011998en.pdf

c. Description: Amnesty International asserts that "the business community has a wide responsibility—moral and legal—to use its influence to promote respect for human rights. . . . [It] therefore developed an introductory set of human rights principles, based on international standards, to assist companies in developing their role in situations of human rights violations or the potential for such violations." Its document deals with the responsibility multinational companies have to promote and protect human rights in their own operations.

d. It recommends the development of explicit company policies, training, consulting nongovernmental organizations, and impact assessments. A checklist for use by companies forms part of the document.

7. **ISO 26000: Guidance Standard on Social Responsibility (2010)**

a. Sponsor Organization: International Organization for Standardization (ISO)

b. Link:
https://www.iso.org/iso-26000-social-responsibility.html

c. Description: ISO 26000:2010 is both an international consensus and guidance for assessing an organization's commitment to sustainability and overall ESG performance. It is not a certification process "unlike some other well-known ISO standards. Instead, it helps clarify what social responsibility is, helps businesses and organizations translate principles into effective actions and shares best practices relating to social responsibility, globally. It is aimed at all types of organizations regardless of their activity, size or location."

d. Supplemental/Interpretive Documents:

i. Communication Protocol—describes appropriate wordings organizations can use to communicate about their use of ISO 26000 (https://www.iso.org/files/live/sites/isoofg/files/standards/doc/en/iso_26000_comm_protocol_n.15.pdf).

ISO 26000 basic training materials in the form of a PowerPoint and training protocol guidance (https://www.iso.org.files/live/sites/isoorg/files/standards/docs/en/ISO_26000_basic_training_material_annexslides_2017.pptx).

ii. Documents that link ISO 26000 with the OECD Guidelines for Multinational Enterprises and the United Nations 2030 Agenda (Sustainable Development Goals)

A. ISO 26000 and OECD Guidelines—Practical Overview of the Linkages (https://www.iso.org/publications/PUB100418.html).

B. ISO 26000 and SDGS (https://www.iso.org/publication/PUB100401.html).

8. **Doing Business with Respect for Human Rights: A Guidance Tool for Companies (2010, updated 2016)**

   a. Sponsor Organization: Shift/Oxfam/Global Compact Network Netherlands

   b. Link:
   https://www.businessrespecthumanrights.org/image/2016/10/24/business_respect_human_rights_full.pdf

   c. Description: This is a paper on how to apply business responsibility to respect human rights under the UNGPs in practice. It provides practical guidance on how to prevent and address human rights impacts for use by company staff in the "sustainability or CSR function" as well as "procurement, sales, legal, and public affairs or risk and in different areas of operation, including business units and country subsidiaries."

9. **Blueprint for Embedding Human Rights in Key Company Functions (2016)**

   a. Sponsor Organization: European Business Network for Corporate Social Responsibility (CSR Europe)

   b. Link:
   https://respect.international/wp-content/uploads/2019/11/Human_Rights_Blueprint_0.pdf

   c. Description: This blueprint by CSR Europe provides guidance for "embedding human rights across . . . [organizational functions]." Focusing predominantly on three key functions—human resources, risk management, and procurement. It provides examples of current practices taken by companies around each element and explains how these functions can contribute to the overall process of "effectively integrat[ing] human rights" into the corporate culture.

10. **Children's Rights and Business Principles (2012)**

    a. Sponsor Organization: UNICEF/Save the Children/UN Global Compact

    b. Link:
    https://childrenandbusiness.org

    c. Description: Children's Rights and Business Principles articulate the difference between the responsibility of business to respect, that is, doing the minimum required to avoid infringing on children's rights; and to support, that is, taking voluntary actions that seek to advance the realization of children's rights. These Principles call on businesses to put in place appropriate policies and processes, as set out in the UNGPs, including a policy commitment and a due diligence process to address potential and actual impacts on human rights. The Principles identify a comprehensive range of actions that all businesses should take to prevent and address risks to child rights and "maximize positive business impacts" in the "workplace, the marketplace and the community."

11. FWF Code of Labor Practices (2016)

a. Sponsor Organization: Fair Wear Foundation (FWF)

b. Link:
https://www.fairwear.org/wp-content/uploads/2016/06/fwfcodeo-flabourpractices.pdf

c. Description: The core of this Code is made up of eight labor standards derived from the ILO Conventions and the UN Declaration on Human Rights. The Code's articulation of workers' rights includes additional context for: (i) the limitation of working hours; (ii) the free choice of workplace; (iii) no exploitative child labor; (iv) no discrimination in employment; (v) a legally binding employment contract; (vi) safe and healthy working conditions; (vii) unrestricted freedom of association and the right to collective bargaining; and (viii) payment of a living wage.

12. GRI Sustainability Reporting Standards (2016, updated 2020)

a. Sponsor Organization: Global Reporting Initiative (GRI)

b. Link:
https://www.globalreporting.org/standards

c. Description: A flexible framework for creating standalone sustainability or non-financial reports, including ESG reports, which assist businesses, governments, and other organizations to understand and communicate their impacts on issues such as climate change, human rights, and corruption. Available as a free public good, "organizations can either use the GRI Standards to prepare a sustainability report in accordance with the Standards. Or they can use selected Standards, or parts of their content, to report information for specific users or purposes, such as reporting their climate change impacts for their investors and consumers." Using reference to global standards of sustainability, the resultant report provides an inclusive picture of material topics, their related impacts, and how they are managed. There is a GRI Standards Report Registration System to register information reported using the GRI Standards.

d. Supplementary/Interpretive Documents:

   i. Universal Standard (October 15, 2021), in effect from January 2023

ii. Oil and Gas Sector Standard 2021

13. International Criminal Court (Rome) Statute, Article 7 (1998)

a. Sponsor Organization: International Criminal Court (ICC)

b. Link: https://www.icc-cpi.int/nr/rdonlyres/ea9aeff7-5752-4f84-be94-0a655eb30e16/0/rome_statute_english.pdf

c. Description: The Rome Statute is the treaty that established the International Criminal Court (ICC). As of November 2019, 123 states are party to the statute, which, among other things, establishes the court's functions, jurisdiction, and structure. The Rome Statute established four core international crimes: genocide, crimes against humanity, war crimes, and the crime of aggression. Article 7 defines "crime against humanity" to include "enslavement," "deportation or forcible transfer of population," "imprisonment or other severe deprivation of physical liberty in violation of fundamental rules of international law," and "other inhumane acts of a similar character intentionally causing great suffering, or serious injury to body or to mental or physical health," "committed as part of a widespread or systematic attack directed against any civilian population, with knowledge of the attack." "'Enslavement' means the exercise of any or all of the powers attaching to the right of ownership over a person and includes the exercise of such power in the course of trafficking in persons, in particular women and children."

14. The Essential Elements of MSI (Multi-Stakeholder Initiative) Design (2017)

a. Sponsor Organization: Institute for Multi-Stakeholder Initiative Integrity

b. Link: https://www.msi-integrity.org/wp-content/uploads/2017/11/Essential_Elements_2017.pdf

c. Description: This is a guide for how to craft a voluntary policy addressing business and human rights. It does not suggest specific areas of human rights to focus on or provide a framework for the topics that an initiative such as this should cover, but it does identify ideal qualities of the design and structure of such a policy. This guide is used by MSI Integrity to evaluate the strengths and weaknesses of a company's initiative, but using an evaluation form such as this can provide guidance on how to write a comprehensive policy initiative for business and human rights.

15. UN Guiding Principles Reporting Framework (2015)

a. Sponsor Organizations: Shift and Mazars

b. Link: https://shiftproject.org/resource/un-guidling-principles-reporting-framework

c. Description: The UNGPs Reporting Framework is a comprehensive reporting framework focused on the internal understanding and external reporting of a company's human rights performance under the UNGPs. The Reporting Framework is a short series of questions to which any company should have answers, both to know whether it is doing business with respect for human rights and to show others the progress made. The Reporting Framework is supported by two kinds of guidance: implementation guidance for companies that are reporting, and assurance guidance for internal auditors and external assurance providers. It is used by over 150 major multinational publicly traded companies and is backed by governments, investor coalitions with approximately "$5.3 trillion assets under management," investors, stock exchanges, law firms, and other reporting initiatives.

d. Supplementary/Interpretive Documents:

i. UNGPs Assurance Guidance (2017)

The UNGPs Assurance Guidance is a "subject matter guidance that serves two purposes: one, to help internal auditors assure companies' human rights performance, and two, to support external assurance providers' assurance of companies' human rights reporting." (https://ungpreporting.org/assurance).

16. International Bar Association, *Practical Guide on Business and Human Rights for Business Lawyers* and the companion *IBA Reference Annex to the Practical Guide on Business and Human Rights for Business Lawyers* (2016)

a. Sponsor Organization: International Bar Association

b. Link: https://www.ibanet.org/Document/Default.aspx?DocumentUid+d6306c84-e2f8-4c82-a86f-93940d6736c4

c. Description: The first comprehensive practical guide for implementing the UNGPs into the practice of law worldwide. It was drafted by a team of international legal experts, following nearly two years of research and consultation, and was endorsed by all of the nearly 200 international bar associations and law societies that comprise the IBA.

B. Examples of Companies with Human Rights Initiatives

1. Adidas

   https://www.adidas-group.com/en/sustainability/managing-sustainability/human-rights

2. BHP Billiton

   https://www.bhp.com/our-approach/operating-with-integrity/respecting-human-rights

3. H&M

   https://hmgroup.com/sustainability/fair-and-equal/human-rights

4. Kellogg's

   https://crreport.kelloggcompany.com/human-rights-employee-safety

5. Marks & Spencer

   https://corporate.marksandspencer.com/sustainability/business-wide/human-rights#5abe14057880b264341dfbf3

6. Nestlé

   https://www.nestle.com/csv/impact/respecting-human-rights

7. Patagonia

   https://www.patagonia.com/corporate-responsibility.html

8. Rio Tinto

   https://www.riotinto.com/en/sustainability/human-rights

9. Total

   https://www.total.com/sites/default/files/atoms/files/human_rights_internal_guide_va.pdf

10. Unilever

    https://www.unilever.com/sustainable-living/enhancing-livelihoods/fairness-in-the-workplace/advancing-human-rights-in-our-own-operations/

C. Other Resources

1. <u>Alliance 8.7</u>

   Alliance 8.7 is a global partnership, chaired by the ILO, which fosters multi-stakeholder collaboration to support governments in achieving target 8.7 of the 2030 Sustainable Development Goals designed by the United

Nations General Assembly in 2015 and part of UN Resolution 70/1, known as the "2030 Agenda." It promotes (a) "accelerat[ed] action" "to eradi[cate] forced labour, modern slavery, human trafficking and child labour"; (b) research, data collection, and knowledge sharing on prevalence and "what works"; and (c) "driving innovation and leveraging resources." The Alliance works globally through four thematic Action Groups and a Communication Group and supports the national efforts of countries that have committed to accelerate action, organize national multi-stakeholder consultations, and set up respective time-bound action plans with measurable targets.

https://www.alliance87.org

2. Business & Human Rights Resource Centre

   An independent, nonprofit global organization that provides resources and guidance for businesses "to advance human rights . . . and eradicate abuse." Its website is in eight languages: English, Arabic, Chinese, French, German, Portuguese, Russian, and Spanish. The Centre has regional researchers based in Australia, Brazil, China, Colombia, India, Kenya, Jordan, Mexico, Myanmar, Philippines, Senegal, South Africa, Tunisia, the United Kingdom, Ukraine, and the United States of America. It draws global attention to businesses' human rights impacts (positive and negative), seeks responses from companies when civil society raises concerns, and establishes close contacts with grassroots NGOs, local businesspeople, and other stakeholders.

   https://www.business-humanrights.org/en

3. Business for Social Responsibility

   BSR™ is a global nonprofit organization "that works with its . . . network of more than 250 member companies [and other partners] to build a just and sustainable world. From its offices in Asia, Europe, and North America, BSR™ develops sustainable business strategies and solutions through consulting, research, and cross-sector collaboration. It has developed several "collaborative [industry] initiatives, . . . including the Global Network Initiative and the Electronic Industry Citizenship Coalition, which [it] then spun off into independent institutions. More recently developed collaborative initiatives, including the Future of Fuels and the Future of Internet Power, and HERhealth and HERfinance, help companies across industries and sectors focus on cross-cutting issues like energy and women's empowerment." Environmental issues, particularly energy and climate, ecosystems services, and water, are a growing focus of its time and resources, fostering a "growing recognition at the highest level of business that sustainability is core to success."

   https://www.bsr.org

4. Fair Labor Association

The Fair Labor Association (FLA) is "a collaborative effort" of universities, civil society organizations, and socially responsible companies dedicated "to protecting workers' rights around the world." It is headquartered in Washington, D.C., with offices in China and Switzerland. "FLA places the onus on companies to voluntarily meet internationally recognized labor standards wherever their products are made." It offers: (i) a "collaborative approach allowing civil society organizations, universities and socially responsible companies to sit at the same table and find effective solutions to labor issues"; (ii) "innovative and sustainable strategies and resources to help companies improve compliance systems"; (iii) "transparent and independent assessments, the results of which are published online"; and (iv) a "mechanism to address the most serious labor rights violations through a Third Party Complaint process."

https://www.fairlabor.org/sites/default/files/sci-factsheet_7-23-12.pdf

5. Issara Institute

Founded in 2014, Issara is non-profit organization based in Asia and the United States tackling issues of human trafficking and forced labour through worker voice, partnership and innovation. Issara is committed to collaborative partnerships with the private sector to create levers and opportunities for identifying and resolving adverse human rights impacts and risk, and at the same time committed to empowering workers to claim their rights. Issara's Inclusive Labour Monitoring (ILM) focuses on continuous workplace monitoring and systems strengthening, with on-the-ground technical teams to support workers and business, while innovations such as the Golden Dreams application provide a platform for workers and a recruitment marketplace to ensure ethical conditions for jobseekers. Recognizing that the people being exploited (job seekers and workers), the people doing the exploiting and the people mandated to stop the exploitation are the three key actors directly involved in the act and process of labour exploitation and human trafficking within global supply chains, it seeks to directly intervene and disrupt harmful behaviors and systems while empowering positive behaviors and systems. Issara partners directly with global brands and retailers, supports and coordinates with large networks of civil society organizations, grassroots actors, business and recruitment actors, and engages with hundreds of thousands of workers in Southeast and South Asia.

https://issarainstitute.org

6. Labor Exploitation Accountability Hub

"The Accountability Hub aims to improve both government and corporate accountability for human trafficking, forced labour and slavery in national and global business supply chains. . . . The Hub . . . provides a platform for . . . research and advocacy on accountability issues, including by fostering connections and information sharing among key stakeholders from different parts of the world. The main feature of the Hub is the publicly accessible Labour Exploitation Accountability Database, which provides a broad inventory of national laws and regulations addressing corporate accountability for severe labor exploitation in supply chains. The database is searchable by country, legal topic, and by keywords, and includes brief notes on the implementation of the collected legal mechanisms. Country summary pages also provide an overview of the national context and legal framework, and highlight key implementation issues."

https://www.accountabilityhub.org

7. Modern Slavery Registry

Modern Slavery Registry was a central registry for statements published pursuant to Section 54 of the United Kingdom Modern Slavery Act, which requires commercial organizations that operate in the UK and that have an annual revenue over £36 million to produce a statement of the steps taken to address and prevent the risk of modern slavery in their operations and supply chains. The Registry was guided and supported by a governance committee which includes: Freedom Fund, Humanity United, Freedom United, Anti-Slavery International, the Ethical Trading Initiative, CORE Coalition, UNICEF UK, Focus on Labour Exploitation (FLEX), Trades Union Congress, UN Principles for Responsible Investment, and Oxfam GB. Modern Slavery Registry is now closed, however, because the government of the United Kingdom will launch its own registry in 2021. Historical records and guidance information are still available on their website.

https://www.modernslaveryregistry.org

https://www.gov.uk/government/publications/contacts-database-for-guidance-on-modern-slavery-reporting/contacts-database-for-guidance-on-modern-slavery-reporting

8. Responsible Business Alliance

"Founded in 2004 by a group of leading electronics companies, the Responsible Business Alliance (RBA), formerly the Electronic Industry Citizenship Coalition (EICC), is a nonprofit comprised of electronics, retail, auto and toy companies committed to supporting the rights and well-being of workers and communities worldwide affected by the global supply chain. RBA members commit and are held accountable to a common Code of Conduct and utilize a range of RBA training and assessment tools to support continual improvement in the social, environmental and ethical responsibility of their supply chains."

https://www.responsiblebusiness.org

9. Shift

   Shift, founded in 2011 by core members of Professor John Ruggie's United Nations Mandate Team, is internationally renowned as the "leading center of expertise on the UN Guiding Principles on Business and Human Rights." It was chaired by Professor John Ruggie. "Shift is a non-profit, mission-driven organization headquartered in New York City," whose purpose is to transform how "business gets done" to ensure respect for people's lives and dignity. It "works across all continents" with businesses to help shape their practices, culture, and behavior and works with governments, financial institutions, civil society, and other stakeholders to embed the right requirements and incentives into businesses' operating frameworks.

   https://shiftproject.org

10. Verité

    An "independent, non-profit, civil society organization, Verité . . . [has partnered,] since 1995[,] with hundreds of corporations, governments, and NGOs to illuminate labor rights violations in supply chains and remedy them to the benefit of workers and companies alike. . . . [It] provide[s] businesses with tools that help to eliminate labor abuses . . . , [endeavors] to empower workers to advocate for their rights . . . , create[s] publicly-shared resources that enlighten and drive action . . . [and] contribute[s] . . . to government labor and human rights policy." Verité assists companies in "benchmarking policy," "evaluating sourcing to field-based interviews," and "developing a portrait of their supply chain that identifies risk and labor rights abuses." "Verité has a history of work in over 70 countries, with a global network of experts in Africa, Asia, Europe, South America, North America and Australia."

    https://www.verite.org

RESPONSIBLE PURCHASING CODE OF CONDUCT: SCHEDULE Q

Version 1.0

1. ***Institutional commitments.***

   1.1 Buyer recognizes that it has an obligation to respect human rights throughout its supply chains, in particular with respect to those human rights and principles enshrined in the United Nations Declaration of Human Rights, the ILO Declaration on Fundamental Principles and Rights at Work, and in applicable labor and employment laws.

   1.2 Accordingly, Buyer commits to taking the human rights implications of its decisions into account at all times and to working towards the full implementation of the United Nations Guiding Principles on Business and Human Rights (UNGPs), the Organisation for Economic Co-Operation and Development's (OECD) Guidelines for Multinational Enterprises, and the ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy.

   1.3 In particular, consistent with the UNGPs and the relevant OECD Due Diligence Guidance for Responsible Business Conduct (sector specific where available), Buyer will establish and maintain a human rights due diligence process appropriate to its size and circumstances to identify, prevent, mitigate, and account for how Buyer addresses the impacts of its activities on the human rights of individuals directly or indirectly affected by its supply chains.

   1.4 Such due diligence will be both forward-looking and backward-looking, preventative, risk-based, and ongoing. It will involve meaningful engagement with stakeholders[1] through participation in regular, transparent, two-way consultation and the timely

1. Stakeholders are typically defined as those persons or groups who could be affected by a company's activities, actions, and decisions. This comprises a broad group, including workers, workers' representatives, trade unions (including Global Unions), community members, civil society organizations, investors, and professional industry and trade associations.

sharing of relevant information with stakeholders in a format that they can understand and access. Due diligence will also require Buyer to provide support for and participate in remediation where appropriate and necessary, in particular where it caused or contributed to an adverse impact.

1.5 All of the commitments undertaken by Buyer under this Responsible Purchasing Code of Conduct serve to advance and institutionalize human rights due diligence throughout Buyer's own operations and supply chains so as to achieve or exceed the internationally recognized human rights standards identified in 1.1.

1.6 Buyer commits to improving alignment across its teams and business units on relevant aspects of human rights and procurement and to assign oversight and responsibility for the human rights performance of its supply chain to its senior management and executive board.

1.7 Buyer recognizes that its purchasing practices can either improve the human rights performance of its supply chains, or exacerbate and compound adverse human rights impacts for workers. Accordingly, Buyer will train and incentivize its procurement team to understand the direct links between Buyer's purchasing practices and the labor conditions in its supply chains.

1.8 Buyer will at all times foster a culture of cooperation and partnership with its suppliers. Buyer will treat its suppliers fairly and with respect and will communicate with them clearly and promptly throughout their relationship.

1.9 Buyer will communicate externally all relevant information pertaining to its human rights policies, processes, and activities.

2. Selecting suppliers.

2.1 Buyer will select suppliers that have the financial, managerial, and legal capacity to meet both the commercial and the human rights obligations under the contract.

2.2 Buyer will engage in dialogue with potential suppliers to ensure that they fully understand what is expected of them with respect to Buyer's own human rights standards. This will include Buyer informing potential suppliers that they will be contractually required to cascade Buyer's human rights standards to their own business relationships (i.e., beyond "tier 1"), that Buyer will expect to obtain, and supplier will be required to provide, throughout the life of the contract all relevant information regarding supplier's own business relationships, and that Buyer will provide support for such activities, where appropriate and feasible.

3. ***Negotiating the contract.***

3.1 Buyer will negotiate its supply contracts so as to meet its production requirements, while respecting and promoting human rights. Should a conflict arise between these objectives, the latter shall take priority.

3.2 Buyer will not offer contracts on a take-it-or-leave-it basis or treat suppliers' questions and negotiations as an automatic rejection of Buyer's offer. Buyer will give suppliers an opportunity to negotiate the terms of the contract to ensure that both parties have a voice in structuring the arrangement and in advancing the human rights objectives of said arrangement.

3.3 Buyer will collaborate with suppliers to agree on a contract price that accommodates all costs of production, including costs associated with upholding responsible business conduct. For the avoidance of doubt, such costs shall, at a minimum, include minimum wages, statutory benefits, and health and safety costs required by applicable law or collective bargaining agreements.

3.4 Buyer will collaborate with its suppliers to agree on a timeline that ensures that orders will not trigger excessive working hours or unauthorized and unregulated subcontracting. Should Buyer require short lead times, Buyer will negotiate contract terms that ensure that its suppliers can perform under the contract while meeting Buyer's own human rights standards.

3.5 Buyer will formalize its arrangements with its suppliers in a written contract.

4. ***Performing and renewing the contract.***

4.1 Should change orders (e.g., quantity increases or decreases, design alterations, timeline adjustment) be sought by Buyer during the contract term, Buyer will communicate updated requirements to its supplier clearly, promptly, and accurately. In cases where oral instructions containing change orders are provided, Buyer will confirm such instructions in writing as swiftly as possible.

4.2 When making changes to an order, Buyer will engage in a dialogue with its supplier to establish that the latter can adjust to the new requirements without running afoul of Buyer's own human rights standards. If the supplier cannot adjust, Buyer will make commercially reasonable modifications to enable the contract to conform to Buyer's own human rights standards, for example, by amending target delivery times and providing appropriate additional compensation. Likewise, should the supplier need to modify the contract/order so as to continue meeting Buyer's human rights standards, Buyer will collaborate with the supplier to identify appropriate modifications.

4.3 Throughout the contract term(s), Buyer will engage in regular communication with its suppliers and provide ongoing opportunities for suppliers to tell Buyer whether they can meet Buyer's timelines without undue negative impacts on the human rights performance of the contract. Should a supplier require more time to deliver a product in order to continue meeting Buyer's own human rights standards, Buyer will, where commercially practicable, endeavor to accommodate a new timeline.

4.4 If a new timeline cannot be agreed and the supplier elects not to perform under the contract in order to prevent or mitigate attending human rights risks, Buyer will not retaliate. Specifically, Buyer will not blacklist or sue a supplier that can establish that its decision not to perform under the contract was rooted in concern for upholding human rights standards.

4.5 Should a supplier need to engage in subcontracting to meet Buyer's changed requirements, then, as soon as reasonably practicable after receiving the subcontracting request from the supplier, Buyer will review the request, and, if satisfied that the subcontract would not increase the risk of adverse impacts, Buyer will authorize such subcontracting.

4.6 In the event of a significant unforeseen increase in input costs during the contractual relationship, Buyer and supplier will negotiate adjustments to the contract price and/or make other modifications to accommodate those increases. Such increases may be incurred as a result of, for example, minimum wage rises, collective bargaining agreements, Buyer's own commitments to paying a living wage, or unforeseen increases in material costs, other manufacturing costs, and/or currency fluctuations.

4.7 Buyer will regularly seek feedback from its suppliers on the impact of its purchasing practices on the human rights performance of their contracts and ensure that said feedback will not produce adverse consequences for suppliers. Recognizing that suppliers may be reluctant to provide such feedback candidly, Buyer may seek to collect information anonymously (e.g. via an annual survey) or partner with an independent third party that can aggregate the data and present its findings to Buyer. Buyer also commits to providing feedback to its suppliers so that they are able to improve their own policies and programs.

4.8 To aid suppliers in meeting their obligations under Buyer's own human rights standards, Buyer will strive to provide reasonable material and practical assistance (e.g., financial, technological, training, capacity building) to suppliers throughout the contract term(s).

4.9 Buyer will collaborate with its suppliers to establish benchmarks for assessing the human rights performance of the contract(s), in order to enable Buyer's procurement team to make informed assessments regarding whether to award, renew, or terminate the contract(s). When it comes time to renew the contract(s), Buyer will seek to reward suppliers for superior human rights performance.

4.10 Buyer commits to paying all suppliers in accordance with the terms agreed at the outset of the contract, without attempting to change payment terms retroactively. Should changes to payment terms be necessary, Buyer will ensure that such changes are mutually agreed with, and not to the detriment of, suppliers. To support this commitment, Buyer will provide its suppliers with clear and easily accessible guidance—in supplier's own language—on payment procedures and corresponding dispute resolution mechanisms.

5. Remediation for human rights harms.

5.1 Buyer will ensure that effective, adequately funded, and governed operational level grievance mechanisms are in place to receive and address the concerns and grievances of affected or potentially affected stakeholders. These operational level grievance mechanisms will be consistent with the effectiveness criteria laid out in the UNGPs (legitimate, accessible, predictable, equitable, transparent, rights-compatible, a source of continuous learning, and based on engagement and dialogue).

5.2 Where there is a risk of an adverse impact or where an adverse impact has occurred, Buyer will collaborate with its suppliers and with affected stakeholders to identify the "root cause" of the impact, so as to cease the impact and also prevent future harms.

5.3 In the event that a human rights harm occurs in connection with the contract(s), and Buyer caused or contributed to the harm, Buyer will participate in remediation, in collaboration with other buyers as appropriate, and in proportion to its responsibility for the adverse impact and/or its capacity to remediate the impact.

Where Buyer's activities did not cause or contribute to the adverse impact, but are directly linked to it, Buyer will use or build (in collaboration with other stakeholders) its leverage with its suppliers to prevent any future harms.

5.4 All remediation, whether carried out by suppliers or by suppliers in collaboration with Buyer (and other buyers as appropriate), will restore the affected person or persons to the situation they would have been in had the adverse impact not occurred, where possible. In all cases, remediation shall be proportionate to the scale and significance of the impact and shall be determined in consultation and engagement with impacted stakeholders and/or their representatives.

6. Disengagement and responsible exit.

6.1 Should Buyer wish to disengage from its suppliers because of a potential or already-occurred adverse impact, Buyer will do so responsibly and as a last resort where (i) attempts at preventing or mitigating adverse human rights impacts have failed, (ii) the adverse impact(s) is irremediable, or (iii) there is no reasonable prospect of change.

6.2 Any disengagement, whether for commercial reasons, in response to an unremediated human rights harm, a force majeure event, or for any other reason, will take into account Buyer's sourcing volume and the potential adverse impacts related to disengagement, so that Buyer may identify appropriate measures for disengaging responsibly and for mitigating the hardship that termination may bring upon stakeholders. Decisions regarding mitigation will involve reasonable consultations with affected stakeholders.

6.3 Should Buyer decide to disengage, it will clearly communicate its intent in writing to its suppliers with reasonable notice and a clear timeline.

6.4 If Buyer does disengage, it will pay its suppliers for any outstanding invoices and/or for costs already incurred in meeting the order prior to disengagement.

Basel Committee
on Banking Supervision

Consultative Document

Principles for the effective management and supervision of climate-related financial risks

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Contents

Principles for the effective management and supervision of climate-related financial risks

I. Introduction

1. Climate change may result in physical and transition risks that could affect the safety and soundness of individual banking institutions and have broader financial stability implications for the banking system. To address climate-related financial risks within the banking sector, the Basel Committee on Banking Supervision (BCBS) established a high-level Task Force on Climate-related Financial Risks in 2020 to contribute to the Committee's mandate to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability.

2. The Committee began its work on climate-related financial risks by conducting a stocktake of member jurisdictions' existing regulatory and supervisory initiatives on climate-related financial risks. The results of the stocktake were published in April 2020.[1] The Committee then conducted analytical work to better understand the risk features of climate change and its potential implications for individual banks and the broader banking system. This culminated in the publication of analytical reports on *Climate-related risk drivers and their transmission channels*[2] and *Climate-related financial risks – measurement methodologies*.[3] The Committee is now examining the extent to which climate-related financial risks can be addressed within the Basel Framework, identifying potential gaps in the current framework and considering possible measures to address any identified gaps. Current work in this area is comprehensive in nature, spanning the regulatory, supervisory and disclosure dimensions.

3. With regard to supervision, a review of the existing Basel Framework concluded that while the *Core principles for effective banking supervision* (BCPs) and the supervisory review process (SRP) are sufficiently broad and flexible to accommodate additional supervisory responses to climate-related financial risks, supervisors and banks could benefit from the Committee's guidance to foster alignment in terms of supervisory expectations for addressing these risks.

4. Through the publication of this consultative document in the form of BCBS Guidelines, the Committee seeks to promote a principles-based approach to improving risk management and supervisory practices related to climate-related financial risks. The approach builds on the review of the current Basel Framework, particularly the BCPs and SRP, and draws from existing supervisory initiatives undertaken by individual prudential authorities and other international bodies.

5. The consultative document includes 18 high-level principles. Principles 1 through 12 provide banks with guidance on effective management of climate-related financial risks, while principles 13 through 18 provide guidance for prudential supervisors. The proposed principles seek to achieve a balance in improving practices related to the management of climate-related financial risks and providing a common baseline for internationally active banks and supervisors, while maintaining sufficient flexibility given the degree of heterogeneity and evolving practices in this area.

1 Basel Committee on Banking Supervision, Climate-related financial risks: a survey on current initiatives, 30 April 2020, www.bis.org/bcbs/publ/d502.pdf.

2 Basel Committee on Banking Supervision, *Climate-related risk drivers and their transmission channels*, 14 April 2021, www.bis.org/bcbs/publ/d517.pdf.

3 Basel Committee on Banking Supervision, *Climate-related financial risks – measurement methodologies*, 14 April 2021, www.bis.org/bcbs/publ/d518.pdf.

6. The proposed principles were drafted in a way to accommodate a diverse range of banking systems and are intended to be applied on a proportionate basis depending on the size, complexity and risk profile of the bank or banking sector for which the authority is responsible. Specifically, with regard to scenario analysis, including stress testing, the principles are formulated with a view towards application to large, internationally active banks and to supervisory and other relevant financial authorities in Basel Committee member jurisdictions. However, smaller banks and authorities in all jurisdictions can benefit from a structured consideration of the potential impact of climate-related financial risks.

7. Comments on this consultative document should be submitted by 16 February 2022. All comments may be published on the Bank for International Settlements website unless a respondent specifically requests confidential treatment.

II. Principles for the management of climate-related financial risks

8. Banks are potentially exposed to climate-related financial risks regardless of their size, complexity or business model. They should therefore consider the potential impacts of climate-related risk drivers on their individual business models and assess the financial materiality of these risks. Banks should manage climate-related financial risks in a manner that is proportionate to the nature, scale and complexity of their activities and the overall level of risk that each bank is willing to accept.[4]

9. Climate-related risk can have wide-ranging impacts in terms of the sectors and geographies it affects. Banks should take into account the unique characteristics of such risks, including but not limited to potential transmission channels, the complexity of the impact on the economy and financial sector, uncertainty related to climate change and potential interactions between physical and transition risks.

10. While there are some physical and transition risks that are already evident, the impacts of climate change could manifest over varying time horizons and are likely to exacerbate over time. The Committee's report on transmission channels noted that some climate-related risks may also materialise beyond a bank's traditional two- to three-year capital planning horizon but within the maturities of longer-dated positions. Other climate risks may materialise over a much longer time horizon. The high degree of uncertainty around the timing of these risks suggests that banks should take a prudent and dynamic approach to developing their risk management capacities. Different time horizons should be considered in the process of risk identification and assessment as well as in scenario analysis. The board of directors and senior management are also expected to take a long-term consideration of climate-related financial risks.

11. Banks should continuously develop their capabilities and expertise on climate-related financial risks commensurate with the risks they face and ensure they have appropriate resources allocated to managing these risks.

Corporate governance

<u>Principle 1</u>: Banks should develop and implement a sound process for understanding and assessing the potential impact of climate-related risk drivers on their businesses and on the environments in which they operate. Banks should consider material climate-related financial risks that could manifest over various time horizons and incorporate these risks into their overall business strategies and risk management frameworks. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]

4 See BCPs 8, 9, 14 and 15, and SRP 30.4, 31.5 and 31.30.

12. Banks should take material physical and transition risk drivers into consideration when developing and implementing their business strategies. This includes understanding and evaluating how these risks could impact the resilience of a bank's business model over the short, medium and longer terms and considering how these drivers may affect a bank's ability to achieve its business objectives. This also includes understanding and assessing a bank's exposure to structural changes in the economy, financial system and competitive landscape in which the bank operates as a result of climate-related risk drivers. The board and senior management should be involved in all relevant stages of the process, and the approach established by the board should be clearly communicated to the bank's managers and employees.

<u>Principle 2</u>: The board and senior management should clearly assign climate-related responsibilities to members and committees and exercise effective oversight of climate-related financial risks. The board and senior management should identify responsibilities for climate-related risk management throughout the organisational structure. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]

13. Responsibilities for managing climate-related financial risks should be clearly assigned to board members and committees to ensure material climate-related financial risks are appropriately considered as part of the bank's business strategy and risk management framework.

14. Banks should ensure that the board and senior management have an adequate understanding of climate-related financial risks and that senior management is equipped with the appropriate skills and experience to manage these risks. Where necessary, banks should build capacity and upskill the board and senior management on climate-related topics, such as through internal workshops and training or external collaboration with expert organisations.

15. Banks should clearly define and explicitly assign roles and responsibilities associated with identifying and managing climate-related financial risks throughout the bank's organisational structure and ensure relevant functions and business units have adequate resources and expertise to effectively fulfil responsibilities regarding climate-related financial risk management. Where dedicated climate units are set up, their responsibilities and interaction with existing governance structures should be clearly defined.

<u>Principle 3</u>: Banks should adopt appropriate policies, procedures and controls to be implemented across the entire organisation to ensure effective management of climate-related financial risks. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]

16. Management of material climate-related financial risks should be embedded in policies, processes and controls across all relevant functions and business units, including, for example, in client onboarding and transaction assessment.

Internal control framework

<u>Principle 4</u>: Banks should incorporate climate-related financial risks into their internal control frameworks across the three lines of defence to ensure sound, comprehensive and effective identification, measurement and mitigation of material climate-related financial risks. [Reference principles: BCP 26, SRP 20, SRP 30]

17. The internal control framework should include a clear definition and assignment of climate-related responsibilities and reporting lines across the three lines of defence.

18. In the frontline, climate-related risk assessments may be undertaken during the client onboarding, credit application and credit review processes. Frontline staff should have sufficient awareness and understanding to identify potential climate-related financial risks.

19. The second line of defence, the risk function, should be responsible for undertaking independent climate-related risk assessment and monitoring, including challenging the initial assessment conducted by the frontline, while the compliance function should ensure adherence to applicable rules and regulations.

20. The third line of defence, the internal audit function, should carry out regular reviews of the overall internal control framework and systems in the light of changes in methodology, business and risk profile, as well as in the quality of underlying data.

Capital and liquidity adequacy

Principle 5: Banks should identify and quantify climate-related financial risks and incorporate those assessed as material over relevant time horizons into their internal capital and liquidity adequacy assessment processes. [Reference principles: BCP 15, BCP 24, SRP 20, SRP 30]

21. Banks should develop processes to evaluate the solvency impact of climate-related financial risks that may manifest within their capital planning horizons. Banks should include climate-related financial risks assessed as material over relevant time horizons that may negatively affect their capital position (ie through their impact on traditional risk categories) in their internal capital adequacy assessment process (ICAAP).

22. Banks should assess whether climate-related financial risks could cause net cash outflows or depletion of liquidity buffers, assuming both business-as-usual and stressed conditions (considering severe yet plausible scenarios). Banks should include climate-related financial risks assessed as material over relevant time horizons that may impair their liquidity position in their internal liquidity adequacy assessment process (ILAAP).

23. It is recognised that climate-related financial risks will probably be incorporated into ICAAPs and ILAAPs iteratively and progressively, as the methodologies and data used to analyse these risks continue to mature over time and analytical gaps are addressed. To this end, banks should start building risk analysis capabilities by identifying relevant climate-related risk drivers that may materially impair their financial condition, developing key risk indicators and metrics to quantify exposures to these risks, and assessing the links between climate-related financial risks and traditional financial risk types such as credit and liquidity risks.

Risk management process

Principle 6: Banks should identify, monitor and manage all climate-related financial risks that could materially impair their financial condition, including their capital resources and liquidity positions. Banks should ensure that their risk appetite and risk management frameworks consider all material climate-related financial risks to which they are exposed and establish a reliable approach to identifying, measuring, monitoring and managing those risks. [Reference principles: BCP 15, SRP 30]

24. The board and senior management should ensure that climate-related financial risks, where material, are clearly defined and addressed in the bank's risk appetite framework.

25. Banks should regularly carry out a comprehensive assessment of climate-related financial risks and set clear definitions and thresholds for materiality, bearing in mind that a bank's risk management framework should enable it to recognise all material risks with an integrated firm-wide perspective on risk. These risks may include those posed by concentrations, in particular those related to industry, economic sectors and geographic regions. As with other material risks, banks should develop appropriate key risk indicators for effective management of material climate-related financial risks that align with their regular monitoring and escalation arrangements.

26. Where appropriate, banks should consider risk mitigation measures such as establishing internal limits for the various types of material climate-related financial risks to which they are exposed, eg in their credit, market, liquidity and operational risk profiles.

27. Given the evolving nature of climate-related risks, additional channels for transmitting these risks to traditional financial risk categories may yet be undiscovered. As such, banks should monitor future developments and seek to understand and, where possible, manage the impact of climate-related risk drivers on other material risks that may not yet be apparent.

Management monitoring and reporting

Principle 7: Risk data aggregation capabilities and internal risk reporting practices should account for climate-related financial risks. Banks should seek to ensure that their internal reporting systems are capable of monitoring material climate-related financial risks and producing timely information to ensure effective board and senior management decision-making. [Reference principles: BCP 15, SRP 30, Principles for effective risk data aggregation and risk reporting]

28. A bank's risk data aggregation capabilities should include climate-related financial risks to facilitate the identification and reporting of risk exposures, concentrations and emerging risks. Banks should have systems in place to collect and aggregate climate-related financial risk data across the banking group as part of their overall data governance and IT infrastructure. Banks should also put in place processes to ensure that the aggregated data is accurate and reliable. Banks may consider investing in data infrastructure and enhancing existing systems where appropriate to make it possible to identify, collect, cleanse and centralise the data necessary to assess material climate-related financial risks.

29. Banks should consider actively engaging clients and counterparties and collecting additional data in order to develop a better understanding of their transition strategies and risk profiles. Where reliable or comparable climate-related data are not available, banks may consider using reasonable proxies and assumptions as alternatives in their internal reporting as an intermediate step.

30. The reporting should be timely and updated regularly. Banks may consider an appropriate interval for updating internal risk reports, taking into account the evolving nature of climate-related financial risks.

31. Banks should develop qualitative or quantitative metrics or indicators to assess, monitor, and report climate-related financial risks. Limitations that prevent full climate risk data assessment should be made explicit to stakeholders where relevant.

Comprehensive management of credit risk

Principle 8: Banks should understand the impact of climate-related risk drivers on their credit risk profiles and ensure credit risk management systems and processes consider material climate-related financial risks. [Reference principles: BCP 17, BCP 19, SRP 20, Principles for the management of credit risk]

32. Banks should have clearly articulated credit policies and processes to address material climate-related credit risks. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate the impacts of material climate-related risk drivers on their credit risk profiles (including counterparty credit risk) on a timely basis. Banks should incorporate consideration of material climate-related financial risks into the entire credit life cycle, including client due diligence as part of the onboarding process and ongoing monitoring of clients' risk profiles.

33. Banks should also identify, measure, evaluate, monitor, report and manage the concentrations within and between risk types associated with climate-related financial risks. For example, banks could use metrics or heatmaps to assess and monitor concentration of exposure to geographies and sectors with higher climate-related risk.

34. Banks should consider a range of risk mitigation options to control or minimise material climate-related credit risks. These options may include adjusting credit underwriting criteria, deploying

targeted client engagement, or imposing loan limitations or restrictions such as shorter-tenor lending, lower loan-to-value limits or discounted asset valuations. Banks could also consider setting limits on or applying appropriate alternative risk mitigation techniques to their exposures to companies, economic sectors, geographical regions, or segments of products and services that do not align with their business strategy or risk appetite.

Comprehensive management of market, liquidity, operational and other risks

Principle 9: Banks should understand the impact of climate-related risk drivers on their market risk positions and ensure that market risk management systems and processes consider material climate-related financial risks. [Reference principles: BCP 22]

35. Banks should identify and understand how climate-related risk drivers could impact the value of the financial instruments in their portfolios, evaluate the potential risk of losses on and increased volatility of their portfolio, and establish effective processes to control or mitigate the associated impact.

36. Given the specific characteristics of market risk, analysis of a sudden shock scenario could serve as a useful tool for better understanding and assessing the relevance of climate-related financial risks to a bank's trading book. Such scenario analysis could, for example, feature variation in liquidity across assets exposed to climate-related risk and assume variation in the speed at which exposures could reasonably be closed out.

37. In evaluating mark-to-market exposure to climate-related risks, banks may consider how the pricing and availability of hedges could change given different climate and transition pathways, including in the event of a disorderly transition.

Principle 10: Banks should understand the impact of climate-related risk drivers on their liquidity risk profiles and ensure that liquidity risk management systems and processes consider material climate-related financial risks. [Reference principles: BCP 24, Principles for sound liquidity risk management and supervision]

38. Banks should assess the impacts of climate-related financial risks on net cash outflows (eg increased drawdowns of credit lines, accelerated deposit withdrawals) or the value of assets comprising their liquidity buffers. Where material and appropriate, banks should incorporate these impacts into their calibration of liquidity buffers and into their liquidity risk management frameworks.

Principle 11: Banks should understand the impact of climate-related risk drivers on their operational risk[5] and ensure that risk management systems and processes consider material climate-related risks. Banks should also understand the impact of climate-related risk drivers on other risks[6] and put in place adequate measures to account for these risks where material. This includes climate-related risk drivers that might lead to increasing strategic, reputational, and regulatory compliance risk, as well as liability costs associated with climate-sensitive investments and businesses. [Reference principles: BCP 25, Principles for the sound management of operational risk, Principles for operational resilience, SRP 20, SRP 30]

39. Banks should assess the impact of climate-related risk drivers on their operations in general and their ability to continue providing critical operations. Banks are expected to analyse how physical risk drivers can impact their business continuity and to take material climate-related risks into account when developing business continuity plans.

[5] Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk but excludes strategic and reputational risk.

[6] Examples include strategic, reputational, regulatory, and litigation or liability risk.

40. Banks should assess the impact of climate-related risk drivers on other risks, such as strategic, reputational, regulatory compliance and liability risk, and take such risks, where material, into account as part of their risk management and strategy setting processes.

Scenario analysis

Principle 12: Where appropriate, banks should make use of scenario analysis, including stress testing, to assess the resilience of their business models and strategies to a range of plausible climate-related pathways and determine the impact of climate-related risk drivers on their overall risk profile. These analyses should consider physical and transition risks as drivers of credit, market, operational and liquidity risks over a range of relevant time horizons. [Reference principles: BCP 15, Stress testing principles]

41. The objective(s) of climate scenario analysis, including stress testing, should reflect the bank's overall climate risk management objectives as set out by its board and senior management. These objectives could include, for example: (i) exploring the impacts of climate change and the transition to a low-carbon economy on the bank's strategy and the resiliency of its business model; (ii) identifying relevant climate-related risk factors; (iii) measuring vulnerability to climate-related risks and estimating exposures and potential losses; (iv) diagnosing data and methodological limitations in climate risk management; and (v) informing the adequacy of the bank's risk management framework, including risk mitigation options. Banks may explore the use of stress testing to assess the adequacy of their financial positions in the near term under severe yet plausible scenarios, though these capabilities are expected to mature more progressively over time as methodologies evolve.

42. Scenario analysis should reflect relevant climate-related financial risks for banks. This should include the physical or transition risks that are relevant to a bank's business model, exposure profile and business strategy. Scenarios should cover a range of plausible pathways, as appropriate. Banks should consider the potential benefits and limitations of selected scenarios and assumptions (eg balance sheet assumption).

43. Banks should build sufficient capacity and expertise to conduct climate scenario analysis that are proportionate to their size, business model and complexity. Larger and more complex banks should be expected to have more advanced analytical capability.

44. Scenario analysis should employ a range of time horizons, from short- to long-term, in order to target different risk management objectives. For instance, shorter time frames may be used to analyse the crystallisation of risk within a bank's typical business planning horizon at a lower level of uncertainty. Longer time frames, which carry higher levels of uncertainty, may be used to evaluate the resiliency of existing strategies and business models to structural changes in the economy, financial system or distribution of risks.

45. The field of climate scenario analysis is highly dynamic, and practices are expected to evolve rapidly, especially as climate science advances. Climate scenario models, frameworks and results should be subject to challenge and regular review by a range of internal and/or external experts and independent functions.

III. Principles for the supervision of climate-related financial risks

Prudential regulatory and supervisory requirements for banks

<u>Principle 13</u>: Supervisors should determine that banks' incorporation of material climate-related financial risks into their business strategies, corporate governance and internal control frameworks is sound and comprehensive. [Reference principles: BCP 9, BCP 14, BCP 26, SRP 20]

46. Supervisors should determine that roles and responsibilities for climate-related financial risks, including for the board and senior management, are clearly assigned, adequate and properly documented in relevant policies, procedures and controls.

47. Supervisors should assess the effectiveness of board and senior management oversight of climate-related financial risks and should verify that board and senior management receive accurate and appropriate internal reporting on material climate-related financial risks in order to conduct this oversight.

48. Supervisors should maintain sufficiently frequent contact, as appropriate, with board and senior management to develop an understanding of, and assess the bank's long-term approach to, addressing climate-related financial risks in a forward-looking manner. Where necessary, supervisors should challenge the bank on the assumptions made in setting strategies and business models.

49. Supervisors should determine that banks consider the potential impacts of climate-related risk drivers when developing and implementing their business strategies, including addressing the resiliency of their business models to any material climate-related financial risks over various time horizons and considering how these risks may impact their ability to achieve their business objectives.

50. Supervisors should determine that banks adequately incorporate climate-related financial risks into their corporate governance and internal controls, including adopting appropriate policies, procedures and controls across the three lines of defence, equipping relevant functions with adequate resources and expertise for implementing business strategy and risk management frameworks, and performing regular reviews of the overall internal control framework and system.

<u>Principle 14</u>: Supervisors should determine that banks can adequately identify, monitor and manage all material climate-related financial risks as part of their assessments of banks' risk appetite and risk management frameworks. [Reference principles: BCP 15, SRP 20, SRP 30]

51. Supervisors should review the extent to which banks regularly assess the materiality of climate-related financial risks, supported by appropriate key risk indicators and, where applicable, risk mitigating measures to effectively manage these risks.

52. Supervisors should assess the extent to which material climate-related financial risks are included in banks' risk management frameworks and risk appetite along with appropriate processes and procedures to identify, monitor and manage such risks. This may include ensuring that banks' risk management frameworks take into account all material climate-related financial risks to which they are exposed and assessing whether banks' data aggregation capabilities and internal reporting practices can facilitate identification and reporting of climate-related risk exposures, concentrations and emerging risks as well as banks' ability to deploy a range of risk management approaches.

<u>Principle 15</u>: Supervisors should determine that banks comprehensively identify and assess the impact of climate-related risk drivers on their risk profile and ensure that material climate-related financial risks are adequately considered in their management of credit, market, liquidity, operational, and other types of risk. Supervisors should determine that, where appropriate, banks apply climate scenario analysis. [Reference principles: BCP 17–25, Principles for sound liquidity risk management and supervision, Principles for the sound management of operational risk, Principles for operational resilience]

53. Supervisors should ensure that banks consider a range of mitigation options to manage and control material climate-related risks. Supervisors should also determine that banks consider climate-related financial risks assessed as material over relevant horizons within their ICAAPs and ILAAPs.

54. Where appropriate, supervisors should determine that banks have in place a scenario analysis programme, including stress testing, that is proportionate to their size, business model and complexity, in order to assess the resilience of their business models and strategies to a range of plausible climate-related outcomes. As part of the assessment, supervisors should review and, where necessary, challenge model assumptions, methodologies and results.

Responsibilities, powers and functions of supervisors

Principle 16: In conducting supervisory assessments of supervised banks' management of climate-related financial risks, supervisors should utilise an appropriate range of techniques and tools and adopt adequate follow-up measures in case of material misalignment with supervisory expectations. [Reference principles: BCP 8, BCP 9, SRP 10, SRP 20]

55. Supervisors should set expectations in a manner proportionate to the nature, scale and complexity of relevant banks' activities.

56. To foster cross-border collaboration, home and host supervisors of cross-border banking groups should share information related to the climate risk resilience of banks and banking groups, leveraging existing frameworks for sharing information and undertaking collaborative work.

Principle 17: Supervisors should ensure that they have adequate resources and capacity to effectively assess supervised banks' management of climate-related financial risks. [Reference principles: BCP 9]

57. Supervisors should take regular stock of existing skills and projected requirements, taking into account relevant evolving market practices and supervisory practices in this landscape, and take timely measures to build adequate expertise in identified skill sets. Where aspects of climate-related risk assessments are outsourced, supervisors should maintain appropriate knowledge to ensure that the results of the outsourced analysis are credible and realistic.

58. Supervisors should engage a broad and diverse range of stakeholders to facilitate a collective understanding and measurement of climate-related financial risks and allow for optimisation of climate-dedicated resources.

59. Supervisors could use existing regulatory reports to assess the materiality of climate-related financial risks to banks. In case of data gaps, supervisors may collect additional information from supervised banks such as sector exposures and banks' internal reports.

Principle 18: Supervisors should consider using climate-related risk scenario analysis, including stress testing, to identify relevant risk factors, size portfolio exposures, identify data gaps and inform the adequacy of risk management approaches. Where appropriate, supervisors should consider disclosing the findings of these exercises. [Reference principles: Stress testing principles]

60. Supervisors should clearly articulate their specific objectives for supervisory climate scenario analysis, including stress testing, which could include, for example: (i) exploring the impact of climate change and the transition to a low-carbon economy on supervised banks' strategies and the resiliency of their business models; (ii) identifying and assessing relevant climate-related risk drivers affecting individual banks or the banking system; (iii) facilitating information sharing and identifying common data and methodological gaps and limitations in climate-related risk management; and (iv) informing the adequacy of supervised banks' risk management frameworks, including their risk mitigation options.

61. In designing scenario analysis, supervisors should consider material climate-related financial risks, including physical and transition risks, that take into account the nature, scale and complexity of the banks

within their jurisdiction. The scenarios used should incorporate a range of plausible climate pathways. Supervisors should consider a range of time horizons, from short- to long-term, depending on the objectives of the exercise. For instance, shorter time horizons may be useful to analyse the types of climate-related financial risks that could crystallise within traditional capital planning horizons and to assess their potential impact on regulatory capital, while longer horizons, which carry higher levels of uncertainty, may be useful to gauge exposure to structural changes in the economy or financial system or the distribution of risks.

62. Supervisors should build sufficient capacity and expertise to conduct climate scenario analysis. Supervisors are encouraged to collaborate with a broad and diverse set of stakeholders, including the climate science community, to develop scenarios that can inform comprehensive assessments of climate-related financial risks, and should keep abreast of emerging practices in scenario design and implementation.

63. As scenario analysis continues to evolve, supervisors should recognise the limitations of their analyses when communicating their results or using them in supervisory assessments. Ongoing dialogue among supervisors and between supervisors and banks will contribute to the development of deeper insights on banks' climate-related vulnerabilities and their strategies to mitigate climate-related financial risks.

64. Supervisors should take into account the level of uncertainty associated with scenarios when determining whether to disclose results. Supervisors may consider disclosing scenario analysis results at an appropriate level of aggregation and should include the appropriate level of detail on methodologies, assumptions, the level of uncertainty and key sensitivities when disclosing results.

65. To foster information-sharing, cross-border collaboration and efficient resource utilisation, home and host supervisors are encouraged to establish frameworks for communicating and coordinating scenario analysis with other relevant domestic and cross-jurisdictional authorities where appropriate.

IV. Questions on the proposed principles

66. The Committee welcomes comments on this document from all stakeholders. More specifically, the Committee requests feedback on the following questions:

Q1. Has the Committee appropriately captured the necessary requirements for the effective management of climate-related financial risks and the related supervision? Are there any aspects that the Committee could consider further or that would benefit from additional guidance from the Committee?

Q2. Do you have any comments on the individual principles and supporting commentary?

Q3. How could the transmission of environmental risks to banks' risk profiles be taken into account when considering the potential application of these principles to broader environmental risks in the future? Which key aspects should be considered?

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2022/0051 (COD)

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937

(Text with EEA relevance)

{SEC(2022) 95 final} - {SWD(2022) 38 final} - {SWD(2022) 39 final} -
{SWD(2022) 42 final} - {SWD(2022) 43 final}

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

Reasons for and objectives of the proposal

The behaviour of companies across all sectors of the economy is key to succeed in the Union's transition to a climate-neutral and green economy[1] in line with the European Green Deal[2] and in delivering on the UN Sustainable Development Goals, including on its human rights- and environment-related objectives. This requires implementing comprehensive mitigation processes for adverse human rights and environmental impacts in their value chains, integrating sustainability into corporate governance and management systems, and framing business decisions in terms of human rights, climate and environmental impact, as well as in terms of the company's resilience in the longer term.

EU companies operate in complex surroundings and, especially large ones, rely on global value chains. Given the significant number of their suppliers in the Union and in third countries and the overall complexity of value chains, EU companies, including the large ones, may encounter difficulties to identify and mitigate risks in their value chains linked to respect of human rights or environmental impacts. Identifying these adverse impacts in value chains will become easier if more companies exercise due diligence and thus more data is available on human rights and environmental adverse impacts.

The connection of the EU economy to millions of workers around the world through global value chains comes with a responsibility to address adverse impacts on the rights of these workers. A clear request by Union citizens, in particular in the framework of the Conference on the Future of Europe, for the EU economy to contribute to address these and other adverse impacts is reflected in the existing or upcoming national legislation on human rights and environmental due diligence[3], in the debates ongoing at national level and in the call for action from the European Parliament and the Council. Both of these institutions have called on the Commission to propose Union rules for a cross-sector corporate due diligence obligation.[4] In their Joint Declaration on EU Legislative Priorities for 2022[5], the European Parliament, the Council of the European Union and the European Commission have

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1 Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 ('European Climate Law'), which also includes a binding target to cut domestic net greenhouse gas emissions by at least 55% compared to 1990 levels by 2030.

2 Communication from the Commission on the European Green Deal, COM/2019/640 final.

3 So far France (*Loi relative au devoir de vigilance, 2017)* and Germany (*Sorgfaltspflichtengesetz, 2021)* have introduced a horizontal due diligence law, other Member States (Belgium, the Netherlands, Luxembourg and Sweden) are planning to do so in the near future, and the Netherlands has introduced a more targeted law on child labour (*Wet zorgplicht kinderarbeidm 2019).*

4 European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL)); Council Conclusions on Human Rights and Decent Work in Global Supply Chains of 1 December 2020 (13512/20).

5 Joint declaration of the European Parliament, the Council of the European Union and the European Commission on EU Legislative Priorities for 2022 (OJ C 514I, 21.12.2021, p. 1).

committed to deliver on an economy that works for people, including to improve the regulatory framework on sustainable corporate governance.

Using the existing international voluntary standards on responsible business conduct,[6] an increasing number of EU companies are using value chain due diligence as a tool to identify risks in their value chain and build resilience to sudden changes in the value chains, but companies may also face difficulties when considering to use the value chain due diligence for their activities. Such difficulties can be for instance due to lack of legal clarity regarding corporate due diligence obligations, complexity of value chains, market pressure, information deficiencies, and costs. As a consequence, the benefits of due diligence are not widespread among European companies and across economic sectors.

Mostly large companies have been increasingly deploying due diligence processes as it can provide them with a competitive advantage.[7] This also responds to the increasing market pressure on companies to act sustainably as it helps them avoid unwanted reputational risks vis-à-vis consumers and investors that are becoming increasingly aware of sustainability aspects. However, these processes are based on voluntary standards and do not result in legal certainty for neither companies nor victims in case harm occurs.

Voluntary action does not appear to have resulted in large scale improvement across sectors and, as a consequence, negative externalities from EU production and consumption are being observed both inside and outside the Union. Certain EU companies have been associated with adverse human rights and environmental impacts, including in their value chains.[8] Adverse impacts include, in particular, human rights issues such as forced labour, child labour, inadequate workplace health and safety, exploitation of workers, and environmental impacts such as greenhouse gas emissions, pollution, or biodiversity loss and ecosystem degradation.

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6 United Nations' "Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework" (2011), available at https://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf.
OECD Guidelines for Multinational Enterprises (2011 update), available at: https://doi.org/10.1787/9789264115415-en, with set of recommendations on responsible business conduct, as well as specific OECD Due Diligence Guidance for Responsible Business Conduct (2018) and OECD sectoral guidance, available at: https://mneguidelines.oecd.org/mneguidelines/.

7 See Impact Assessment accompanying this proposal, p. 15, 23.

8 The Study on due diligence, European Commission, Directorate-General for Justice and Consumers, Smit, L., Bright, C., et al., Study on due diligence requirements through the supply chain: final report, Publications Office, 2020, https://data.europa.eu/doi/10.2838/39830, p. 221, indicates that corporate risk assessment processes continue to focus on the materiality of the risks to the company, despite international guidance (UNGPs, OECD) which clarifies that the relevant risks for due diligence must extend beyond the risks of the company to those who are affected (the rights-holders). Negative corporate impacts as a consequence of globalisation and failure to undertake due diligence, ranging from environmental disasters (see at https://www.business-humanrights.org/en/blog/brumadinho-dam-collapse-lessons-in-corporate-due-diligence-and-remedy-for-harm-done/) and land grabbing (see at https://www.europarl.europa.eu/RegData/etudes/STUD/2016/578007/EXPO_STU(2016)578007_EN.pdf) to serious violations of labour and human rights, (see at https://www.europarl.europa.eu/RegData/etudes/BRIE/2014/538222/EPRS_BRI(2014)538222_REV1_EN.pdf) are well documented.

In the last years, emerging legal frameworks on corporate due diligence in Member States[9] reflect the increasing desire to support companies in their endeavour to perform due diligence in their value chains and foster business conduct that respects human rights, children's rights and the environment. On the other hand, they also bring fragmentation and risk undermining legal certainty and a level playing field for companies in the single market.

Union legislation on corporate due diligence would advance respect for human rights and environmental protection, create a level playing field for companies within the Union and avoid fragmentation resulting from Member States acting on their own. It would also include third-country companies operating in the Union market, based on a similar turnover criterion.

Against this background, this Directive will set out a horizontal framework to foster the contribution of businesses operating in the single market to the respect of the human rights and environment in their own operations and through their value chains, by identifying, preventing, mitigating and accounting for their adverse human rights, and environmental impacts, and having adequate governance, management systems and measures in place to this end.

In particular, this Directive will:

(1) improve corporate governance practices to better integrate risk management and mitigation processes of human rights and environmental risks and impacts, including those stemming from value chains, into corporate strategies;

(2) avoid fragmentation of due diligence requirements in the single market and create legal certainty for businesses and stakeholders as regards expected behaviour and liability;

(3) increase corporate accountability for adverse impacts, and ensure coherence for companies regarding obligations under existing and proposed EU initiatives on responsible business conduct;

(4) improve access to remedies for those affected by adverse human rights and environmental impacts of corporate behaviour;

(5) being a horizontal instrument focussing on business processes, applying also to the value chain, this Directive will complement other measures in force or proposed, which directly address some specific sustainability challenges or apply in some specific sectors, mostly within the Union.

Consistency with existing policy provisions in the policy area

At EU level, sustainable corporate governance has been mainly fostered indirectly by imposing reporting requirements in the Non-Financial Reporting Directive (NFRD)[10] on

[9] See footnote 3.

[10] Directive 2014/95/EU amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups (OJ L 330, 15.11.2014, p. 1–9). The NFRD is therefore an amendment of the Accounting Directive, i.e. of Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC and repealing Council Directives 78/660/EEC and 83/349/EEC (OJ L 182, 29.6.2013).

approximately 12 000 companies[11] concerning environmental, social and human rights related risks, impacts, measures (including due diligence) and policies.[12] The NFRD had some positive impact on improvement of responsible business operation, but has not resulted in the majority of companies taking sufficient account of their adverse impacts in their value chains.[13]

The Commission's recent [proposal for a Corporate Sustainability Reporting Directive (CSRD), revising the NFRD[14],] would extend the scope of the companies covered to all large and all listed companies[15], require the audit (assurance) of reported information and strengthen the standardisation of reported information by empowering the Commission to adopt sustainability reporting standards.[16] This Directive will complement the current NFRD and its proposed amendments (proposal for CSRD) by adding a substantive corporate duty for some companies to perform due diligence to identify, prevent, mitigate and account for external harm resulting from adverse human rights and environmental impacts in the company's own operations, its subsidiaries and in the value chain. Of particular relevance of the proposal on CSRD is that it mandates disclosure of plans of an undertaking to ensure that its business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement. The two initiatives are closely interrelated and will lead to synergies. First, a proper information collection for reporting purposes under the proposed CSRD requires setting up processes, which is closely related to identifying adverse impacts in accordance with the due diligence duty set up by this Directive. Second, the CSRD will cover the last step of the due diligence duty, namely the reporting stage, for companies that are also covered by the CSRD. Third, this Directive will set obligations for companies to have in place the plan ensuring that the business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement on which the

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11 Large public-interest entities that have more than 500 employees (and the balance sheet total or net turnover of which exceeds the Accounting Directive's threshold for large enterprises), including listed companies, banks and insurance companies. See CEPS' Study on the Non-Financial Reporting Directive, prepared for the European Commission to support the review of the NFRD, November 2020, available at https://op.europa.eu/en/publication-detail/-/publication/1ef8fe0e-98e1-11eb-b85c-01aa75ed71a1/language-en.

12 See also some provisions of SRD II, i.e. Directive (EU) 2017/828 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (OJ L 132, 20.5.2017, p. 1–25).

13 The Impact Assessment accompanying the Commission's proposal for the Corporate Sustainability Reporting Directive (SWD/2021/150 final) and the CEPS' Study on the Non-Financial Reporting Directive (section 2) found a limited change in corporate policies as a result of the NFRD, consistent with the perception of main stakeholders who could not identify a clear pattern of change in corporate behaviour driven by these reporting rules.

14 Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting (COM/2021/189 final).

15 The sustainability reporting obligation would apply to all large companies as defined by the Accounting Directive (which the CSRD would amend) and, as of 2026, to companies (including non-EU companies but excluding all micro enterprises) listed on EU regulated markets.

16 The elaboration of draft sustainability reporting standards started in parallel with the legislative process in a project task force established by the European Financial Reporting Advisory Group (EFRAG) at the request of the Commission.

CSRD requires to report. Thus, this Directive will lead to companies' reporting being more complete and effective. Therefore, complementarity will increase effectiveness of both measures and drive corporate behavioural change for those companies.

This Directive will also underpin the Sustainable Finance Disclosure Regulation[17] (SFDR) that has recently entered into force and applies to financial market participants (such as investment fund and portfolio managers, insurance undertakings selling insurance-based investment products and undertakings providing various pension products) and financial advisers. Under the SFDR, these undertakings are required to publish, among others, a statement on their due diligence policies with respect to principal adverse impacts of their investment decisions on sustainability factors on a comply or explain basis. At the same time, for companies with more than 500 employees the publication of such a statement is mandatory, and the Commission is empowered to adopt regulatory technical standards on the sustainability indicators in relation to the various types of adverse impacts.[18]

Similarly, this Directive will complement the recent Taxonomy Regulation[19], a transparency tool that facilitates decisions on investment and helps tackle greenwashing by providing a categorisation of environmentally sustainable investments in economic activities that also meet a minimum social safeguard.[20] The reporting covers also minimum safeguards established in Article 18 of the Taxonomy Regulation that refer to procedures companies should implement to ensure the alignment with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organization on Fundamental Principles and Rights at Work and the International Bill of Human Rights when carrying out an economic activity categorized as "sustainable". Like NFRD and the proposal for CSRD, the Taxonomy Regulation does not impose substantive duties on companies other than public reporting requirements, and investors can use such information when allocating capital to companies. By requiring companies to identify their adverse risks in all their operations and value chains, this Directive may help in providing more detailed information to the investors. It therefore complements the Taxonomy Regulation as it has the potential to further help investors to allocate capital to responsible and sustainable companies. Moreover, the Taxonomy Regulation (as providing a common language for sustainable economic activities for investment purposes) can serve as a guiding tool for companies to attract sustainable financing for their corrective action plans and roadmaps.

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17 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (OJ L 317, 9.12.2019, p. 1–16).

18 The three European Supervisory Authorities published on 4 February 2021 their Final Report (available at https://www.esma.europa.eu/press-news/esma-news/three-european-supervisory-authorities-publish-final-report-and-draft-rts) to the Commission, including the draft regulatory technical standards on disclosures under the SFDR.

19 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (OJ L 198, 22.6.2020, p. 13–43).

20 The Taxonomy will be developed gradually. Minimum social safeguards apply to all Taxonomy-eligible investments.

This Directive will complement Directive 2011/36/EU on preventing and combating trafficking in human beings and protecting its victims[21], which constitutes a comprehensive legal framework to effectively fight all forms of exploitation in the Union by natural and legal persons, in particular forced labour, sexual exploitation, as well as begging, slavery or practices similar to slavery, servitude, or the exploitation of criminal activities, or the removal of organs. It also establishes the liability of legal persons for the offences referred to in that Directive committed for their benefit by any person who has a leading position within the legal person or the commission of the offence was possible due to the lack of supervision or control. Directive 2011/36/EU also provides for sanctions on the legal person held liable.

Furthermore, this Directive will complement the Employers' Sanctions Directive[22], which prohibits the employment of irregularly staying third-country nationals, including victims of trafficking in human beings. The Employers' Sanctions Directive lays down minimum standards on sanctions and other measures to be applied in the Member States against employers who infringe upon the Directive.

This Directive will also complement existing or planned sectoral and product-related value chain due diligence instruments at EU level due to its cross-sectoral scope and broad range of sustainability impacts covered:

The so-called Conflict Minerals Regulation[23] applies to four specific minerals and metals. It requires EU companies in the supply chain to ensure they import tin, tungsten, tantalum and gold from responsible and conflict-free sources only and put in place more specific mechanisms for conducting due diligence, e.g. an independent third-party audit of supply chain due diligence. The due diligence provisions of this Directive address also environmental adverse impacts and will apply to value chains of additional minerals that are not covered in the Conflict Minerals Regulation but produce human rights, climate and environmental adverse impacts.

The Commission's proposal for a Regulation on deforestation-free supply chains[24] focuses on certain commodities and product supply chains. It has a very specific objective, namely to reduce the impact of EU consumption and production on deforestation and forest degradation worldwide. Its requirements will, in some areas, be more prescriptive compared to the general due diligence duties under this Directive. It also includes a prohibition of placing on the market certain commodities and derived products if the requirement of "legal" and

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21 Directive 2011/36/EU of the European Parliament and of the Council of 5 April 2011 on preventing and combating trafficking in human beings and protecting its victims, and replacing Council Framework Decision 2002/629/JHA (OJ L 101, 15 April 2011, p.1).

22 Directive 2009/52/EC of the European Parliament and of the Council of 18 June 2009 providing for minimum standards on sanctions and measures against employers of illegally staying third-country nationals (OJ L 168, 30. June 2009).

23 Regulation (EU) 2017/821 of the European Parliament and of the Council of 17 May 2017 laying down supply chain due diligence obligations for Union importers of tin, tantalum and tungsten, their ores, and gold originating from conflict-affected and high-risk areas (OJ L 130, 19.5.2017, p. 1–20).

24 Proposal for a Regulation of the European Parliament and of the Council on the making available on the Union market as well as export from the Union of certain commodities and products associated with deforestation and forest degradation and repealing Regulation (EU) No 995/2010 (COM(2021) 706 final).

"deforestation free" cannot be ascertained through due diligence. This prohibition will apply to all operators placing the relevant products on the Union market, including EU and non-EU companies, irrespective of their legal form and size. Therefore, while the overall objectives of the two initiatives are mutually supportive, their specific objectives are different. This Directive will complement the Regulation on deforestation-free products by introducing a value chain due diligence related to activities that are not covered by the Regulation on deforestation-free products but might be directly or indirectly leading to deforestation.

The Commission's proposal for a new Batteries Regulation[25] has the specific objectives of reducing environmental, climate and social impacts throughout all stages of the battery life cycle, strengthening the functioning of the internal market, and ensuring a level playing field through a common set of rules. It requires economic operators placing industrial or electric vehicle batteries (including incorporated in vehicles) larger than 2 kWh on the Union market to establish supply chain due diligence policies. It focusses on those raw materials of which a significant amount of the global production goes into battery manufacturing and that may pose social or environmental adverse impacts (cobalt, natural graphite, lithium, and nickel). The economic operators must submit compliance documentation for third-party verification by notified bodies and are subject to checks by the national market surveillance authorities. This Directive will complement the Batteries Regulation by introducing a value chain due diligence related to raw materials that are not covered in that Regulation but without requiring certification for placing the products on the EU market.

The future Sustainable Products Initiative (SPI) aims to revise the current Ecodesign Directive[26] and concerns more broadly the sustainability of products placed on the EU market and the transparency of related information.

This proposal will play an essential role in tackling the use of forced labour the global value chains. As announced in the Communication on decent work worldwide[27] the Commission is preparing a new legislative proposal that will effectively prohibit the placing on the Union market of products made by forced labour, including forced child labour. The new initiative will cover both domestic and imported products and combine a ban with a robust, risk-based enforcement framework. The new instrument will build on international standards and complement horizontal and sectoral initiatives, in particular the due diligence obligations as laid down in this proposal.

This Directive is without prejudice to the application of other requirements in the areas of human rights, protection of the environment and climate change under other Union legislative acts. If the provisions of this Directive conflict with a provision of another Union legislative act pursuing the same objectives and providing for more extensive or more specific

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25 Proposal for a Regulation of the European Parliament and of the Council concerning batteries and waste batteries, repealing Directive 2006/66/EC and amending Regulation (EU) No 2019/1020 (COM/2020/798 final).

26 Directive 2009/125/EC of the European Parliament and of the Council of 21 October 2009 establishing a framework for the setting of ecodesign requirements for energy-related products (OJ L 285, 31.10.2009, p. 10).

27 Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on decent work worldwide for a global just transition and a sustainable recovery, COM(2022) 66 final.

obligations, the provisions of the other Union legislative act should prevail to the extent of the conflict and should apply to those specific obligations

Consistency with other Union policies

This Directive is important to fulfil objectives of various existing and planned Union measures in the field of the human rights, including labour rights, and environment.

As part of the European Green Deal, the Commission has listed an initiative on sustainable corporate governance among the deliverables of the Action Plan on a Circular Economy, the Biodiversity strategy, the Farm to Fork strategy, the Chemicals strategy, Updating the 2020 New Industrial Strategy: Building a stronger Single Market for Europe's recovery, and the Strategy for Financing the Transition to a Sustainable Economy.

EU environmental law introduces various environmental requirements for companies, Member States, or defines goals for the Union[28]. However, it generally does not apply to value chains outside the Union where up to 80-90% of the environmental harm of EU production may occur[29]. The Environmental Liability Directive[30] establishes a framework for environmental liability with regard to prevention and remedying environmental damage based on the "polluter pays" principle for companies' own operations. It does not cover companies' value chains. The civil liability related to adverse environmental impacts of this Directive will be complementary to the Environmental Liability Directive.

This Directive will complement EU climate legislation, including the European Climate Law, setting in stone the Union's climate ambition, with the intermediate target of reducing net greenhouse gas emissions by at least 55% by 2030, to set Europe on a responsible path to becoming climate-neutral by 2050. Most specifically, this Directive will complement the "Fit for 55" Package[31] and its various key actions, such as setting more ambitious energy efficiency and renewable energy targets for Member States by 2030 or the upgrading of the EU Emissions Trading System[32], which needs to be underpinned by a wider transformation of production processes to achieve climate neutrality by 2050 across the economy and throughout value chains. The "Fit for 55" Package will only indirectly apply to some non-EU

[28] For example it introduces limitations on the release of some pollutants, defines EU goals (such as the European Climate Law) or sets targets for Member States (such as for energy efficiency), defines obligations for Member States (e.g. on protection of natural habitats), establishes minimum content in authorisation procedures for some economic activities (e.g. Environmental Impact Assessment), etc.

[29] See e.g. Jungmichel, Norbert, Christina Schampel and Daniel Weiss (2017): Atlas on Environmental Impacts - Supply Chains – Environmental Impacts and Hot Spots in the Supply Chain, Adephi/Systain, available at https://www.adelphi.de/en/system/files/mediathek/bilder/Umweltatlas%20Lieferkette%20-%20adelphi-Systain-englisch.pdf.

[30] Directive 2004/35/CE of the European Parliament and of the Council of 21 April 2004 on environmental liability with regard to the prevention and remedying of environmental damage (OJ L 143, 30.4.2004, p. 56–75).

[31] The "Fit for 55" Package is a series of proposals adopted by the Commission on 14 July 2021 aiming to make the EU's climate, energy, land use, transport and taxation policies fit for reducing net greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels.

[32] Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC establishing a system for greenhouse gas emission allowance trading within the Union, Decision (EU) 2015/1814 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and Regulation (EU) 2015/757 (COM/2021/551 final).

value chains of EU companies through the Carbon Border Adjustment Mechanism (CBAM)[33] which aims at preventing "carbon leakage"[34] by imposing a carbon adjustment price for selected imported products not subject to the carbon price deriving from the EU Emission Trading System.

Existing EU health and safety, and fundamental rights legislation targets very specific adverse impacts (such as violations of the right to privacy and data protection, discrimination, specific health aspects related to dangerous substances, threats to health and safety of workers, violations of rights of the child, etc.) within the Union[35] but does not apply in all cases to companies' value chains outside the Union.

The initiative is in line with the EU Action Plan on Human Rights and Democracy 2020-2024[36], which includes a commitment for the Union and Member States to strengthen their engagement to actively promote the implementation of international standards on responsible business conduct such as the UN Guiding Principles on Business and Human Rights and the OECD Guidelines on Multinational Enterprises and Due Diligence. It is consistent with the EU Strategy on the Rights of the Child[37] which commits the Union to a zero tolerance approach against child labour and to ensure that supply chains of EU companies are free of child labour. In the EU Strategy on Combatting Trafficking in Human Beings 2021- 2025[38] the Commission committed to put forward a legislative proposal on sustainable corporate governance to foster long-term sustainable and responsible corporate behaviour. The initiative also contributes to the goals of the Commission's Communication on decent work worldwide[39], which is adopted together with this proposal.

This Directive will contribute to the European Pillar of Social Rights as both promote rights such as fair working conditions[40]. It will – beyond its external angle – deal with the violation of international labour standards when they occur in the Union (e.g. forced labour cases in

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33 Proposal for a Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism (COM(2021) 564 final).

34 "Carbon leakage" resulting from the increased EU climate ambition could lead to increase total global emissions. The CBAM carbon adjustment price on selected types of imported products in the iron steel, aluminium, cement, electricity, fertilizers sectors would level the playing field between EU and imported products.

35 Under EU law, every EU worker has certain minimum rights relating to protection against discrimination based on sex, race, religion, age, disability and sexual orientation, labour law (part-time work, fixed-term contracts, working hours, informing and consulting employees). A summary is available at https://eur-lex.europa.eu/summary/chapter/employment_and_social_policy.html?root_default=SUM_1_CODED%3D17&locale=en.

36 Joint Communication to the European Parliament and the Council on the EU Action Plan on Human Rights and Democracy 2020-2024 (JOIN/2020/5 final).

37 Communication from the Commission on the EU strategy on the rights of the child (COM/2021/142 final).

38 Communication from the Commission on the EU Strategy on Combatting Trafficking in Human Beings 2021- 2025 (COM(2021) 171 final).

39 (COM(2022)66 final).

40 E.g. Pillar 10 of European Pillar of Social Rights on healthy, safe and well-adapted work environment and Article 7(b) International Covenant on Economic, Social and Cultural Rights (see annex of this Directive) on just and favourable conditions at work including safe and healthy working conditions.

agriculture). Therefore, internally it would also reinforce the protection of workers in the Union alongside the existing social *acquis* and contribute to preventing and tackling abuses within and across Member States.

Thus, this Directive will complement the EU's regulatory environment that currently does not include an Union-wide transparent and predictable framework that helps EU companies in all sectors of the economy to assess and manage sustainability risks and impacts with respect to the core human rights and environmental risks, including across their value chains.

2. LEGAL BASIS, SUBSIDIARITY AND PROPORTIONALITY

Legal basis

The proposal is based on Article 50 and Article 114 of the Treaty on the Functioning of the European Union (TFEU).

Article 50(1) TFEU and in particular Article 50(2)(g) TFEU provide for the EU competence to act in order to attain freedom of establishment as regards a particular activity, in particular "*by coordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or forms within the meaning of the second paragraph of Article 54 TFEU with a view to making such safeguards equivalent throughout the Union*". An example of this can be coordination measures concerning the protection of interests of companies' shareholders and other stakeholders with a view to making such protection equivalent throughout the Union, where disparities between national rules are such as to obstruct freedom of establishment[41]. Recourse to this provision is possible if the aim is to prevent the emergence of current or future obstacles to the freedom of establishment resulting from the divergent development of national laws. The emergence of such obstacles must be likely and the measure in question must be designed to prevent them.[42]

This proposal regulates sustainability due diligence obligations of companies and at the same time covers – to the extent linked to that due diligence – corporate directors' duties and corporate management systems to implement due diligence. Thus, the proposal concerns processes and measures for the protection of the interests of members and stakeholders of the companies. Several Member States have recently introduced legislation on sustainability due diligence,[43] while others are in the process of legislating or considering action[44]. Also, an increasing number of Member States have recently been regulating the matter by requiring directors to take into account the company's external impacts[45], prioritize the interests of

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[41] It is recalled that as regards corporate governance measures, the EU has already legislated based on the same legal basis, e.g. Shareholders Rights Directives I and II.

[42] See e.g. Case C 380/03 Germany v Parliament and Council [2006] ECR I-11573, paragraph 38 and the case-law cited.

[43] See footnote 3. As regards EEA countries, Norway has adopted due diligence legislation.

[44] Austria, Belgium, Denmark, Finland, Italy, Luxembourg, the Netherlands (regarding broader legislation on responsible business conduct). There are civil society campaigns in favour of introducing due diligence legislation ongoing in Ireland, Spain and Sweden. Annex 8 of the Impact Assessment accompanying this proposal provides a detailed overview on Member State/EEA laws and initiatives.

[45] French *Loi Pacte*.

stakeholders in their decisions[46], or adopt a policy statement on the company's human rights strategy[47]. New and emerging laws on due diligence are considerably different in the Union despite the intention of all the Member States to build on existing international standards (UN Guiding Principles on Business and Human Rights OECD Responsible Business Conduct standards) and thus lead to diverging requirements. Certain Member States have adopted, or are likely to adopt, legislation that is limited to specific sustainability concerns in value chains.[48] Personal scope, substantive due diligence requirements, enforcement regimes and related directors' duties diverge and may do so even more in the future.[49] Other Member States can be expected to decide not to legislate in this field. Significantly different requirements among Member States thus create fragmentation of the internal market. This fragmentation is likely to increase over time.

This fragmentation also risks leading to an uneven playing field for companies within the internal market. First, companies and their directors – in particular of those which have cross-border value chains – are already subject to differing requirements and will likely be subject to even more differing requirements depending on where their registered seat is located. This creates distortions of competition. Besides, depending on how they structure their operations in the internal market, some companies may simultaneously fall within the scope of two or more different national legal frameworks dealing with sustainable corporate governance.[50] This could lead to duplication of requirements, difficulties in complying, lack of legal certainty for companies, and even mutually incompatible parallel legal requirements. Inversely, some companies may not fall within the scope of any national framework for the mere reason that they do not have links relevant under national law with the jurisdiction of a Member State that has due diligence rules in place and thereby gaining an advantage over their competitors.

The proposed act is designed to prevent and remove such obstacles to free movement and distortions of competition by harmonising the requirements for companies to carry out due diligence in their own operation, subsidiaries and value chains and related directors' duties. They will lead to a level playing field where companies of similar size and their directors are subject to the same requirements for integrating sustainable corporate governance and corporate due diligence measures in their internal management systems and thereby protecting the interests of the company's stakeholders in a similar way. Harmonised conditions would be beneficial for cross-border establishment including company operations and also investments, since it would facilitate comparison of corporate sustainability requirements and make engagement easier and thus less costly.

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46 For example the Netherlands.

47 See the German *Sorgfaltspflichtengesetz*).

48 For instance, the Dutch law referred to above sets up horizontal mandatory due diligence for child labour concerns through the whole value chain. In Austria, a political party referred a draft bill on social responsibility regarding forced and child labour in the garment sector.

49 The French *Loi relative au devoir de vigilance* and the German *Sorgfaltspflichtengesetz* differ considerably in terms of personal scope material requirements and enforcement regime.

50 For instance, pursuant to the German *Sorgfaltspflichtengesetz*, any company with a branch office and at least 3000 employees in Germany (1000 as from 2024) fall within the scope of the law.

Article 50 TFEU is *lex specialis* for measures adopted in order to attain freedom of establishment. Among the proposed measures, those concerning companies' corporate governance fall under this legal basis, in particular integrating due diligence into companies' policies, measures on companies' plan to ensure that the business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement, and related remuneration measures, as well as provisions on directors' duty of care, and directors' duties concerning setting up and overseeing due diligence.

In order to address the described internal market barriers comprehensively, Article 50 TFEU is here combined with the general provision of Article 114 TFEU. Article 114 TFEU provides for the adoption of measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market. The Union legislature may have recourse to Article 114 TFEU in particular where disparities between national rules are such as to obstruct the fundamental freedoms or create distortions of competition and thus have a direct effect on the functioning of the internal market.

As set out above, the differences between national rules on sustainable corporate governance and due diligence obligations have a direct impact on the functioning of the internal market, and that impact is likely to increase in the future. Beyond the matters regulated in Article 50 TFEU, this act concerns other areas of the establishment and functioning of the internal market. Notably, in the absence of action by the Union legislator, the production and movement of goods and services would be skewed to the benefit of jurisdictions with no due diligence regimes or with less demanding regimes, or companies established in such jurisdictions, substantially impacting the flow of goods and services. Moreover, companies supplying goods or services, in particular SMEs, will be confronted with diverging rules and expectations from customers located in different Member States. For instance, whilst one Member State law may require the supplier to carry out third-party audits, another Member State may require the same supplier to participate in a recognised industry schemes and multi-stakeholder initiatives. One Member State may require the company to carry out due diligence in relation to established business relationships whilst the other Member State may cover the direct suppliers only. This would lead to a multiplication of different partially incompatible requirements distorting the free flow of goods and services in the Union.

It is foreseeable that these distortions and impacts would become more serious with time as more and more Member States will adopt diverging national laws or may even lead to a race to the bottom in forthcoming due diligence legislations.

Distortions are also relevant for civil liability in case of harm caused in a company's value chain. Some national legal frameworks on due diligence include an express civil liability regime linked to the failure to execute due diligence, while others expressly exclude a specific civil liability regime.[51] A number of companies have been brought before courts for causing

[51] The French *Loi relative au devoir de vigilance* includes a provision on civil liability. The German *Sorgfaltspflichtengesetz* clarifies that a violation of an obligation under the law does not give rise to any civil liability while general liability rules remain unaffected. Moreover national civil liability legislations are not harmonized.

or failing to prevent adverse impacts at the level of their subsidiaries or value chains. Such cases are decided based on differing rules today. In the absence of common rules, divergent national liability regimes may lead to different outcomes depending on whether there is ownership control (as regards subsidiaries) or factual control (either through direct contracts or where control could be exercised by the company through contractual cascading or other leverage in indirect business relationships). This fragmentation would lead to distortions of competition in the internal market as a company located in one Member State would be subject to damages claims due to harm caused in its value chain whilst a company with the same value chain would be exempt from this financial and reputational risk because of diverging national rules.

The proposed civil liability regime would clarify which rules apply in case harm occurs in a company's own operation, at the level of its subsidiaries and at the level of direct and indirect business relations in the value chain. In addition, the proposed provision on applicable law serves the purpose of ensuring application of the harmonised rules, including on civil liability, also in cases where otherwise the law applicable to such claim is not the law of a Member State. It will therefore be essential to ensure the necessary level-playing field.

Subsidiarity

First, Member States' legislation alone in the area is unlikely to be sufficient and efficient. As regards specific transboundary problems, such as pollution, climate change, biodiversity etc. individual action is hampered in case of inaction by other Member States. The achievement of international commitments such as the goals of the UNFCCC[52]'s Paris Agreement on climate change, the Convention on Biological Diversity, as well as other multilateral environmental agreements by individual Member State action alone is unlikely. Furthermore, risks resulting from adverse human rights and environment impacts present in companies' value chains have often cross-border effects (e.g. pollution, transnational supply and value chains).

Second, many companies are operating EU-wide or globally; value chains expand to other Union Member States and increasingly to third countries. Institutional investors which invest across the borders own a large part (38%[53]) of the total market capitalisation of large European listed companies, therefore many companies have cross-border ownership and their operations are influenced by regulations in some countries or lack of action in others. This is one of the reasons why frontrunner companies arguably are reluctant to do a further steps in addressing sustainability issues including those in the value chains today[54] and ask for a cross-border level playing field.

Third, companies operating across the internal market and beyond need legal certainty and a level-playing field for their sustainable growth. Some Member States have recently introduced legislation on due diligence[55], while others are in the process of legislating or

52 United Nations Framework Convention on Climate Change

53 This number comes from the Impact Assessment of the Shareholders Rights Directive II.

54 E.g. food producer Danone has recently been forced to cut costs by investors on grounds of lack of short-term profitability, see article *Can Anglo-Saxon activist investors whip Danone into shape?*, available at https://www.economist.com/business/2021/02/20/can-anglo-saxon-activist-investors-whip-danone-into-shape.

55 See footnote 3.

considering action[56]. Existing Member State rules and those under preparation already have, and would further lead to diverging requirements, which risks being inefficient and leading to an uneven playing field. There are considerable indirect effects of diverging due diligence laws on the suppliers that supply to different companies falling under different laws, as the obligations are in practice translated into contractual clauses. If due diligence requirements are significantly different among Member States, this creates legal uncertainty, fragmentation of the Single market, additional costs and complexity for companies and their investors operating across borders as well as other stakeholders. EU action can avoid this and therefore has added value.

Finally, compared to individual action by Member States, EU intervention can ensure a strong European voice in policy developments at the global level[57].

Proportionality

The burden on companies stemming from compliance costs, has been adapted to the size, resources available, and the risk profile. Companies will only have to take appropriate measures that are commensurate with the degree of severity and the likelihood of the adverse impact, and reasonably available to the company, taking into account the circumstances of the specific case, including characteristics of the economic sector and of the specific business relationship and the company's influence thereof, and the need to ensure prioritisation of action. For that purpose the material and personal scope, and the enforcement provisions were restricted as further explained below.

As regards the "personal scope" of the due diligence obligations (i.e. which business categories are covered), small and medium sized enterprises (SMEs) that include micro companies and overall account for around 99 % of all companies in the Union, are excluded from the due diligence duty. For this category of companies, the financial and administrative burden of setting up and implementing a due diligence process would be relatively high. For the most part, they do not have pre-existing due diligence mechanisms in place, they have no know-how, specialised personnel, and the cost of carrying out due diligence would impact them disproportionately. They will, however, be exposed to some of the costs and burden through business relationships with companies in scope as large companies are expected to pass on demands to their suppliers. Hence, supporting measures will be necessary to help SMEs build operational and financial capacity. Companies whose business partner is an SME, are also required to support them in fulfilling the due diligence requirements, in case such requirements would jeopardize the viability of the SME. Moreover, the value chain of the financial sector does not cover SMEs that are receiving loan, credit, financing, insurance or reinsurance. At the same time, exposure of an individual SME to adverse sustainability impacts will as a general rule be lower than the exposure of larger companies. Therefore, very

56 See footnote 44.

57 In 2014, the UN Human Rights Council decided to establish an open-ended intergovernmental working group (OEIGWG) on transnational corporations and other business enterprises with respect to human rights, whose mandate shall be to elaborate an international legally binding instrument (LBI) to regulate, in international human rights law, the activities of transnational corporations and other business enterprises. In 2021, the OEIGWG released a third revised draft LBI on business activities and human rights, including due diligence measures and corporate liability for human rights abuses.

large companies[58] will be within the scope of the full due diligence obligation, also because many of them already have certain processes in place e.g. because of reporting obligations. In particular, the selected turnover criteria will filter those having the largest impact on the Union economy. Moreover, this Directive lays down measures to limit the passing on of the burden from those large companies to the smaller suppliers in the value chain and to use fair, reasonable, non-discriminatory and proportionate requirements *vis-a-vis* SMEs.

As far as companies with lower turnover and less employees[59] are concerned, the due diligence obligation is limited to those companies active in particularly high-impact sectors that are at the same time covered by existing sectoral OECD guidance[60]. Moreover, despite the fact that OECD guidance covers the financial sector, it is not included in the high- impact sectors due to its specificities. This limitation aims to create a balance between the interest in achieving the goals of the Directive and the interest in minimising the financial and administrative burden on companies. The due diligence obligation for these companies will be simplified as they would only focus on severe adverse impacts that are relevant for their sector. Moreover, the due diligence obligation will apply to them only 2 years after the end of the transposition period for this Directive allowing to establish the necessary processes and procedures and benefit from industry cooperation, technological developments, standards, etc. that are likely to be prompted by the earlier implementation date for larger companies.

To the extent that this Directive also covers third-country companies, the criteria used for defining the scope of EU and non-EU companies covered are not the same, but ensure that third country companies are not more likely to fall within the scope. For them, a net turnover threshold is used (EUR 150 million for group 1 and EUR 40 million for group 2), but all of this turnover needs to be generated in the Union. EU companies, in turn, have to have a net turnover of EUR 150 million generated worldwide and have to fulfil an employee criterion as well (above 500 employees in group 1 and above 250 employees in group 2). Such difference in the criteria used is justified for the following reasons:

– The EU turnover criterion for third-country companies creates a link to the EU. Including only turnover generated in the Union is justified since such a threshold, appropriately calibrated, creates a territorial connection between the third-country companies and the Union by the effects that the activities of these companies may have on the EU internal market, which is sufficient for the Union law to apply to third-country companies.

– Also, the Country-by-Country Reporting Directive – an amendment to the Accounting Directive – has already established the methods for calculating net turnover for non-EU companies, while such methodology does not exist for

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58 Large limited liability companies with more than 500 employees and a net turnover of more than EUR 150 million.

59 Large limited liability companies with more than 250 employees and a net turnover of more than EUR 40 million but not simultaneously exceeding both the 500 employee and the net turnover EUR 150 million net turnover thresholds, as well as third-country companies of a comparable legal form with a net EU turnover of EUR 40 to 150 million.

60 The OECD developed such sectoral guidance in order to promote the effective observance of OECD Guidelines on Multinational Enterprises. See the list of sectoral guidance documents at: http://mneguidelines.oecd.org/sectors/.

calculating the number of employees of third-country companies. The experience with the French law regulating due diligence shows that, in the absence of a common definition of an employee[61], the number of employees (worldwide) is difficult to calculate, which hinders the identification of which third-country companies are covered by the scope, preventing effective enforcement of the rules.

– Using both employee and turnover criteria for EU companies would ensure better alignment with the proposal for a Corporate Sustainability reporting Directive which should be used for the reporting of due diligence measures and policy for EU companies.

– While the Directive will cover about 13 000 EU companies[62], based on the estimations of the Commission, it will only cover about 4 000 third-country companies[63]. The fact that EU companies will only be covered if they also reach the minimum limit on the number of employees is very unlikely to change the conditions of competition in the EU internal market: the two size criteria applicable to EU companies, even if cumulative, will result in still covering relatively smaller companies compared to non-EU companies due to the fact that, in their case, the entire worldwide net turnover of the company is to be taken into account.

Finally, large third-country companies having a high turnover in the Union have the capacity to implement due diligence and will benefit from the advantages coming with due diligence also in their operations elsewhere. In all other aspects, third-country companies are covered by the due diligence rules the same way as their EU counterparts (for example as regards the regime applicable to companies operating in high-impact sectors and identical phase in period for those companies). The harmonisation of the duties of directors is limited to EU companies only, thus third-country companies will have more restricted obligations.

The “material scope” is focused and structured mainly upon the corporate due diligence obligation and covers human rights and those environmental adverse impacts that can be clearly defined in selected international conventions. Directors’ duties proposed ensure a close link with the due diligence obligations and are thus necessary for the due diligence to be effective. Directors’ duties also include the clarification of how directors are expected to comply with the duty of care to act in the best interest of the company.

Effective enforcement of the due diligence duty is key to achieving the objectives of the initiative. This Directive will provide for a combination of sanctions and civil liability.

As regards private enforcement through civil liability, a different approach is used regarding the company`s own operations and its subsidiaries on the one hand and regarding business relations on the other hand. In particular, civil liability concerns only established business relationships with which a company expects to have a lasting relationship, in view of its

[61] For the Union see for example Article 5 of the Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized companies (2003/361/EC) (OJ L 124, 20.5.2003, p. 36).

[62] In group 1: 9 400 companies, in group 2: 3 400 companies.

[63] In group 1: 2 600 companies, in group 2: 1 400 companies. The methodology used for calculating the number of third-country companies is explained in the accompanying Staff Working Document.

intensity or duration and which does not represent a negligible or merely ancillary part of the company`s value chain. The company should not be liable for failing to prevent or cease harm at the level of indirect business relationships if it used contractual cascading and assurance and put in place measures to verify compliance with it, unless it was unreasonable, in the circumstances of the case, to expect that the action actually taken, including as regards verifying compliance, would be adequate to prevent, mitigate, bring to an end or minimise the extent of the adverse impact. In addition, in the assessment of the existence and extent of liability, due account is to be taken of the company's efforts, insofar as they relate directly to the damage in question, to comply with any remedial action required of them by a supervisory authority, any investments made and any targeted support provided as well as any collaboration with other entities to address adverse impacts in its value chains.

This approach to civil liability will also limit the risk of excessive litigation.

The measures related to public enforcement of the due diligence duty do not go beyond what is necessary. This Directive clarifies that any sanction imposed due to non-compliance with the due diligence obligations has to be proportionate. If the public authorities that investigate the company's compliance with this Directive identify a failure to comply they should first grant the company an appropriate period of time to take remedial action. The Directive outlines a limited number of sanctions that should apply in all Member States but leaves it to the Member States to ensure a proportionate enforcement process, in line with their national law. When pecuniary sanctions are imposed, they shall be based on the company's turnover to ensure their proportionate level.

Furthermore, this Directive does not entail unnecessary costs for the Union, national governments, regional or local authorities. The Directive will leave it up to the Member States how to organise enforcement. Supervision can be carried out by existing authorities. To reduce the costs (for instance when supervising third-country companies active in various Member States) and improve the supervision, coordination, investigation and exchange of information the Commission will set up a European Network of Supervisory Authorities.

This Directive allows for company cooperation, use of industrial schemes and multi-stakeholder initiatives to reduce the cost of compliance for the companies with this Directive.

Choice of the instrument

The proposed instrument is a Directive, since Article 50 TFEU is the legal basis for company law legislation regarding the protection of the interests of companies' members and others with a view to making such protection equivalent throughout the Union. Article 50 TFEU requires the European Parliament and the Council to act by means of directives.

The Commission shall adopt delegated acts laying down the criteria for the reporting by third country companies on due diligence.

In order to provide support to companies and to Member State authorities on how companies should fulfil their due diligence obligations, the Commission, where necessary in consultation with relevant European bodies, international bodies having expertise in due diligence implementation, and others, may issue guidelines. Guidelines may also be used to outline non-binding model contractual clauses that companies can use when cascading the obligation in their value chain.

In addition, the Commission may put in place other supporting measures building on existing EU actions and tools to support due diligence implementation within the Union and in third countries, including facilitation of joint stakeholder initiatives to help companies fulfil their obligations and support SMEs impacted by this Directive in other ways. This may be further complemented by EU development cooperation instruments to support third country governments and upstream economic operators in third countries addressing adverse human rights and environmental impacts of their operations and upstream business relationships.

3. RESULTS OF EX-POST EVALUATIONS, STAKEHOLDER CONSULTATIONS AND IMPACT ASSESSMENTS

Stakeholder consultations

In line with the better regulation guidelines, several consultation activities have taken place:

– The inception impact assessment (roadmap), which received 114 feedbacks;

– The open public consultation[64], which received 473 461 responses and 122.785 citizen signatures, the vast majority of which were submitted through campaigns using pre-filled questionnaires, and 149 position papers;

– A dedicated consultation of social partners;

– A number of stakeholder workshops and meetings, e.g. meeting of the Informal Company Law Expert Group, mainly composed of company law legal academics (ICLEG), meeting with Member State representatives in the Company Law Expert Group (CLEG); and

– Conferences and meetings with business associations, individual businesses, including Small and Medium-sized Enterprises (SMEs) representatives, civil society, including non-governmental and not-for-profit organisations, as well as international organisations, such as OECD.

Overall, the consultation activities showed that there is generally a wide acknowledgement among stakeholders of the need for an EU legal framework for due diligence.[65] In particular, large companies across the board asked for greater harmonisation in the area of due diligence to improve legal certainty and create a level playing field. Citizens and civil society associations perceived the current regulatory framework as ineffective to ensure corporate accountability for negative impacts on the human rights and environment.

A vast majority of respondents to the open public consultation, including most participating Member States, were in favour of a horizontal approach to due diligence over a sector-specific or thematic approach[66]. Companies indicated that they feared the risk of competitive disadvantages vis-à-vis third-country companies that do not have the same duties. Accordingly, most respondents agreed that due diligence rules should also apply to third-

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64 Summary of the open public consultation for the initiative on sustainable corporate governance, available at https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance/public-consultation_en.

65 For instance, in response to the open public consultation, NGOs supported the need for action with 95.9%, companies with 68.4% (large companies with 75.5%, SMEs with 58.7 %) and business associations with 59.6 %.

66 While 97.2% of NGOs preferred a horizontal approach, overall companies did so with 86.8%, including SMEs (81.8%), as well as business association (85.3%). This is true also for Member States respondents.

country companies which are not established in the EU but carry out activities of a certain scale in the EU[67].

Regarding an enforcement mechanism accompanying a mandatory due diligence duty, all stakeholder groups responding to the open public consultation indicated by a majority that supervision by competent national authorities with a mechanism of EU cooperation/coordination is the most suited option.[68]

A majority of respondents in all stakeholder groups considered binding rules with targets to be the option entailing the most costs, but also the most benefits overall. Although most respondents saw the positive impact on third countries, a subset of respondents fear a potential negative impact of due diligence rules on third countries if companies investing in third countries with weak human rights, including social and labour, and environmental protection, would have to withdraw from these countries.

Detailed information on the consultation strategy and conclusions of the stakeholder consultations can be found in Annex 2 of the impact assessment report.

Collection and use of expertise

To support the analysis of the different options, the Commission awarded support contracts to external experts for a study on due diligence requirements through the supply chain[69] and for a study on directors' duties and sustainable corporate governance[70]. These experts worked in close cooperation with the Commission throughout the different phases of the study.

Besides these support studies, additional expertise was identified through literature research and through the stakeholder consultation responses.

Alongside the above-mentioned support studies, expert group meetings, and stakeholder consultations, the Commission also paid close attention to the relevant European Parliament resolution and to the Council Conclusions. The European Parliament resolution of 10 March 2021 provided recommendations to the Commission on corporate due diligence and corporate accountability, calling upon the Commission to propose EU rules for a comprehensive corporate due diligence obligation. The Council Conclusions on Human Rights and Decent Work in Global Supply Chains of 1 December 2020 called upon the Commission to table a proposal for an EU legal framework on sustainable corporate governance, including cross-sector corporate due diligence obligations along global value chains.

Impact assessment

The analysis in the impact assessment addressed in a broad sense the problem arising from the need to reinforce sustainability in corporate governance and management systems, with two

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67 97 % of respondents agreed to this statement (NGOs 96.1%, business associations 96.5%, companies 93.8%, including SMEs 86.4%). All Member State respondents agree with this statement as well.

68 It was followed by the option of judicial enforcement with liability (49%) and supervision by competent national authorities based on complaints about non-compliance with effective sanctions (44%).

69 See reference in footnote 8.

70 European Commission, Directorate-General for Justice and Consumers, Study on directors' duties and sustainable corporate governance: final report, Publications Office, 2020, https://data.europa.eu/doi/10.2838/472901. https://data.europa.eu/doi/10.2838/472901.

dimensions: (1) stakeholder interests and stakeholder-related (sustainability) risks to companies are not sufficiently taken into account in corporate risk management systems and decisions; (2) companies do not sufficiently mitigate their adverse human rights and environmental impacts, do not have adequate governance, management systems and measures to mitigate their harmful impacts.

After consideration of different policy options mainly in the areas of corporate due diligence duty and directors' duties, the impact assessment proposed a preferred package of policy options across three elements: corporate due diligence, directors' duties and remuneration, which complement each other.

The draft impact assessment was submitted to the Commission's Regulatory Scrutiny Board on 9 April 2021. Following the negative opinion by the Board, a revised impact assessment was submitted to the Board for a second opinion on 8 November 2021. While noting the significant revision of the report in response to the Board`s first opinion, the Board nevertheless issued a second negative opinion on 26 November 2021[71], which underlined the need for political guidance on whether, and under which conditions, the sustainable corporate governance initiative could proceed further. The Board maintained its negative opinion because it considered that the impact assessment report did not sufficiently (1) address the problem description and provide convincing evidence that EU businesses, in particular SMEs, do not already sufficiently reflect sustainability aspects or do not have sufficient incentives to do so; (2) present a scope of policy options and identify or fully assess key policy choices; (3) assess the impacts in a complete, balanced and neutral way and reflect uncertainty related to the realisation of benefits, and (4) demonstrate the proportionality of the preferred option.

Therefore, in order to address the comments of the Board's second negative opinion, the impact assessment is complemented by a staff working document on the follow-up of the Board's opinion that provides additional clarifications and evidence on the areas where the Board had provided specific suggestions of improvements.

According to the Commission's Better Regulation rules a positive opinion from the Regulatory Scrutiny board is required for a file to proceed to the adoption stage. However, the Vice President for Inter-Institutional Relations and Foresight can allow for the continuation of the preparations for an initiative that has been subject to a second negative opinion by the Regulatory Scrutiny Board. It is important to flag that the opinions of the Regulatory scrutiny Board are an assessment of the quality of the impact assessment and not an assessment of the related legislative proposal.

The Commission, also in the light of the agreement by the Vice-President for Inter-Institutional Relations and Foresight, has considered it opportune to proceed with the initiative for the following reasons:

– the *political importance* of this initiative for the Commission's political priority of "An economy that works for people", including within the context of the Sustainable Finance package and the European Green Deal and

[71] SEC(2022)95

- the *urgency of action* in the field of value chain due diligence as contribution to the sustainability transition, and to address the risk of the increasing Single market fragmentation, as well as the view that
- the *additional clarification and evidence* provided satisfactorily addressed the shortcomings of the impact assessment identified by the Regulatory Scrutiny Board and were considered in the adapted legal proposal.

With regard to its importance and urgency, the Commission also took note that the initiative was included in the Joint Political Priorities for 2022 by the European Parliament, the Council and the Commission.

After careful analysis of the Board's findings and considering the reflections on the additional clarifications and evidence provided, the Commission considers that the proposal, which has been significantly revised as compared to the package of policy options put forward by the impact assessment, allows still to decisively move forward towards the overall objective to better exploit the potential of the single market to contribute to the transition to a sustainable economy and to foster long-term sustainable and responsible corporate behaviour. The Directive is more focused and targeted compared to the preferred option outlined in the draft impact assessment. The core of it is the due diligence obligation, while significantly reducing directors' duties by linking them closely to the due diligence obligation. In addition, the scope of due diligence is adapted. A detailed description of the adaptations made to the preferred option package of the impact assessment can be found in the accompanying Staff Working Document that presents the follow-up to the opinion of the Regulatory Scrutiny Board and additional information.

In short, the "personal scope" i.e. which business categories are covered has been significantly reduced following reflections triggered by the Board's comments on the problem description, in particular with regard to SMEs, and on the proportionality of the preferred option. Concretely, SMEs have been completely excluded, from the scope, and the coverage of high-impact sectors has been shifted only to companies having more than 250 employees and more than EUR 40 million worldwide net turnover (while large companies which simultaneously exceed both the 500 employee and the EUR 150 million worldwide net turnover limits are covered by the scope irrespective of their sectors of economic activities. The high-impact sectors are directly defined in the text, thus also reflecting on the Board's comments as regards legislative technique. The definition of high-impact sectors has been limited to sectors with high risk of adverse impacts and for which OECD guidance exists. For midcap companies in high-impact sectors, the rules will start to apply after a transition period of two years to allow for a longer adaptation period. In addition, the due diligence obligations of these companies are limited only to severe impacts relevant for their sector.

To reach the objectives of the initiative effectively, the scope of this proposal extends to companies from third countries. Only such non-EU companies are covered which have a direct link to the Union market, and which meet the similar turnover threshold as EU companies but within Union market. Furthermore, they will face the same obligations regarding due diligence as the respective EU companies.

The Directive also indicates that accessible and practical support is necessary for companies, in particular SMEs in the value chain, to prepare for the obligations (or the consequent demands the may be passed on to them indirectly). This could include practical guidance and supporting tools such as hotlines, databases or training, as well as the setup of an observatory to help companies with the implementation of the Directive. Moreover, the review clause makes explicit reference to the personal scope of the Directive (i.e. coverage of business categories), which should be reviewed in light of the practical experiences with the application of the legislation. Other mitigation measures to reduce indirect impact on the SMEs are part of the obligations of companies in the scope of this Directive.

As regards the material scope (i.e. what is covered), a cross-cutting instrument covering human rights and environmental impacts has been retained. This reflects the strong consensus amongst stakeholder groups that a horizontal framework is necessary to address the identified problems.

Furthermore, the Board commented that the impact assessment is not sufficiently clear about the need to regulate directors' duties on top of due diligence requirements. The Commission therefore decided to address this issue by deviating from the preferred options' package in the impact assessment and focussing on the directors' duties element, in light also of the existing international standards[72], on due diligence and duty of care. This encompasses directors' duties relating to the setting up and overseeing the implementation of corporate due diligence processes and measures, establishing code of conduct for this purpose as well as integrating due diligence into the corporate strategy. In order to fully reflect the role of directors in light of the corporate due diligence obligations, the directors' general duty of care for the company, which is present in the company law of all Member States, is also being clarified providing that when fulfilling their duty to act in the best interest of the company, directors should take into account the sustainability matters of the proposal for a corporate sustainability reporting Directive, including, where applicable, human rights, climate change and environmental consequences, including in the short, medium and long term horizons. Further reaching specific directors' duties that had been put forward in the impact assessment are not retained. This will ensure that the proposal delivers on its objective while remaining proportionate.

With regard to comments of the Board, this Explanatory Memorandum as well as the recitals of the legislative proposal contain comprehensive explanations of the policy choices made. While the impact assessment submitted to the Board and the Board's opinion have been published unchanged, a separate accompanying Staff Working Document has been prepared to provide additional evidence and clarifications that follows up on the Board's remarks including as regards evidence. This document addresses in particular the following:

1. Problem description:

– the scale and evolution of the environmental and sustainability problems directly linked to the apparent absence or insufficient use of corporate sustainability management practices by EU companies to be tackled by this Directive and the added value of the Directive in relation to the comprehensive package of measures to promote sustainability under the Green Deal;

– why the market and competitive dynamics together with the further evolution of companies' corporate strategies and risk management systems are considered insufficient and as regards the assumed causal link between using corporate sustainability tools and their practical effect in tackling the problems;

2. Impacts of the preferred option:

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[72] See footnote 6.

– issues related to third countries, integrating observations (i) on expected developments in third countries (including taking into account EU and international trade and development support measures), (ii) on impacts on third countries and on suppliers in third countries;

– the enforcement mechanism, further expanding on the added value of a two-pillar enforcement system that builds on administrative enforcement and civil liability;

– impacts on competition and competitiveness.

Regulatory fitness and simplification

Small and medium-sized enterprises, including micro enterprises are not included in the scope and indirect effects on them will be mitigated through supporting measures and guidelines at Union and Member State level as well in business to business relations with the use of model contractual clauses and by proportionality requirements for the larger business partner.

Fundamental rights

As explained in the impact assessment and based on existing evidence, mandatory due diligence requirements can have significant benefits for the protection and promotion of fundamental rights.

4. BUDGETARY IMPLICATIONS

There are no direct implications to the Union budget.

5. OTHER ELEMENTS

Implementation plans and monitoring, evaluation and reporting arrangements

The Commission will set up a European Network of Supervisory Authorities to help with the implementation of this Directive. Such Network will be composed by the representatives of the supervisory authorities designated by the Member States and where necessary joined by other Union agencies with relevant expertise in the areas covered by this Directive, to ensure compliance by the companies of their due diligence obligations, in order to facilitate and ensure the coordination and convergence of regulatory, investigative, sanctioning and supervisory practices, and the sharing of information among these supervisory authorities.

After seven years following the end of the transposition period, the Commission shall report on the implementation of this Directive, including, among other aspects, its effectiveness. The report shall be accompanied, if appropriate, by a legislative proposal.

In order to provide clarity and support to companies and Member States with the implementation of the directive, the Commission will issue guidance, where necessary.

Explanatory documents

To ensure the proper implementation of this Directive, the explanatory document, e.g. in the form of correlation tables would be necessary.

Detailed explanation of the specific provisions of the proposal

Article 1 sets out the subject matter of the Directive, i.e. laying down rules on obligations of due diligence by companies regarding actual and potential human rights and environmental adverse impacts, with respect to their own operations, the operations of their subsidiaries, and the value chain operations carried out by established business relationships; the provision also specifies that this Directive establishes rules on liability for violations of the due diligence obligation.

Article 2 establishes the personal scope of application of the Directive and sets out the criteria based on which a Member State is competent to regulate matters covered in this Directive.

Article 3 contains definitions for the purpose of this Directive.

Article 4 requires Member States to ensure that companies conduct human rights and environmental due diligence by complying with the specific requirements listed in Articles 5 to 11 of the Directive.

Article 5 requires Member States to ensure that companies integrate due diligence into all corporate policies and have in place a due diligence policy that is updated annually. The provision specifies that this policy should include a description of the company's approach to due diligence, of a code of conduct to be followed by the company's employees and subsidiaries, of the processes put in place to implement due diligence.

Article 6 establishes the obligation for Member States to ensure that companies take appropriate measures to identify actual or potential adverse human rights and environmental impacts in their own operations, in their subsidiaries and at the level of their established direct or indirect business relationships in their value chain.

Article 7 sets out the requirement for Member States to ensure that companies take appropriate measures to prevent potential adverse impacts identified pursuant to Article 6, or to adequately mitigate those impacts, where prevention is not possible or requires gradual implementation.

Article 8 establishes the obligation for Member States to ensure that companies take appropriate measures to bring to an end actual adverse human rights and environmental impacts that they had or could have identified pursuant to Article 6. Where an adverse impact that has occurred at the level of established direct or indirect established business relationships cannot be brought to an end, Member States should ensure that companies minimise the extent of the impact.

Article 9 sets out the obligation for Member States to ensure that companies provide for the possibility to submit complaints to the company in case of legitimate concerns regarding those potential or actual adverse impacts, including in the company's value chain. Companies are required to grant this possibility to persons who are affected or have reasonable grounds to believe that they might be affected by an adverse impact, to trade unions and other workers' representatives representing individuals working in the value chain concerned, and to civil society organisations active in the area concerned.

Article 10 introduces the obligation for Member States to require companies to periodically assess the implementation of their due diligence measures in order to verify that adverse impacts are properly identified and that preventive or corrective measures are implemented, and to determine the extent to which adverse impacts have been prevented or brought to an end or their extent minimised.

Article 11 establishes the obligation for Member States to ensure that companies that are not subject to reporting requirements under Directive 2013/34/EU report on the matters covered by this Directive and publish an annual statement on their website.

Article 12 sets out the obligation for the Commission to adopt guidance about non-binding model contract clauses to help companies comply with Article 7(2), point (b), and Article 8(3) point (c).

Article 13 sets out the possibility for the Commission, in order to provide support to companies or to Member State authorities on how companies should fulfil their due diligence obligations, to issue guidelines, for specific sectors or specific adverse impacts, in consultation with the European Union Agency for Fundamental Rights, the European Environment Agency, and where appropriate with international bodies having expertise in due diligence.

Article 14 requires the Member States and Commission to provide accompanying measures to companies in the scope of this Directive actors and to actors along global value chains that are indirectly impacted by the obligations of the Directive. Such support can range from the operation of dedicated websites, portals or platforms to financial support to SMEs, and facilitation of joint stakeholder initiatives. This provision further clarifies that companies may rely on industry schemes and multi-stakeholder initiatives to support the implementation of due diligence and that the Commission, in collaboration with Member States, may issue guidance for assessing the fitness of such schemes.

Article 15 requires the Member States ensure that certain companies adopt a plan to ensure that the business model and strategy of the company are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement.

Article 16 introduces the requirement for companies formed in accordance with the legislation of a third country and falling within the scope of application of the present Directive pursuant to Article 2(2), to designate a sufficiently mandated authorised representative in the Union to be addressed by Member States' competent authorities, on all issues necessary for the receipt of, compliance with and enforcement of legal acts issued in relation to this Directive.

Article 17 sets out the requirement for Member States to designate one or more national supervisory authorities in order to ensure compliance by companies with their due diligence obligations and their obligation under Article 15(1) and (2) and to exercise the powers of enforcement of those obligations in accordance with Article 18.

Article 18 sets out the appropriate powers and resources of the supervisory authorities designated by the Member States to carry out their tasks of supervision and enforcement.

Article 19 establishes the requirement for Member States to ensure that any natural or legal person that has reasons to believe, on the basis of objective circumstances, that a company does not appropriately comply with the provisions of this Directive, is entitled to submit substantiated concerns, in particular in the Member State of his or her habitual residence, registered office, place of work or place of the alleged infringement, to the supervisory authorities.

Article 20 sets out that Member States shall lay down rules on sanctions applicable to infringements of the national provisions adopted pursuant to this Directive, and shall take all measures necessary to ensure that they are implemented. The sanctions shall be effective, dissuasive and proportionate. Member States shall ensure that decision of the supervisory authorities containing sanctions related to the breach of the provisions of this directive should be published.

Article 21 introduces a European Network of Supervisory Authorities composed by the representatives of the supervisory national authorities referred to in Article 16, with the aim to facilitate and ensure the coordination and alignment of regulatory, investigative, sanctioning and supervisory practices, and the sharing of information among these supervisory authorities.

Article 22 sets out the requirement for Member States to lay down rules governing the civil liability of the company for damages arising due to its failure to comply with the due diligence obligations under specific conditions. It also introduces the obligation for Member States to ensure that the liability provided for in paragraphs 1 to 3 of this Article is not denied on the sole ground that the law applicable to such claims is not the law of a Member State.

Article 23 establishes the application of Directive (EU) 2019/1937 of the European Parliament and of the Council of 23 October 2019 on the protection of persons who report breaches of Union law, to the reporting of all breaches of this Directive and the protection of persons reporting such breaches.

Article 23 clarifies conditions of public support for companies.

Article 25 clarifies directors' duty of care.

Article 26 lays down the duty for directors of EU companies to set up and oversee the implementation of corporate sustainability due diligence processes and measures and to adapt the corporate strategy to due diligence.

Article 27 amends the Annex of Directive (EU) No 2019/1937.

Article 28 sets out the rules concerning delegated acts.

Article 29 contains a provision on the review of this Directive.

Article 30 contains provisions on the transposition of the Directive.

Article 31 sets the date of when this Directive enters into force.

Article 32 sets out the addressees of this Directive.

The lists contained in the Annex specify the adverse environmental impacts and adverse human rights impacts relevant for this Directive, to cover the violation of rights and prohibitions including the international human rights agreements (Part I Section 1), human rights and fundamental freedoms conventions (Part I Section 2), and the violation of internationally recognised objectives and prohibitions included in the environmental conventions (Part II).

2022/0051 (COD)

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 50(1) and (2)(g) and Article 114 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Economic and Social Committee[73],

Acting in accordance with the ordinary legislative procedure,

Whereas:

(1) The Union is founded on the respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights as enshrined in the EU Charter of Fundamental Rights. Those core values that have inspired the Union's own creation, as well as the universality and indivisibility of human rights, and respect for the principles of the United Nations Charter and international law, should guide the Union's action on the international scene. Such action includes fostering the sustainable economic, social and environmental development of developing countries.

(2) A high level of protection and improvement of the quality of the environment and promoting European core values are among the priorities of the Union, as set out in the Commission's Communication on A European Green Deal[74]. These objectives require the involvement not only of the public authorities but also of private actors, in particular companies.

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[73] OJ C , , p. .

[74] Communication from the Commission to the European Parliament the European Council, the Council, the European Economic and Social Committee and the Committee of the Region "The European Green Deal" (COM/2019/640 final).

(3) In its Communication on a Strong Social Europe for Just Transition[75], the Commission committed to upgrading Europe's social market economy to achieve a just transition to sustainability. This Directive will also contribute to the European Pillar of Social Rights, which promotes rights ensuring fair working conditions. It forms part of the EU policies and strategies relating to the promotion of decent work worldwide, including in global value chains, as referred to in the Commission Communication on decent work worldwide[76].

(4) The behaviour of companies across all sectors of the economy is key to success in the Union's sustainability objectives as Union companies, especially large ones, rely on global value chains. It is also in the interest of companies to protect human rights and the environment, in particular given the rising concern of consumers and investors regarding these topics. Several initiatives fostering enterprises which support value-oriented transformation already exist on Union[77], as well as national[78] level.

(5) Existing international standards on responsible business conduct specify that companies should protect human rights and set out how they should address the protection of the environment across their operations and value chains. The United Nations Guiding Principles on Business and Human Rights[79] recognise the responsibility of companies to exercise human rights due diligence by identifying, preventing and mitigating the adverse impacts of their operations on human rights and by accounting for how they address those impacts. Those Guiding Principles state that businesses should avoid infringing human rights and should address adverse human rights impacts that they have caused, contributed to or are linked with in their own operations, subsidiaries and through their direct and indirect business relationships.

(6) The concept of human rights due diligence was specified and further developed in the OECD Guidelines for Multinational Enterprises[80] which extended the application of due diligence to environmental and governance topics. The OECD Guidance on Responsible

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75 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – A Strong Social Europe for Just Transitions (COM/2020/14 final).

76 Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on decent work worldwide for a global just transition and a sustainable recovery, COM(2022) 66 final.

77 'Enterprise Models and the EU agenda', *CEPS Policy Insights*, No PI2021-02/ January 2021.

78 E.g. https://www.economie.gouv.fr/entreprises/societe-mission

79 United Nations' "Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework", 2011, available at https://www.ohchr.org/documents/publications/guidingprinciplesbusinesshr_en.pdf.

80 OECD Guidelines for Multinational Enterprises, 2011 updated edition, available at http://mneguidelines.oecd.org/guidelines/.

Business Conduct and sectoral guidance[81] are internationally recognised frameworks setting out practical due diligence steps to help companies identify, prevent, mitigate and account for how they address actual and potential impacts in their operations, value chains and other business relationships. The concept of due diligence is also embedded in the recommendations of the International Labour Organisation (ILO) Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy.[82]

(7) The United Nations' Sustainable Development Goals[83], adopted by all United Nations Member States in 2015, include the objectives to promote sustained, inclusive and sustainable economic growth. The Union has set itself the objective to deliver on the UN Sustainable Development Goals. The private sector contributes to those aims.

(8) International agreements under the United Nations Framework Convention on Climate Change, to which the Union and the Member States are parties, such as the Paris Agreement[84] and the recent Glasgow Climate Pact[85], set out precise avenues to address climate change and keep global warming within 1.5 C degrees. Besides specific actions being expected from all signatory Parties, the role of the private sector, in particular its investment strategies, is considered central to achieve these objectives.

(9) In the European Climate Law[86], the Union also legally committed to becoming climate-neutral by 2050 and to reducing emissions by at least 55% by 2030. Both these commitments require changing the way in which companies produce and procure. The Commission's 2030 Climate Target Plan[87] models various degrees of emission reductions required from different economic sectors, though all need to see considerable reductions under all scenarios for the Union to meet its climate objectives. The Plan also underlines that "changes in corporate governance rules and practices, including on sustainable finance, will make company owners and managers prioritise sustainability objectives in their actions and strategies." The 2019 Communication on the European Green Deal[88]

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81 OECD Guidance on Responsible Business Conduct, 2018, and sector-specific guidance, available at https://www.oecd.org/investment/due-diligence-guidance-for-responsible-business-conduct.htm.

82 The International Labour Organisation's "Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy, Fifth Edition, 2017, available at: https://www.ilo.org/empent/Publications/WCMS_094386/lang--en/index.htm.

83 https://www.un.org/ga/search/view_doc.asp?symbol=A/RES/70/1&Lang=E.

84 https://unfccc.int/files/essential_background/convention/application/pdf/english_paris_agreement.pdf.

85 Glasgow Climate Pact, adopted on 13 November 2021 at COP26 in Glasgow, https://unfccc.int/sites/default/files/resource/cma2021_L16_adv.pdf.https://unfccc.int/sites/default/files/resource/cma2021_L16_adv.pdf.

86 Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 ('European Climate Law') PE/27/2021/REV/1 (OJ L 243, 9.7.2021, p. 1).

87 SWD/2020/176 final.

88 COM/2019/640 final.

sets out that all Union actions and policies should pull together to help the Union achieve a successful and just transition towards a sustainable future. It also sets out that sustainability should be further embedded into the corporate governance framework.

(10) According to the Commission Communication on forging a climate-resilient Europe[89] presenting the Union Strategy on Adaptation to climate change, new investment and policy decisions should be climate-informed and future-proof, including for larger businesses managing value chains. This Directive should be consistent with that Strategy. Similarly, there should be consistency with the Commission Directive […] amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks (Capital Requirements Directive)[90], which sets out clear requirements for banks' governance rules including knowledge about environmental, social and governance risks at board of directors level.

(11) The Action Plan on a Circular Economy[91], the Biodiversity strategy[92], the Farm to Fork strategy[93] and the Chemicals strategy[94] and Updating the 2020 New Industrial Strategy: Building a stronger Single Market for Europe's recovery[95], Industry 5.0[96] and the European Pillar of Social Rights Action Plan[97] and the 2021 Trade Policy Review[98] list an initiative on sustainable corporate governance among their elements.

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89 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on Forging a climate-resilient Europe – the new EU Strategy on Adaptation to Climate Change (COM/2021/82 final), available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2021:82:FIN.

90 OJ C […], […], p. […].

91 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on A new Circular Economy Action Plan For a cleaner and more competitive Europe (COM/2020/98 final).

92 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the EU Biodiversity Strategy for 2030 Bringing nature back into our lives (COM/2020/380 final).

93 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on A Farm to Fork Strategy for a fair, healthy and environmentally-friendly food system (COM/2020/381 final).

94 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the Chemicals Strategy for Sustainability Towards a Toxic-Free Environment (COM/2020/667 final).

95 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on Updating the 2020 New Industrial Strategy: Building a stronger Single Market for Europe's recovery (COM/2021/350 final).

96 Industry 5.0; https://ec.europa.eu/info/research-and-innovation/research-area/industrial-research-and-innovation/industry-50_en

97 https://op.europa.eu/webpub/empl/european-pillar-of-social-rights/en/

(12) This Directive is in coherence with the EU Action Plan on Human Rights and Democracy 2020-2024[99]. This Action Plan defines as a priority to strengthen the Union's engagement to actively promote the global implementation of the United Nations Guiding Principles on Business and Human Rights and other relevant international guidelines such as the OECD Guidelines for Multinational Enterprises, including by advancing relevant due diligence standards.

(13) The European Parliament, in its resolution of 10 March 2021 calls upon the Commission to propose Union rules for a comprehensive corporate due diligence obligation[100]. The Council Conclusions on Human Rights and Decent Work in Global Supply Chains of 1 December 2020 called upon the Commission to table a proposal for a Union legal framework on sustainable corporate governance, including cross-sector corporate due diligence obligations along global supply chains.[101] The European Parliament also calls for clarifying directors` duties in its own initiative report adopted on 2 December 2020 on sustainable corporate governance. In their Joint Declaration on EU Legislative Priorities for 2022[102], the European Parliament, the Council of the European Union and the Commission have committed, to deliver on an economy that works for people, and to improve the regulatory framework on sustainable corporate governance.

(14) This Directive aims to ensure that companies active in the internal market contribute to sustainable development and the sustainability transition of economies and societies through the identification, prevention and mitigation, bringing to an end and minimisation of potential or actual adverse human rights and environmental impacts connected with companies' own operations, subsidiaries and value chains.

(15) Companies should take appropriate steps to set up and carry out due diligence measures, with respect to their own operations, their subsidiaries, as well as their established direct and indirect business relationships throughout their value chains in accordance with the provisions of this Directive. This Directive should not require companies to guarantee, in all circumstances, that adverse impacts will never occur or that they will be stopped. For

98 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Trade Policy Review – An Open, Sustainable and Assertive Trade Policy (COM/2021/66/final).

99 Joint Communication to the European Parliament and the Council on the EU Action Plan on Human Rights and Democracy 2020-2024 (JOIN/2020/5 final).

100 European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL)), P9_TA(2021)0073, available at https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?lang=en&reference=2020/2129(INL).

101 Council Conclusions on Human Rights and Decent Work in Global Supply Chains, 1 December 2020 (13512/20).

102 Joint declaration of the European Parliament, the Council of the European Union and the European Commission on EU Legislative Priorities for 2022, available at https://ec.europa.eu/info/sites/default/files/joint_declaration_2022.pdf.

example with respect to business relationships where the adverse impact results from State intervention, the company might not be in a position to arrive at such results. Therefore, the main obligations in this Directive should be 'obligations of means'. The company should take the appropriate measures which can reasonably be expected to result in prevention or minimisation of the adverse impact under the circumstances of the specific case. Account should be taken of the specificities of the company's value chain, sector or geographical area in which its value chain partners operate, the company's power to influence its direct and indirect business relationships, and whether the company could increase its power of influence.

(16) The due diligence process set out in this Directive should cover the six steps defined by the OECD Due Diligence Guidance for Responsible Business Conduct, which include due diligence measures for companies to identify and address adverse human rights and environmental impacts. This encompasses the following steps: (1) integrating due diligence into policies and management systems, (2) identifying and assessing adverse human rights and environmental impacts, (3) preventing, ceasing or minimising actual and potential adverse human rights, and environmental impacts, (4) assessing the effectiveness of measures, (5) communicating, (6) providing remediation.

(17) Adverse human rights and environmental impact occur in companies' own operations, subsidiaries, products, and in their value chains, in particular at the level of raw material sourcing, manufacturing, or at the level of product or waste disposal. In order for the due diligence to have a meaningful impact, it should cover human rights and environmental adverse impacts generated throughout the life-cycle of production and use and disposal of product or provision of services, at the level of own operations, subsidiaries and in value chains.

(18) The value chain should cover activities related to the production of a good or 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 established business relationships of the company. It should encompass upstream established direct and indirect business relationships that design, extract, manufacture, transport, store and supply raw material, products, parts of products, or provide services to the company that are necessary to carry out the company's activities, and also downstream relationships, including established direct and indirect business relationships, that use or receive products, parts of products or services from the company up to the end of life of the product, including inter alia the distribution of the product to retailers, the transport and storage of the product, dismantling of the product, its recycling, composting or landfilling.

(19) As regards regulated financial undertakings providing loan, credit, or other financial services, "value chain" with respect to the provision of such services should be limited to the activities of the clients receiving such services, and the subsidiaries thereof whose activities are linked to the contract in question. Clients that are households and natural persons not acting in a professional or business capacity, as well as small and medium sized undertakings, should not be considered to be part of the value chain. The activities of the companies or other legal entities that are included in the value chain of that client should not be covered.

(20) In order to allow companies to properly identify the adverse impacts in their value chain and to make it possible for them to exercise appropriate leverage, the due diligence obligations should be limited in this Directive to established business relationships. For the purpose of this Directive, established business relationships should mean such direct and indirect business relationships which are, or which are expected to be lasting, in view of their intensity and duration and which do not represent a negligible or ancillary part of the value chain. The nature of business relationships as "established" should be reassessed periodically, and at least every 12 months. If the direct business relationship of a company is established, then all linked indirect business relationships should also be considered as established regarding that company.

(21) Under this Directive, EU companies with more than 500 employees on average and a worldwide net turnover exceeding EUR 150 million in the financial year preceding the last financial year should be required to comply with due diligence. As regards companies which do not fulfil those criteria, but which had more than 250 employees on average and more than EUR 40 million worldwide net turnover in the financial year preceding the last financial year and which operate in one or more high-impact sectors, due diligence should apply 2 years after the end of the transposition period of this directive, in order to provide for a longer adaptation period. In order to ensure a proportionate burden, companies operating in such high-impact sectors should be required to comply with more targeted due diligence focusing on severe adverse impacts. Temporary agency workers, including those posted under Article 1(3), point (c), of Directive 96/71/EC, as amended by Directive 2018/957/EU of the European Parliament and of the Council[103], should be included in the calculation of the number of employees in the user company. Posted workers under Article 1(3), points (a) and (b), of Directive 96/71/EC, as amended by Directive 2018/957/EU, should only be included in the calculation of the number of employees of the sending company.

(22) In order to reflect the priority areas of international action aimed at tackling human rights and environmental issues, the selection of high-impact sectors for the purposes of this Directive should be based on existing sectoral OECD due diligence guidance. The following sectors should be regarded as high-impact for the purposes of this Directive: the manufacture of textiles, leather and related products (including footwear), and the wholesale trade of textiles, clothing and footwear; agriculture, forestry, fisheries (including aquaculture), the manufacture of food products, and the wholesale trade of agricultural raw materials, live animals, wood, food, and beverages; the extraction of mineral resources regardless of where they are extracted from (including crude petroleum, natural gas, coal, lignite, metals and metal ores, as well as all other, non-

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[103] Directive (EU) 2018/957 of the European Parliament and of the Council of 28 June 2018 amending Directive 96/71/EC concerning the posting of workers in the framework of the provision of services (OJ L 173, 9.7.2018, p. 16).

metallic minerals and quarry products), the manufacture of basic metal products, other non-metallic mineral products and fabricated metal products (except machinery and equipment), and the wholesale trade of mineral resources, basic and intermediate mineral products (including metals and metal ores, construction materials, fuels, chemicals and other intermediate products). As regards the financial sector, due to its specificities, in particular as regards the value chain and the services offered, even if it is covered by sector-specific OECD guidance, it should not form part of the high-impact sectors covered by this Directive. At the same time, in this sector, the broader coverage of actual and potential adverse impacts should be ensured by also including very large companies in the scope that are regulated financial undertakings, even if they do not have a legal form with limited liability.

(23) In order to achieve fully the objectives of this Directive addressing human rights and adverse environmental impacts with respect to companies' operations, subsidiaries and value chains, third-country companies with significant operations in the EU should also be covered. More specifically, the Directive should apply to third-country companies which generated a net turnover of at least EUR 150 million in the Union in the financial year preceding the last financial year or a net turnover of more than EUR 40 million but less than EUR 150 million in the financial year preceding the last financial year in one or more of the high-impact sectors, as of 2 years after the end of the transposition period of this Directive.

(24) For defining the scope of application in relation to non-EU companies the described turnover criterion should be chosen as it creates a territorial connection between the third-country companies and the Union territory. Turnover is a proxy for the effects that the activities of those companies could have on the internal market. In accordance with international law, such effects justify the application of Union law to third-country companies. To ensure identification of the relevant turnover of companies concerned, the methods for calculating net turnover for non-EU companies as laid down in Directive (EU) 2013/34 as amended by Directive (EU) 2021/2101 should be used. To ensure effective enforcement of this Directive, an employee threshold should, in turn, not be applied to determine which third-country companies fall under this Directive, as the notion of "employees" retained for the purposes of this Directive is based on Union law and could not be easily transposed outside of the Union. In the absence of a clear and consistent methodology, including in accounting frameworks, to determine the employees of third-country companies, such employee threshold would therefore create legal uncertainty and would be difficult to apply for supervisory authorities. The definition of turnover should be based on Directive 2013/34/EU which has already established the methods for calculating net turnover for non-Union companies, as turnover and revenue definitions are similar in international accounting frameworks too. With a view to ensuring that the supervisory authority knows which third country companies generate the required turnover in the Union to fall under the scope of this Directive, this Directive should require that a supervisory authority in the Member State where the third country company's authorised representative is domiciled or established and, where it is different, a supervisory authority in the Member State in which the company generated most of its net turnover in the Union in the financial year preceding the last financial year are informed that the company is a company falling under the scope of this Directive.

(25) In order to achieve a meaningful contribution to the sustainability transition, due diligence under this Directive should be carried out with respect to adverse human rights impact on protected persons resulting from the violation of one of the rights and prohibitions as enshrined in the international conventions as listed in the Annex to this Directive. In order to ensure a comprehensive coverage of human rights, a violation of a prohibition or right not specifically listed in that Annex which directly impairs a legal interest protected in those conventions should also form part of the adverse human rights impact covered by this Directive, provided that the company concerned could have reasonably established the risk of such impairment and any appropriate measures to be taken in order to comply with the due diligence obligations under this Directive, taking into account all relevant circumstances of their operations, such as the sector and operational context. Due diligence should further encompass adverse environmental impacts resulting from the violation of one of the prohibitions and obligations pursuant to the international environmental conventions listed in the Annex to this Directive.

(26) Companies have guidance at their disposal that illustrates how their activities may impact human rights and which corporate behaviour is prohibited in accordance with internationally recognised human rights. Such guidance is included for instance in The United Nations Guiding Principles Reporting Framework[104] and the United Nations Guiding Principles Interpretative Guide[105]. Using relevant international guidelines and standards as a reference, the Commission should be able to issue additional guidance that will serve as a practical tool for companies.

(27) In order to conduct appropriate human rights, and environmental due diligence with respect to their operations, their subsidiaries, and their value chains, companies covered by this Directive should integrate due diligence into corporate policies, identify, prevent and mitigate as well as bring to an end and minimise the extent of potential and actual adverse human rights and environmental impacts, establish and maintain a complaints procedure, monitor the effectiveness of the taken measures in accordance with the requirements that are set up in this Directive and communicate publicly on their due diligence. In order to ensure clarity for companies, in particular the steps of preventing and mitigating potential adverse impacts and of bringing to an end, or when this is not possible, minimising actual adverse impacts should be clearly distinguished in this Directive.

(28) In order to ensure that due diligence forms part of companies' corporate policies, and in line with the relevant international framework, companies should integrate due diligence into all their corporate policies and have in place a due diligence policy. The due

104 https://www.ungpreporting.org/wp-content/uploads/UNGPReportingFramework_withguidance2017.pdf.

105 https://www.ohchr.org/Documents/Issues/Business/RtRInterpretativeGuide.pdf.https://www.ohchr.org/Documents/Issues/Business/RtRInterpretativeGuide.pdf.

diligence policy should contain a description of the company's approach, including in the long term, to due diligence, a code of conduct describing the rules and principles to be followed by the company's employees and subsidiaries; a description of the processes put in place to implement due diligence, including the measures taken to verify compliance with the code of conduct and to extend its application to established business relationships. The code of conduct should apply in all relevant corporate functions and operations, including procurement and purchasing decisions. Companies should also update their due diligence policy annually.

(29) To comply with due diligence obligations, companies need to take appropriate measures with respect to identification, prevention and bringing to an end adverse impacts. An 'appropriate measure' should mean a measure that is capable of achieving the objectives of due diligence, commensurate with the degree of severity and the likelihood of the adverse impact, and reasonably available to the company, taking into account the circumstances of the specific case, including characteristics of the economic sector and of the specific business relationship and the company's influence thereof, and the need to ensure prioritisation of action. In this context, in line with international frameworks, the company's influence over a business relationship should include, on the one hand its ability to persuade the business relationship to take action to bring to an end or prevent adverse impacts (for example through ownership or factual control, market power, pre-qualification requirements, linking business incentives to human rights and environmental performance, etc.) and, on the other hand, the degree of influence or leverage that the company could reasonably exercise, for example through cooperation with the business partner in question or engagement with another company which is the direct business partner of the business relationship associated with adverse impact.

(30) Under the due diligence obligations set out by this Directive, a company should identify actual or potential adverse human rights and environmental impacts. In order to allow for a comprehensive identification of adverse impacts, such identification should be based on quantitative and qualitative information. For instance, as regards adverse environmental impacts, the company should obtain information about baseline conditions at higher risk sites or facilities in value chains. Identification of adverse impacts should include assessing the human rights, and environmental context in a dynamic way and in regular intervals: prior to a new activity or relationship, prior to major decisions or changes in the operation; in response to or anticipation of changes in the operating environment; and periodically, at least every 12 months, throughout the life of an activity or relationship. Regulated financial undertakings providing loan, credit, or other financial services should identify the adverse impacts only at the inception of the contract. When identifying adverse impacts, companies should also identify and assess the impact of a business relationship's business model and strategies, including trading, procurement and pricing practices. Where the company cannot prevent, bring to an end or minimize all its adverse impacts at the same time, it should be able to prioritize its action, provided it takes the measures reasonably available to the company, taking into account the specific circumstances.

(31) In order to avoid undue burden on the smaller companies operating in high-impact sectors which are covered by this Directive, those companies should only be obliged to identify those actual or potential severe adverse impacts that are relevant to the respective sector.

(32) In line with international standards, prevention and mitigation as well as bringing to an end and minimisation of adverse impacts should take into account the interests of those adversely impacted. In order to enable continuous engagement with the value chain business partner instead of termination of business relations (disengagement) and possibly exacerbating adverse impacts, this Directive should ensure that disengagement is a last-resort action, in line with the Union`s policy of zero-tolerance on child labour. Terminating a business relationship in which child labour was found could expose the child to even more severe adverse human rights impacts. This should therefore be taken into account when deciding on the appropriate action to take.

(33) Under the due diligence obligations set out by this Directive, if a company identifies potential adverse human rights or environmental impacts, it should take appropriate measures to prevent and adequately mitigate them. To provide companies with legal clarity and certainty, this Directive should set out the actions companies should be expected to take for prevention and mitigation of potential adverse impacts where relevant depending on the circumstances.

(34) So as to comply with the prevention and mitigation obligation under this Directive, companies should be required to take the following actions, where relevant. Where necessary due to the complexity of prevention measures, companies should develop and implement a prevention action plan. Companies should seek to obtain contractual assurances from a direct partner with whom they have an established business relationship that it will ensure compliance with the code of conduct or the prevention action plan, including by seeking corresponding contractual assurances from its partners to the extent that their activities are part of the companies' value chain. The contractual assurances should be accompanied by appropriate measures to verify compliance. To ensure comprehensive prevention of actual and potential adverse impacts, companies should also make investments which aim to prevent adverse impacts, provide targeted and proportionate support for an SME with which they have an established business relationship such as financing, for example, through direct financing, low-interest loans, guarantees of continued sourcing, and assistance in securing financing, to help implement the code of conduct or prevention action plan, or technical guidance such as in the form of training, management systems upgrading, and collaborate with other companies.

(35) In order to reflect the full range of options for the company in cases where potential impacts could not be addressed by the described prevention or minimisation measures, this Directive should also refer to the possibility for the company to seek to conclude a contract with the indirect business partner, with a view to achieving compliance with the company's code of conduct or a prevention action plan, and conduct appropriate measures to verify compliance of the indirect business relationship with the contract.

(36) In order to ensure that prevention and mitigation of potential adverse impacts is effective, companies should prioritize engagement with business relationships in the value chain, instead of terminating the business relationship, as a last resort action after attempting at preventing and mitigating adverse potential impacts without success. However, the

Directive should also, for cases where potential adverse impacts could not be addressed by the described prevention or mitigation measures, refer to the obligation for companies to refrain from entering into new or extending existing relations with the partner in question and, where the law governing their relations so entitles them to, to either temporarily suspend commercial relationships with the partner in question, while pursuing prevention and minimisation efforts, if there is reasonable expectation that these efforts are to succeed in the short-term; or to terminate the business relationship with respect to the activities concerned if the potential adverse impact is severe. In order to allow companies to fulfil that obligation, Member States should provide for the availability of an option to terminate the business relationship in contracts governed by their laws. It is possible that prevention of adverse impacts at the level of indirect business relationships requires collaboration with another company, for example a company which has a direct contractual relationship with the supplier. In some instances, such collaboration could be the only realistic way of preventing adverse impacts, in particular, where the indirect business relationship is not ready to enter into a contract with the company. In these instances, the company should collaborate with the entity which can most effectively prevent or mitigate adverse impacts at the level of the indirect business relationship while respecting competition law.

(37) As regards direct and indirect business relationships, industry cooperation, industry schemes and multi-stakeholder initiatives can help create additional leverage to identify, mitigate, and prevent adverse impacts. Therefore it should be possible for companies to rely on such initiatives to support the implementation of their due diligence obligations laid down in this Directive to the extent that such schemes and initiatives are appropriate to support the fulfilment of those obligations. Companies could assess, at their own initiative, the alignment of these schemes and initiatives with the obligations under this Directive. In order to ensure full information on such initiatives, the Directive should also refer to the possibility for the Commission and the Member States to facilitate the dissemination of information on such schemes or initiatives and their outcomes. The Commission, in collaboration with Member States, may issue guidance for assessing the fitness of industry schemes and multi-stakeholder initiatives.

(38) Under the due diligence obligations set out by this Directive, if a company identifies actual human rights or environmental adverse impacts, it should take appropriate measures to bring those to an end. It can be expected that a company is able to bring to an end actual adverse impacts in their own operations and in subsidiaries. However, it should be clarified that, as regards established business relationships, where adverse impacts cannot be brought to an end, companies should minimise the extent of such impacts. Minimisation of the extent of adverse impacts should require an outcome that is the closest possible to bringing the adverse impact to an end. To provide companies with legal clarity and certainty, this Directive should define which actions companies should be required to take for bringing actual human rights and environmental adverse impacts to an end and minimisation of their extent, where relevant depending on the circumstances.

(39) So as to comply with the obligation of bringing to an end and minimising the extent of actual adverse impacts under this Directive, companies should be required to take the

following actions, where relevant. They should neutralise the adverse impact or minimise its extent, with an action proportionate to the significance and scale of the adverse impact and to the contribution of the company's conduct to the adverse impact. Where necessary due to the fact that the adverse impact cannot be immediately brought to an end, companies should develop and implement a corrective action plan with reasonable and clearly defined timelines for action and qualitative and quantitative indicators for measuring improvement. Companies should also seek to obtain contractual assurances from a direct business partner with whom they have an established business relationship that they will ensure compliance with the company's code of conduct and, as necessary, a prevention action plan, including by seeking corresponding contractual assurances from its partners, to the extent that their activities are part of the company's value chain. The contractual assurances should be accompanied by the appropriate measures to verify compliance. Finally, companies should also make investments aiming at ceasing or minimising the extent of adverse impact, provide targeted and proportionate support for an SMEs with which they have an established business relationship and collaborate with other entities, including, where relevant, to increase the company's ability to bring the adverse impact to an end.

(40) In order to reflect the full range of options for the company in cases where actual impacts could not be addressed by the described measures, this Directive should also refer to the possibility for the company to seek to conclude a contract with the indirect business partner, with a view to achieving compliance with the company's code of conduct or a corrective action plan, and conduct appropriate measures to verify compliance of the indirect business relationship with the contract.

(41) In order to ensure that bringing actual adverse impacts to an end or minimising them is effective, companies should prioritize engagement with business relationships in the value chain, instead of terminating the business relationship, as a last resort action after attempting at bringing actual adverse impacts to an end or minimising them without success. However, this Directive should also, for cases where actual adverse impacts could not be brought to an end or adequately mitigated by the described measures, refer to the obligation for companies to refrain from entering into new or extending existing relations with the partner in question and, where the law governing their relations so entitles them to, to either temporarily suspend commercial relationships with the partner in question, while pursuing efforts to bring to an end or minimise the extent of the adverse impact, or terminate the business relationship with respect to the activities concerned, if the adverse impact is considered severe. In order to allow companies to fulfil that obligation, Member States should provide for the availability of an option to terminate the business relationship in contracts governed by their laws.

(42) Companies should provide the possibility for persons and organisations to submit complaints directly to them in case of legitimate concerns regarding actual or potential human rights and environmental adverse impacts. Organisations who could submit such complaints should include trade unions and other workers' representatives representing individuals working in the value chain concerned and civil society organisations active in the areas related to the value chain concerned where they have knowledge about a potential or actual adverse impact. Companies should establish a procedure for dealing

with those complaints and inform workers, trade unions and other workers' representatives, where relevant, about such processes. Recourse to the complaints and remediation mechanism should not prevent the complainant from having recourse to judicial remedies. In accordance with international standards, complaints should be entitled to request from the company appropriate follow-up on the complaint and to meet with the company's representatives at an appropriate level to discuss potential or actual severe adverse impacts that are the subject matter of the complaint. This access should not lead to unreasonable solicitations of companies.

(43) Companies should monitor the implementation and effectiveness of their due diligence measures. They should carry out periodic assessments of their own operations, those of their subsidiaries and, where related to the value chains of the company, those of their established business relationships, to monitor the effectiveness of the identification, prevention, minimisation, bringing to an end and mitigation of human rights and environmental adverse impacts. Such assessments should verify that adverse impacts are properly identified, due diligence measures are implemented and adverse impacts have actually been prevented or brought to an end. In order to ensure that such assessments are up-to-date, they should be carried out at least every 12 months and be revised in-between if there are reasonable grounds to believe that significant new risks of adverse impact could have arisen.

(44) Like in the existing international standards set by the United Nations Guiding Principles on Business and Human Rights and the OECD framework, it forms part of the due diligence requirement to communicate externally relevant information on due diligence policies, processes and activities conducted to identify and address actual or potential adverse impacts, including the findings and outcomes of those activities. The proposal to amend Directive 2013/34/EU as regards corporate sustainability reporting sets out relevant reporting obligations for the companies covered by this directive. In order to avoid duplicating reporting obligations, this Directive should therefore not introduce any new reporting obligations in addition to those under Directive 2013/34/EU for the companies covered by that Directive as well as the reporting standards that should be developed under it. As regards companies that are within the scope of this Directive, but do not fall under Directive 2013/34/EU, in order to comply with their obligation of communicating as part of the due diligence under this Directive, they should publish on their website an annual statement in a language customary in the sphere of international business.

(45) In order to facilitate companies' compliance with their due diligence requirements through their value chain and limiting shifting compliance burden on SME business partners, the Commission should provide guidance on model contractual clauses.

(46) In order to provide support and practical tools to companies or to Member State authorities on how companies should fulfil their due diligence obligations, the Commission, using relevant international guidelines and standards as a reference, and in consultation with Member States and stakeholders, the European Union Agency for Fundamental Rights, the European Environment Agency, and where appropriate with international bodies having expertise in due diligence, should have the possibility to issue guidelines, including for specific sectors or specific adverse impacts.

(47) Although SMEs are not included in the scope of this Directive, they could be impacted by its provisions as contractors or subcontractors to the companies which are in the scope. The aim is nevertheless to mitigate financial or administrative burden on SMEs, many of which are already struggling in the context of the global economic and sanitary crisis. In order to support SMEs, Member States should set up and operate, either individually or jointly, dedicated websites, portals or platforms, and Member States could also financially support SMEs and help them build capacity. Such support should also be made accessible, and where necessary adapted and extended to upstream economic operators in third countries. Companies whose business partner is an SME, are also encouraged to support them to comply with due diligence measures, in case such requirements would jeopardize the viability of the SME and use fair, reasonable, non-discriminatory and proportionate requirements vis-a-vis the SMEs.

(48) In order to complement Member State support to SMEs, the Commission may build on existing EU tools, projects and other actions helping with the due diligence implementation in the EU and in third countries. It may set up new support measures that provide help to companies, including SMEs on due diligence requirements, including an observatory for value chain transparency and the facilitation of joint stakeholder initiatives.

(49) The Commission and Member States should continue to work in partnership with third countries to support upstream economic operators build the capacity to effectively prevent and mitigate adverse human rights and environmental impacts of their operations and business relationships, paying specific attention to the challenges faced by smallholders. They should use their neighbourhood, development and international cooperation instruments to support third country governments and upstream economic operators in third countries addressing adverse human rights and environmental impacts of their operations and upstream business relationships. This could include working with partner country governments, the local private sector and stakeholders on addressing the root causes of adverse human rights and environmental impacts.

(50) In order to ensure that this Directive effectively contributes to combating climate change, companies should adopt a plan to ensure that the business model and strategy of the company are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement. In case climate is or should have been identified as a principal risk for or a principal impact of the company's operations, the company should include emissions reduction objectives in its plan.

(51) With a view to ensure that such emission reduction plan is properly implemented and embedded in the financial incentives of directors, the plan should be duly taken into account when setting directors' variable remuneration, if variable remuneration is linked to the contribution of a director to the company's business strategy and long-term interests and sustainability.

(52) In order to allow for the effective oversight of and, where necessary, enforcement of this Directive in relation to those companies that are not governed by the law of a Member State, those companies should designate a sufficiently mandated authorised representative in the Union and provide information relating to their authorised representatives. It

should be possible for the authorised representative to also function as point of contact, provided the relevant requirements of this Directive are complied with.

(53) In order to ensure the monitoring of the correct implementation of companies' due diligence obligations and ensure the proper enforcement of this Directive, Member States should designate one or more national supervisory authorities. These supervisory authorities should be of a public nature, independent from the companies falling within the scope of this Directive or other market interests, and free of conflicts of interest. In accordance with national law, Member States should ensure appropriate financing of the competent authority. They should be entitled to carry out investigations, on their own initiative or based on complaints or substantiated concerns raised under this Directive. Where competent authorities under sectoral legislation exist, Member States could identify those as responsible for the application of this Directive in their areas of competence. They could designate authorities for the supervision of regulated financial undertaking also as supervisory authorities for the purposes of this Directive.

(54) In order to ensure effective enforcement of national measures implementing this Directive, Member States should provide for dissuasive, proportionate and effective sanctions for infringements of those measures. In order for such sanction regime to be effective, administrative sanctions to be imposed by the national supervisory authorities should include pecuniary sanctions. Where the legal system of a Member State does not provide for administrative sanctions as foreseen in this Directive, the rules on administrative sanctions should be applied in such a way that the sanction is initiated by the competent supervisory authority and imposed by the judicial authority. Therefore, it is necessary that those Member States ensure that the application of the rules and sanctions has an equivalent effect to the administrative sanctions imposed by the competent supervisory authorities.

(55) In order to ensure consistent application and enforcement of national provisions adopted pursuant to this Directive, national supervisory authorities should cooperate and coordinate their action. For that purpose a European Network of Supervisory Authorities should be set up by the Commission and the supervisory authorities should assist each other in performing their tasks and provide mutual assistance.

(56) In order to ensure effective compensation of victims of adverse impacts, Member States should be required to lay down rules governing the civil liability of companies for damages arising due to its failure to comply with the due diligence process. The company should be liable for damages if they failed to comply with the obligations to prevent and mitigate potential adverse impacts or to bring actual impacts to an end and minimise their extent, and as a result of this failure an adverse impact that should have been identified, prevented, mitigated, brought to an end or its extent minimised through the appropriate measures occurred and led to damage.

(57) As regards damages occurring at the level of established indirect business relationships, the liability of the company should be subject to specific conditions. The company should not be liable if it carried out specific due diligence measures. However, it should not be exonerated from liability through implementing such measures in case it was unreasonable to expect that the action actually taken, including as regards verifying compliance, would be adequate to prevent, mitigate, bring to an end or minimise the

adverse impact. In addition, in the assessment of the existence and extent of liability, due account is to be taken of the company's efforts, insofar as they relate directly to the damage in question, to comply with any remedial action required of them by a supervisory authority, any investments made and any targeted support provided as well as any collaboration with other entities to address adverse impacts in its value chains.

(58) The liability regime does not regulate who should prove that the company's action was reasonably adequate under the circumstances of the case, therefore this question is left to national law.

(59) As regards civil liability rules, the civil liability of a company for damages arising due to its failure to carry out adequate due diligence should be without prejudice to civil liability of its subsidiaries or the respective civil liability of direct and indirect business partners in the value chain. Also, the civil liability rules under this Directive should be without prejudice to Union or national rules on civil liability related to adverse human rights impacts or to adverse environmental impacts that provide for liability in situations not covered by or providing for stricter liability than this Directive.

(60) As regards civil liability arising from adverse environmental impacts, persons who suffer damage can claim compensation under this Directive even where they overlap with human rights claims.

(61) In order to ensure that victims of human rights and environmental harms can bring an action for damages and claim compensation for damages arising due to a company's failure to comply with the due diligence obligations stemming from this Directive, even where the law applicable to such claims is not the law of a Member State, as could be for instance be the case in accordance with international private law rules when the damage occurs in a third country, this Directive should require Member States to ensure that the liability provided for in provisions of national law transposing this Article is of overriding mandatory application in cases where the law applicable to claims to that effect is not the law of a Member State.

(62) The civil liability regime under this Directive should be without prejudice to the Environmental Liability Directive 2004/35/EC. This Directive should not prevent Member States from imposing further, more stringent obligations on companies or from otherwise taking further measures having the same objectives as that Directive.

(63) In all Member States' national laws, directors owe a duty of care to the company. In order to ensure that this general duty is understood and applied in a manner which is coherent and consistent with the due diligence obligations introduced by this Directive and that directors systematically take into account sustainability matters in their decisions, this Directive should clarify, in a harmonised manner, the general duty of care of directors to act in the best interest of the company, by laying down that directors take into account the sustainability matters as referred to in Directive 2013/34/EU, including, where applicable, human rights, climate change and environmental consequences, including in the short, medium and long term horizons. Such clarification does not require changing existing national corporate structures.

(64) Responsibility for due diligence should be assigned to the company's directors, in line with the international due diligence frameworks. Directors should therefore be

responsible for putting in place and overseeing the due diligence actions as laid down in this Directive and for adopting the company's due diligence policy, taking into account the input of stakeholders and civil society organisations and integrating due diligence into corporate management systems. Directors should also adapt the corporate strategy to actual and potential impacts identified and any due diligence measures taken.

(65) Persons who work for companies subject to due diligence obligations under this Directive or who are in contact with such companies in the context of their work-related activities can play a key role in exposing breaches of the rules of this Directive. They can thus contribute to preventing and deterring such breaches and strengthening the enforcement of this Directive. Directive (EU) 2019/1937 of the European Parliament and of the Council[106] should therefore apply to the reporting of all breaches of this Directive and to the protection of persons reporting such breaches.

(66) In order to specify the information that companies not subject to reporting requirements under the provisions on corporate sustainability reporting under Directive 2013/34/EU should be communicating on the matters covered by this Directive, the power to adopt acts in accordance with Article 290 of the Treaty on the Functioning of the European Union should be delegated to the Commission in respect of determining additional rules concerning the content and criteria of such reporting, specifying information on the description of due diligence, potential and actual impacts and actions taken on those. It is of particular importance that the Commission carry out appropriate consultations during its preparatory work, including at expert level, and that those consultations be conducted in accordance with the principles laid down in the Interinstitutional Agreement of 13 April 2016 on Better Law-Making[107]. In particular, to ensure equal participation in the preparation of delegated acts, the European Parliament and the Council receive all documents at the same time as Member States' experts, and their experts systematically have access to meetings of Commission expert groups dealing with the preparation of delegated acts.

(67) This Directive should be applied in compliance with Union data protection law and the right to the protection of privacy and personal data as enshrined in Articles 7 and 8 of the Charter of Fundamental Rights of the European Union. Any processing of personal data under this Directive is to be undertaken in accordance with Regulation (EU) 2016/679 of the European Parliament and of the Council[108], including the requirements of purpose limitation, data minimisation and storage limitation.

[106] Directive (EU) 2019/1937 of the European Parliament and of the Council of 23 October 2019 on the protection of persons who report breaches of Union law (OJ L 305, 26.11.2019, p. 17).

[107] OJ L 123, 12.5.2016, p. 1.

[108] Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of

(68) The European Data Protection Supervisor was consulted in accordance with Article 28(2) of Regulation (EU) 2018/1725 of the European Parliament and of the Council[109] and delivered an opinion on … 2022.

(69) This Directive is without prejudice to obligations in the areas of human rights, protection of the environment and climate change under other Union legislative acts. If the provisions of this Directive conflict with a provision of another Union legislative act pursuing the same objectives and providing for more extensive or more specific obligations, the provisions of the other Union legislative act should prevail to the extent of the conflict and shall apply to those specific obligations.

(70) The Commission should assess and report whether new sectors should be added to the list of high-impact sectors covered by this Directive, in order to align it to guidance from the Organisation for Economic Cooperation and Development or in light of clear evidence on labour exploitation, human rights violations or newly emerging environmental threats, whether the list of relevant international conventions referred to in this Directive should be amended, in particular in the light of international developments, or whether the provisions on due diligence under this Directive should be extended to adverse climate impacts.

(71) The objective of this Directive, namely better exploiting the potential of the single market to contribute to the transition to a sustainable economy and contributing to sustainable development through the prevention and mitigation of potential or actual human rights and environmental adverse impacts in companies' value chains, cannot be sufficiently achieved by the Member States acting individually or in an uncoordinated manner, but can rather, by reason of the scale and effects of the actions, be better achieved at Union level. In particular, addressed problems and their causes are of a transnational dimension, as many companies are operating Union wide or globally and value chains expand to other Member States and to third countries. Moreover, individual Member States' measures risk being ineffective and lead to fragmentation of the internal market. Therefore, the Union may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 TEU. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve that objective.

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such data, and repealing Directive 95/46/EC (General Data Protection Regulation) OJ L 119, 4.5.2016, p. 1–88.

[109] Regulation (EU) 2018/1725 of the European Parliament and of the Council of 23 October 2018 on the protection of natural persons with regard to the processing of personal data by the Union institutions, bodies, offices and agencies and on the free movement of such data (OJ L 295, 21.11.2018, p. 39).

HAVE ADOPTED THIS DIRECTIVE:

Article 1

Subject matter

1. This Directive lays down rules

(a) on obligations for companies regarding actual and potential human rights adverse impacts and environmental adverse impacts, with respect to their own operations, the operations of their subsidiaries, and the value chain operations carried out by entities with whom the company has an established business relationship and

(b) on liability for violations of the obligations mentioned above.

The nature of business relationships as 'established' shall be reassessed periodically, and at least every 12 months.

2. This Directive shall not constitute grounds for reducing the level of protection of human rights or of protection of the environment or the protection of the climate provided for by the law of Member States at the time of the adoption of this Directive.

3. This Directive shall be without prejudice to obligations in the areas of human rights, protection of the environment and climate change under other Union legislative acts. If the provisions of this Directive conflict with a provision of another Union legislative act pursuing the same objectives and providing for more extensive or more specific obligations, the provisions of the other Union legislative act shall prevail to the extent of the conflict and shall apply to those specific obligations.

Article 2

Scope

1. This Directive shall apply to companies which are formed in accordance with the legislation of a Member State and which fulfil one of the following conditions:

(a) the company had more than 500 employees on average and had a net worldwide turnover of more than EUR 150 million in the last financial year for which annual financial statements have been prepared;

(b) the company did not reach the thresholds under point (a), but had more than 250 employees on average and had a net worldwide turnover of more than EUR 40 million in the last financial year for which annual financial statements have been prepared, provided that at least 50% of this net turnover was generated in one or more of the following sectors:

(i) the manufacture of textiles, leather and related products (including footwear), and the wholesale trade of textiles, clothing and footwear;

(ii) agriculture, forestry, fisheries (including aquaculture), the manufacture of food products, and the wholesale trade of agricultural raw materials, live animals, wood, food, and beverages;

(iii) the extraction of mineral resources regardless from where they are extracted (including crude petroleum, natural gas, coal, lignite, metals and metal ores, as well as all other, non-metallic minerals and quarry products), the manufacture of basic metal products, other non-metallic mineral products and fabricated metal products (except machinery and equipment), and the wholesale trade of mineral resources, basic and intermediate mineral products (including metals and metal ores, construction materials, fuels, chemicals and other intermediate products).

2. This Directive shall also apply to companies which are formed in accordance with the legislation of a third country, and fulfil one of the following conditions:

(a) generated a net turnover of more than EUR 150 million in the Union in the financial year preceding the last financial year;

(b) generated a net turnover of more than EUR 40 million but not more than EUR 150 million in the Union in the financial year preceding the last financial year, provided that at least 50% of its net worldwide turnover was generated in one or more of the sectors listed in paragraph 1, point (b).

3. For the purposes of paragraph 1, the number of part-time employees shall be calculated on a full-time equivalent basis. Temporary agency workers shall be included in the calculation of the number of employees in the same way as if they were workers employed directly for the same period of time by the company.

4. As regards the companies referred to in paragraph 1, the Member State competent to regulate matters covered in this Directive shall be the Member State in which the company has its registered office.

Article 3

Definitions

For the purpose of this Directive, the following definitions shall apply:

(a) ‘company’ means any of the following:

(i) a legal person constituted as one of the legal forms listed in Annex I to Directive 2013/34/EU of the European Parliament and of the Council[110];

(ii) a legal person constituted in accordance with the law of a third country in a form comparable to those listed in Annex I and II of that Directive;

(iii) a legal person constituted as one of the legal forms listed in Annex II to Directive 2013/34/EU composed entirely of undertakings organised in one of the legal forms falling within points (i) and (ii);

(iv) a regulated financial undertaking, regardless of its legal form, which is

– a credit institution as defined in Article 4(1), point (1), of Regulation (EU) No 575/2013 the European Parliament and of the Council[111];

– an investment firm as defined in Article 4(1), point (1), of Directive 2014/65/EU the European Parliament and of the Council[112];

– an alternative investment fund manager (AIFM) as defined in Article 4(1), point (b), of Directive 2011/61/EU of the European Parliament and of the Council (2), including a manager of Euveca under Regulation (EU) No 345/2013 of the European Parliament and of the Council[113], a manager of EuSEF under Regulation (EU) No 346/2013 of the European Parliament and of the Council[114] and a manager of ELTIF under Regulation (EU) 2015/760 of the European Parliament and of the Council[115];

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110 Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings (OJ L 182, 29.6.2013, p. 19).

111 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

112 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349).

113 Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds (OJ L 115, 25.4.2013, p. 1).

114 Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds (OJ L 115, 25.4.2013, p. 18).

115 Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds (OJ L 123, 19.5.2015, p. 98).

- an undertaking for collective investment in transferable securities (UCITS) management company as defined Article 2(1), point (b), of Directive 2009/65/EC of the European Parliament and of the Council[116];
- an insurance undertaking as defined in Article 13, point (1), of Directive 2009/138/EC of the European Parliament and of the Council[117];
- a reinsurance undertaking as defined in Article 13, point (4), of Directive 2009/138/EC;
- an institution for occupational retirement provision as defined in Article 1, point (6) of Directive 2016/2341 of the European Parliament and of the Council[118];
- pension institutions operating pension schemes which are considered to be social security schemes covered by Regulation (EC) No 883/2004 of the European Parliament and of the Council[119] and Regulation (EC) No 987/2009 of the European Parliament and of the Council[120] as well as any legal entity set up for the purpose of investment of such schemes;
- an alternative investment fund (AIF) managed by an AIFM as defined in Article 4(1), point (b), of Directive 2011/61/EU or an AIF supervised under the applicable national law;
- UCITS in the meaning of Article 1(2) of Directive 2009/65/EC;
- a central counterparty as defined in Article 2, point (1), of Regulation (EU) No 648/2012 of the European Parliament and of the Council[121];

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116 Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32).

117 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 335, 17.12.2009, p. 1).

118 Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs) (OJ L 354, 23.12.2016, p. 37).

119 Regulation (EC) No 883/2004 of the European Parliament and of the Council of 29 April 2004 on the coordination of social security systems (OJ L 166, 30.4.2004, p. 1).

120 Regulation (EC) No 987/2009 of the European Parliament and of the Council of 16 September 2009 laying down the procedure for implementing Regulation (EC) No 883/2004 on the coordination of social security systems (OJ L 284, 30.10.2009, p. 1).

121 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201, 27.7.2012, p. 1).

– a central securities depository as defined in Article 2(1), point (1), of Regulation (EU) No 909/2014 of the European Parliament and of the Council[122];

– an insurance or reinsurance special purpose vehicle authorised in accordance with Article 211 of Directive 2009/138/EC;

– ‘securitisation special purpose entity’ as defined in Article 2, point (2), of Regulation (EU) No 2017/2402 of the European Parliament and of the Council[123];

– an insurance holding company as defined in Article 212(1), point (f), of Directive 2009/138/EC or a mixed financial holding company as defined in Article 212(1), point (h), of Directive 2009/138/EC, which is part of an insurance group that is subject to supervision at the level of the group pursuant to Article 213 of that Directive and which is not exempted from group supervision pursuant to Article 214(2) of Directive 2009/138/EC;

– a payment institution as defined in point (d) of Article 1(1) of Directive (EU) 2015/2366 of the European Parliament and of the Council[124];

– an electronic money institution as defined in point (1) of Article 2 of Directive 2009/110/EC of the European Parliament and of the Council[125];

– a crowdfunding service provider as defined in point (e) Article 2(1) of Regulation (EU) 2020/1503 of the European Parliament and of the Council[126];

– a crypto-asset service provider as defined in Article 3(1), point (8), of [the proposal for a Regulation of the European Parliament and of the Council on

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122 Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 (OJ L 257, 28.8.2014, p. 1).

123 Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 (OJ L 347, 28.12.2017, p. 35).

124 Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC (OJ L 337, 23.12.2015, p. 35).

125 Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC (OJ L 267, 10.10.2009, p. 7).

126 Regulation (EU) 2020/1503 of the European Parliament and of the Council of 7 October 2020 on European crowdfunding service providers for business, and amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937 (OJ L 347, 20.10.2020, p. 1).

Markets in Crypto-assets, and amending Directive (EU) 2019/1937[127]] where performing one or more crypto-asset services as defined in Article 3(1), point (9), of [the proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/1937];

(b) 'adverse environmental impact' means an adverse impact on the environment resulting from the violation of one of the prohibitions and obligations pursuant to the international environmental conventions listed in the Annex, Part II;

(c) 'adverse human rights impact' means an adverse impact on protected persons resulting from the violation of one of the rights or prohibitions listed in the Annex, Part I Section 1, as enshrined in the international conventions listed in the Annex, Part I Section 2;

(d) 'subsidiary' means a legal person through which the activity of a 'controlled undertaking' as defined in Article 2(1), point (f), of Directive 2004/109/EC of the European Parliament and of the Council[128] is exercised;

(e) 'business relationship' means a relationship with a contractor, subcontractor or any other legal entities ('partner')

(i) with whom the company has a commercial agreement or to whom the company provides financing, insurance or reinsurance, or

(ii) that performs business operations related to the products or services of the company for or on behalf of the company;

(f) 'established business relationship' means a business relationship, whether direct or indirect, which is, or which is expected to be lasting, in view of its intensity or duration and which does not represent a negligible or merely ancillary part of the value chain;

(g) 'value chain' means activities 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

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[127] COM/2020/593 final.

[128] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (OJ L 390, 31.12.2004, p. 38).

financial undertakings does not cover SMEs receiving loan, credit, financing, insurance or reinsurance of such entities;

(h) 'independent third-party verification' means verification of the compliance by a company, or parts of its value chain, with human rights and environmental requirements resulting from the provisions of this Directive by an auditor which is independent from the company, free from any conflicts of interests, has experience and competence in environmental and human rights matters and is accountable for the quality and reliability of the audit;

(i) 'SME' means a micro, small or a medium-sized enterprise, irrespective of its legal form, that is not part of a large group, as those terms are defined in Article 3(1), (2), (3) and (7) of Directive 2013/34/EU;

(j) 'industry initiative' means a combination of voluntary value chain due diligence procedures, tools and mechanisms, including independent third-party verifications, developed and overseen by governments, industry associations or groupings of interested organisations;

(k) 'authorised representative' means a natural or legal person resident or established in the Union who has a mandate from a company within the meaning of point (a)(ii) to act on its behalf in relation to compliance with that company's obligations pursuant to this Directive;

(l) 'severe adverse impact' means an adverse environmental impact or an adverse human rights impact that is especially significant by its nature, or affects a large number of persons or a large area of the environment, or which is irreversible, or is particularly difficult to remedy as a result of the measures necessary to restore the situation prevailing prior to the impact;

(m) 'net turnover' means

(i) the 'net turnover' as defined in Article 2, point (5), of Directive 2013/34/EU; or,

(ii) where the company applies international accounting standards adopted on the basis of Regulation (EC) No 1606/2002 of the European Parliament and of the Council[129] or is a company within the meaning of point (a)(ii), the revenue as defined by or within the meaning of the financial reporting framework on the basis of which the financial statements of the company are prepared;

(n) 'stakeholders' means the company's employees, the employees of its subsidiaries, and other individuals, groups, communities or entities whose rights or interests are or could

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129 Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards (OJ L 243, 11.9.2002, p.1).

be affected by the products, services and operations of that company, its subsidiaries and its business relationships;

(o) ‘director’ means:

(i) any member of the administrative, management or supervisory bodies 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);

(p) ‘board of directors’ means the administrative or supervisory body responsible for supervising the executive management of the company, or, if no such body exists, the person or persons performing equivalent functions;

(q) ‘appropriate measure’ means a measure that is capable of achieving the objectives of due diligence, commensurate with the degree of severity and the likelihood of the adverse impact, and reasonably available to the company, taking into account the circumstances of the specific case, including characteristics of the economic sector and of the specific business relationship and the company’s influence thereof, and the need to ensure prioritisation of action.

Article 4

Due diligence

1. Member States shall ensure that companies conduct human rights and environmental due diligence as laid down in Articles 5 to 11 (‘due diligence’) by carrying out the following actions:

(a) integrating due diligence into their policies in accordance with Article 5;

(b) identifying actual or potential adverse impacts in accordance with Article 6;

(c) preventing and mitigating potential adverse impacts, and bringing actual adverse impacts to an end and minimising their extent in accordance with Articles 7 and 8;

(d) establishing and maintaining a complaints procedure in accordance with Article 9;

(e) monitoring the effectiveness of their due diligence policy and measures in accordance with Article 10;

(f) publicly communicating on due diligence in accordance with Article 11.

2. Member States shall ensure that, for the purposes of due diligence, companies are entitled to share resources and information within their respective groups of companies and with other legal entities in compliance with applicable competition law.

Article 5

Integrating due diligence into companies' policies

1. Member States shall ensure that companies integrate due diligence into all their corporate policies and have in place a due diligence policy. The due diligence policy shall contain all of the following:

   (a) a description of the company's approach, including in the long term, to due diligence;

   (b) a code of conduct describing rules and principles to be followed by the company's employees and subsidiaries;

   (c) a description of the processes put in place to implement due diligence, including the measures taken to verify compliance with the code of conduct and to extend its application to established business relationships.

2. Member States shall ensure that the companies update their due diligence policy annually.

Article 6

Identifying actual and potential adverse impacts

1. Member States shall ensure that companies take appropriate measures to identify actual and potential adverse human rights impacts and adverse environmental impacts arising from their own operations or those of their subsidiaries and, where related to their value chains, from their established business relationships, in accordance with paragraph 2, 3 and 4.

2. By way of derogation from paragraph 1, companies referred to in Article 2(1), point (b), and Article 2(2), point (b), shall only be required to identify actual and potential severe adverse impacts relevant to the respective sector mentioned in Article 2(1), point (b).

3. When companies referred to in Article 3, point (a)(iv), provide credit, loan or other financial services, identification of actual and potential adverse human rights impacts and adverse environmental impacts shall be carried out only before providing that service..

4. Member States shall ensure that, for the purposes of identifying the adverse impacts referred to in paragraph 1 based on, where appropriate, quantitative and qualitative information, companies are entitled to make use of appropriate resources, including independent reports and information gathered through the complaints procedure provided for in Article 9. Companies shall, where relevant, also carry out consultations with potentially affected groups including workers and other relevant stakeholders to gather information on actual or potential adverse impacts.

Article 7

Preventing potential adverse impacts

1. Member States shall ensure that companies take appropriate measures to prevent, or where prevention is not possible or not immediately possible, adequately mitigate potential adverse human rights impacts and adverse environmental impacts that have been, or should have been, identified pursuant to Article 6, in accordance with paragraphs 2, 3, 4 and 5 of this Article.

2. Companies shall be required to take the following actions, where relevant:

(a) where necessary due to the nature or complexity of the measures required for prevention, develop and implement a prevention action plan, with reasonable and clearly defined timelines for action and qualitative and quantitative indicators for measuring improvement. The prevention action plan shall be developed in consultation with affected stakeholders;

(b) seek contractual assurances from a business partner with whom it has a direct business relationship that it will ensure compliance with the company's code of conduct and, as necessary, a prevention action plan, including by seeking corresponding contractual assurances from its partners, to the extent that their activities are part of the company's value chain (contractual cascading). When such contractual assurances are obtained, paragraph 4 shall apply;

(c) make necessary investments, such as into management or production processes and infrastructures, to comply with paragraph 1;

(d) provide targeted and proportionate support for an SME with which the company has an established business relationship, where compliance with the code of conduct or the prevention action plan would jeopardise the viability of the SME;

(e) in compliance with Union law including competition law, collaborate with other entities, including, where relevant, to increase the company's ability to bring the adverse impact to an end, in particular where no other action is suitable or effective.

3. As regards potential adverse impacts that could not be prevented or adequately mitigated by the measures in paragraph 2, the company may seek to conclude a contract with a partner with whom it has an indirect relationship, with a view to achieving compliance with the company's code of conduct or a prevention action plan. When such a contract is concluded, paragraph 4 shall apply.

4. The contractual assurances or the contract shall be accompanied by the appropriate measures to verify compliance. For the purposes of verifying compliance, the company may refer to suitable industry initiatives or independent third-party verification.

When contractual assurances are obtained from, or a contract is entered into, with an SME, the terms used shall be fair, reasonable and non-discriminatory. Where measures to verify compliance are carried out in relation to SMEs, the company shall bear the cost of the independent third-party verification.

5. As regards potential adverse impacts within the meaning of paragraph 1 that could not be prevented or adequately mitigated by the measures in paragraphs 2, 3 and 4, the company shall be required to refrain from entering into new or extending existing relations with the partner in connection with or in the value chain of which the impact has arisen and shall, where the law governing their relations so entitles them to, take the following actions:

(a) temporarily suspend commercial relations with the partner in question, while pursuing prevention and minimisation efforts, if there is reasonable expectation that these efforts will succeed in the short-term;

(b) terminate the business relationship with respect to the activities concerned if the potential adverse impact is severe.

Member States shall provide for the availability of an option to terminate the business relationship in contracts governed by their laws.

6. By way of derogation from paragraph 5, point (b), when companies referred to in Article 3, point (a)(iv), provide credit, loan or other financial services, they shall not be required to terminate the credit, loan or other financial service contract when this can be reasonably expected to cause substantial prejudice to the entity to whom that service is being provided.

Article 8

Bringing actual adverse impacts to an end

1. Member States shall ensure that companies take appropriate measures to bring actual adverse impacts that have been, or should have been, identified pursuant to Article 6 to an end, in accordance with paragraphs 2 to 6 of this Article.

2. Where the adverse impact cannot be brought to an end, Member States shall ensure that companies minimise the extent of such an impact.

3. Companies shall be required to take the following actions, where relevant:

(a) neutralise the adverse impact or minimise its extent, including by the payment of damages to the affected persons and of financial compensation to the affected communities. The action shall be proportionate to the significance and scale of the adverse impact and to the contribution of the company’s conduct to the adverse impact;

(b) where necessary due to the fact that the adverse impact cannot be immediately brought to an end, develop and implement a corrective action plan with reasonable and clearly defined timelines for action and qualitative and quantitative indicators for measuring improvement. Where relevant, the corrective action plan shall be developed in consultation with stakeholders;

(c) seek contractual assurances from a direct partner with whom it has an established business relationship that it will ensure compliance with the code of conduct and, as necessary, a corrective action plan, including by seeking corresponding contractual assurances from its partners, to the extent that they are part of the value chain (contractual cascading). When such contractual assurances are obtained, paragraph 5 shall apply.

(d) make necessary investments, such as into management or production processes and infrastructures to comply with paragraphs 1, 2 and 3;

(e) provide targeted and proportionate support for an SME with which the company has an established business relationship, where compliance with the code of conduct or the corrective action plan would jeopardise the viability of the SME;

(f) in compliance with Union law including competition law, collaborate with other entities, including, where relevant, to increase the company's ability to bring the adverse impact to an end, in particular where no other action is suitable or effective.

4. As regards actual adverse impacts that could not be brought to an end or adequately mitigated by the measures in paragraph 3, the company may seek to conclude a contract with a partner with whom it has an indirect relationship, with a view to achieving compliance with the company's code of conduct or a corrective action plan. When such a contract is concluded, paragraph 5 shall apply.

5. The contractual assurances or the contract shall be accompanied by the appropriate measures to verify compliance. For the purposes of verifying compliance, the company may refer to suitable industry initiatives or independent third-party verification.

When contractual assurances are obtained from, or a contract is entered into, with an SME, the terms used shall be fair, reasonable and non-discriminatory. Where measures to verify compliance are carried out in relation to SMEs, the company shall bear the cost of the independent third-party verification.

6. As regards actual adverse impacts within the meaning of paragraph 1 that could not be brought to an end or the extent of which could not be minimised by the measures provided for in paragraphs 3, 4 and 5, the company shall refrain from entering into new or extending existing relations with the partner in connection to or in the value chain of which the impact has arisen and shall, where the law governing their relations so entitles them to, take one of the following actions:

(a) temporarily suspend commercial relationships with the partner in question, while pursuing efforts to bring to an end or minimise the extent of the adverse impact, or

(b) terminate the business relationship with respect to the activities concerned, if the adverse impact is considered severe.

Member States shall provide for the availability of an option to terminate the business relationship in contracts governed by their laws.

7. By way of derogation from paragraph 6, point (b), when companies referred to in Article 3, point (a)(iv), provide credit, loan or other financial services, they shall not be required to terminate the credit, loan or other financial service contract, when this can be reasonably expected to cause substantial prejudice to the entity to whom that service is being provided.

Article 9

Complaints procedure

1. Member States shall ensure that companies provide the possibility for persons and organisations listed in paragraph 2 to submit complaints to them where they have legitimate concerns regarding actual or potential adverse human rights impacts and adverse environmental impacts with respect to their own operations, the operations of their subsidiaries and their value chains.

2. 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 affected by an adverse impact,

   (b) trade unions and other workers' representatives representing individuals working in the value chain concerned,

   (c) civil society organisations active in the areas related to the value chain concerned.

3. Member States shall ensure that the companies establish a procedure for dealing with complaints referred to in paragraph 1, including a procedure when the company considers the complaint to be unfounded, and inform the relevant workers and trade unions of those procedures. Member States shall ensure that where the complaint is well-founded, the adverse impact that is the subject matter of the complaint is deemed to be identified within the meaning of Article 6.

4. Member States shall ensure that complainants are entitled

   (a) to request appropriate follow-up on the complaint from the company with which they have filed a complaint pursuant to paragraph 1, and

   (b) to meet with the company's representatives at an appropriate level to discuss potential or actual severe adverse impacts that are the subject matter of the complaint.

Article 10

Monitoring

Member States shall ensure that companies carry out periodic assessments of their own operations and measures, those of their subsidiaries and, where related to the value chains of the company, those of their established business relationships, to monitor the effectiveness of the identification, prevention, mitigation, bringing to an end and minimisation of the extent of human rights and environmental adverse impacts. Such assessments shall be based, where appropriate, on qualitative and quantitative indicators and be carried out at least every 12 months and whenever there are reasonable grounds to believe that significant new risks of the occurrence of those adverse impacts may arise. The due diligence policy shall be updated in accordance with the outcome of those assessments.

Article 11

Communicating

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.

Article 12

Model contractual clauses

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.

Article 13

Guidelines

In order to provide support to companies or to Member State authorities on how companies should fulfil their due diligence obligations, the Commission, in consultation with Member States and stakeholders, the European Union Agency for Fundamental Rights, the European Environment Agency, and where appropriate with international bodies having expertise in due diligence, may issue guidelines, including for specific sectors or specific adverse impacts.

Article 14

Accompanying measures

1. Member States shall, in order to provide information and support to companies and the partners with whom they have established business relationships in their value chains in their efforts to fulfil the obligations resulting from this Directive, set up and operate individually or jointly dedicated websites, platforms or portals. Specific consideration shall be given, in that respect, to the SMEs that are present in the value chains of companies.

2. Without prejudice to applicable State aid rules, Member States may financially support SMEs.

3. The Commission may complement Member States' support measures building on existing Union action to support due diligence in the Union and in third countries and may devise new measures, including facilitation of joint stakeholder initiatives to help companies fulfil their obligations.

4. Companies may rely on industry schemes and multi-stakeholder initiatives to support the implementation of their obligations referred to in Articles 5 to 11 of this Directive to the extent that such schemes and initiatives are appropriate to support the fulfilment of those obligations. The Commission and the Member States may facilitate the dissemination of information on such schemes or initiatives and their outcome. The Commission, in collaboration with Member States, may issue guidance for assessing the fitness of industry schemes and multi-stakeholder initiatives.

Article 15

Combating climate change

1. Member States shall ensure that companies referred to in Article 2(1), point (a), and Article 2(2), point (a), shall adopt a plan to ensure that the business model and strategy of the company are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement. This plan shall, in particular, identify, on the basis of information reasonably available to the company, the extent to which climate change is a risk for, or an impact of, the company's operations.

2. Member States shall ensure that, in case climate change is or should have been identified as a principal risk for, or a principal impact of, the company's operations, the company includes emission reduction objectives in its plan.

3. Member States shall ensure that companies duly take into account the fulfilment of the obligations referred to in paragraphs 1 and 2 when setting variable remuneration, if variable remuneration is linked to the contribution of a director to the company's business strategy and long-term interests and sustainability.

Article 16

Authorised representative

1. Member States shall ensure that each company referred to in Article 2(2) designates a legal or natural person as its authorised representative, established or domiciled in one of the Member States where it operates. The designation shall be valid when confirmed as accepted by the authorised representative.

2. Member States shall ensure that the name, address, electronic mail address and telephone number of the authorised representative is notified to a supervisory authority in the Member State where the authorised representative is domiciled or established. Member States shall ensure that the authorised representative is obliged to provide, upon request, a copy of the designation in an official language of a Member State to any of the supervisory authorities.

3. Member States shall ensure that a supervisory authority in the Member State where the authorised representative is domiciled or established and, where it is different, a supervisory authority in the Member State in which the company generated most of its net turnover in the Union in the financial year preceding the last financial year are informed that the company is a company within the meaning of Article 2(2).

4. Member States shall ensure that each company empowers its authorised representative to receive communications from supervisory authorities on all matters necessary for compliance with and enforcement of national provisions transposing this Directive. Companies shall be required to provide their authorised representative with the necessary powers and resources to cooperate with supervisory authorities.

Article 17

Supervisory Authorities

1. Each Member State shall designate one or more supervisory authorities to supervise compliance with the obligations laid down in national provisions adopted pursuant to Articles 6 to 11 and Article 15(1) and (2) (‘supervisory authority’).

2. As regards the companies referred to in Article 2(1), the competent supervisory authority shall be that of the Member State in which the company has its registered office.

3. As regards companies referred to in Article 2(2), the competent supervisory authority shall be that of the Member State in which the company has a branch. If the company does not have a branch in any Member State, or has branches located in different Member States, the competent supervisory authority shall be the supervisory authority of the Member State in which the company generated most of its net turnover in the Union in the financial year preceding the last financial year before the date indicated in Article 30 or the date on which the company first fulfils the criteria laid down in Article 2(2), whichever comes last.

   Companies referred to in Article 2(2) may, on the basis of a change in circumstances leading to it generating most of its turnover in the Union in a different Member State, make a duly reasoned request to change the supervisory authority that is competent to regulate matters covered in this Directive in respect of that company.

4. Where a Member State designates more than one supervisory authority, it shall ensure that the respective competences of those authorities are clearly defined and that they cooperate closely and effectively with each other.

5. Member States may designate the authorities for the supervision of regulated financial undertakings also as supervisory authorities for the purposes of this Directive.

6. By the date indicated in Article 30(1), point (a), Member States shall inform the Commission of the names and contact details of the supervisory authorities designated pursuant to this Article, as well as of their respective competence where there are several designated supervisory authorities. They shall inform the Commission of any changes thereto.

7. The Commission shall make publicly available, including on its website, a list of the supervisory authorities. The Commission shall regularly update the list on the basis of the information received from the Member States.

8. Member States shall guarantee the independence of the supervisory authorities and shall ensure that they, and all persons working for or who have worked for them and auditors

or experts acting on their behalf, exercise their powers impartially, transparently and with due respect for obligations of professional secrecy. In particular, Member States shall ensure that the authority is legally and functionally independent from the companies falling within the scope of this Directive or other market interests, that its staff and the persons responsible for its management are free of conflicts of interest, subject to confidentiality requirements, and that they refrain from any action incompatible with their duties.

Article 18

Powers of supervisory authorities

1. Member States shall ensure that the supervisory authorities have adequate powers and resources to carry out the tasks assigned to them under this Directive, including the power to request information and carry out investigations related to compliance with the obligations set out in this Directive.

2. A supervisory authority may initiate an investigation on its own motion or as a result of substantiated concerns communicated to it pursuant to Article 19, where it considers that it has sufficient information indicating a possible breach by a company of the obligations provided for in the national provisions adopted pursuant to this Directive.

3. Inspections shall be conducted in compliance with the national law of the Member State in which the inspection is carried out and with prior warning to the company, except where prior notification hinders the effectiveness of the inspection. Where, as part of its investigation, a supervisory authority wishes to carry out an inspection on the territory of a Member State other than its own, it shall seek assistance from the supervisory authority in that Member State pursuant to Article 21(2).

4. If, as a result of the actions taken pursuant to paragraphs 1 and 2, a supervisory authority identifies a failure to comply with national provisions adopted pursuant to this Directive, it shall grant the company concerned an appropriate period of time to take remedial action, if such action is possible.

   Taking remedial action does not preclude the imposition of administrative sanctions or the triggering of civil liability in case of damages, in accordance with Articles 20 and 22, respectively.

5. When carrying out their tasks, supervisory authorities shall have at least the following powers:

   (a) to order the cessation of infringements of the national provisions adopted pursuant to this Directive, abstention from any repetition of the relevant conduct and, where appropriate, remedial action proportionate to the infringement and necessary to bring it to an end;

   (b) to impose pecuniary sanctions in accordance with Article 20;

   (c) to adopt interim measures to avoid the risk of severe and irreparable harm.

6. Where the legal system of the Member State does not provide for administrative sanctions, this Article and Article 20 may be implemented in such a manner that the

sanction is initiated by the competent supervisory authority and imposed by the competent national courts, while ensuring that those legal remedies are effective and have an equivalent effect to the administrative sanctions imposed by supervisory authorities.

7. Member States shall ensure that each natural or legal person has the right to an effective judicial remedy against a legally binding decision by a supervisory authority concerning them.

Article 19

Substantiated concerns

1. Member States shall ensure that natural and legal persons are entitled to submit substantiated concerns to any supervisory authority when they have reasons to believe, on the basis of objective circumstances, that a company is failing to comply with the national provisions adopted pursuant to this Directive (‘substantiated concerns’).

2. Where the substantiated concern falls under the competence of another supervisory authority, the authority receiving the concern shall transmit it to that authority.

3. Member States shall ensure that supervisory authorities assess the substantiated concerns and, where appropriate, exercise their powers as referred to in Article 18.

4. The supervisory authority shall, as soon as possible and in accordance with the relevant provisions of national law and in compliance with Union law, inform the person referred to in paragraph 1 of the result of the assessment of their substantiated concern and shall provide the reasoning for it.

5. Member States shall ensure that the persons submitting the substantiated concern according to this Article and having, in accordance with national law, a legitimate interest in the matter have access to a court or other independent and impartial public body competent to review the procedural and substantive legality of the decisions, acts or failure to act of the supervisory authority.

Article 20

Sanctions

1. Member States shall lay down the rules on sanctions applicable to infringements of national provisions adopted pursuant to this Directive, and shall take all measures necessary to ensure that they are implemented. The sanctions provided for shall be effective, proportionate and dissuasive.

2. In deciding whether to impose sanctions and, if so, in determining their nature and appropriate level, due account shall be taken of the company’s efforts to comply with any remedial action required of them by a supervisory authority, any investments made and any targeted support provided pursuant to Articles 7 and 8, as well as collaboration with other entities to address adverse impacts in its value chains, as the case may be.

3. When pecuniary sanctions are imposed, they shall be based on the company’s turnover.

4. Member States shall ensure that any decision of the supervisory authorities containing sanctions related to the breach of the provisions of this directive is published.

Article 21

European Network of Supervisory Authorities

1. The Commission shall set up a European Network of Supervisory Authorities, composed of representatives of the supervisory authorities. The Network shall facilitate the cooperation of the supervisory authorities and the coordination and alignment of regulatory, investigative, sanctioning and supervisory practices of the supervisory authorities and, as appropriate, sharing of information among them.

   The Commission may invite Union agencies with relevant expertise in the areas covered by this Directive to join the European Network of Supervisory Authorities.

2. Supervisory authorities shall provide each other with relevant information and mutual assistance in carrying out their duties and shall put in place measures for effective cooperation with each other. Mutual assistance shall include collaboration with a view to the exercise of the powers referred to in Article 18, including in relation to inspections and information requests.

3. Supervisory authorities shall take all appropriate steps needed to reply to a request for assistance by another supervisory authority without undue delay and no later than 1 month after receiving the request. Such steps may include, in particular, the transmission of relevant information on the conduct of an investigation.

4. Requests for assistance shall contain all the necessary information, including the purpose of and reasons for the request. Supervisory authorities shall only use the information received through a request for assistance for the purpose for which it was requested.

5. The requested supervisory authority shall inform the requesting supervisory authority of the results or, as the case may be, of the progress regarding the measures to be taken in order to respond to the request for assistance.

6. Supervisory authorities shall not charge each other fees for actions and measures taken pursuant to a request for assistance.

   However, supervisory authorities may agree on rules to indemnify each other for specific expenditure arising from the provision of assistance in exceptional cases.

7. The supervisory authority that is competent pursuant to Article 17(3) shall inform the European Network of Supervisory Authorities of that fact and of any request to change the competent supervisory authority.

8. When doubts exist as to the attribution of competence, the information on which that attribution is based will be shared with the European Network of Supervisory Authorities, which may coordinate efforts to find a solution.

Article 22

Civil liability

1. Member States shall ensure that companies are liable for damages if:

   (a) they failed to comply with the obligations laid down in Articles 7 and 8 and;

   (b) as a result of this failure an adverse impact that should have been identified, prevented, mitigated, brought to an end or its extent minimised through the appropriate measures laid down in Articles 7 and 8 occurred and led to damage.

2. Notwithstanding paragraph 1, Member States shall ensure that where a company has taken the actions referred to in Article 7(2), point (b) and Article 7(4), or Article 8(3), point (c), and Article 8(5), it shall not be liable for damages caused by an adverse impact arising as a result of the activities of an indirect partner with whom it has an established business relationship, unless it was unreasonable, in the circumstances of the case, to expect that the action actually taken, including as regards verifying compliance, would be adequate to prevent, mitigate, bring to an end or minimise the extent of the adverse impact.

   In the assessment of the existence and extent of liability under this paragraph, due account shall be taken of the company's efforts, insofar as they relate directly to the damage in question, to comply with any remedial action required of them by a supervisory authority, any investments made and any targeted support provided pursuant to Articles 7 and 8, as well as any collaboration with other entities to address adverse impacts in its value chains.

3. The civil liability of a company for damages arising under this provision shall be without prejudice to the civil liability of its subsidiaries or of any direct and indirect business partners in the value chain.

4. The civil liability rules under this Directive shall be without prejudice to Union or national rules on civil liability related to adverse human rights impacts or to adverse environmental impacts that provide for liability in situations not covered by or providing for stricter liability than this Directive.

5. Member States shall ensure that the liability provided for in provisions of national law transposing this Article is of overriding mandatory application in cases where the law applicable to claims to that effect is not the law of a Member State.

Article 23

Reporting of breaches and protection of reporting persons

Directive (EU) 2019/1937 shall apply to the reporting of all breaches of this Directive and the protection of persons reporting such breaches.

Article 24

Public support

Member States shall ensure that companies applying for public support certify that no sanctions have been imposed on them for a failure to comply with the obligations of this Directive.

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 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 apply also to the provisions of this Article.

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.

Article 27

Amendment to Directive (EU) No 2019/1937

In Point E.2 of Part I of the Annex to Directive (EU) No 2019/1937, the following point is added:

‘(vi) [Directive … of the European Parliament and of the Council of … on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937[*+]]’

Article 28

Exercise of the delegation

1. The power to adopt delegated acts is conferred on the Commission subject to the conditions laid down in this Article.

2. The power to adopt delegated acts referred to in Article 11 shall be conferred on the Commission for an indeterminate period of time.

3. The delegation of power referred to in Article 11 may be revoked at any time by the European Parliament or by the Council. A decision to revoke shall put an end to the delegation of the power specified in that decision. It shall take effect the day following the publication of the decision in the *Official Journal of the European Union* or at a later date specified therein. It shall not affect the validity of any delegated acts already in force.

4. Before adopting a delegated act, the Commission shall consult experts designated by each Member State in accordance with the principles laid down in the Interinstitutional Agreement of 13 April 2016 on Better Law-Making.

5. As soon as it adopts a delegated act, the Commission shall notify it simultaneously to the European Parliament and to the Council.

6. A delegated act adopted pursuant to Article 11 shall enter into force only if no objection has been expressed either by the European Parliament or the Council within a period of two months of notification of that act to the European Parliament and the Council or if, before the expiry of that period, the European Parliament and the Council have both informed the Commission that they will not object. That period shall be extended by two months at the initiative of the European Parliament or of the Council."

Article 29

Review

No later than … [*OP please insert the date = 7 years after the date of entry into force of this Directive]*, the Commission shall submit a report to the European Parliament and to the Council on the implementation of this Directive. The report shall evaluate the effectiveness of this Directive in reaching its objectives and assess the following issues:

[+] OJ: Please insert in the text the number and the date of the Directive contained in document ... and insert the OJ reference of that Directive in the footnote.

(a) whether the thresholds regarding the number of employees and net turnover laid down in Article 2(1) need to be lowered;

(b) whether the list of sectors in Article 2(1), point (b), needs to be changed, including in order to align it to guidance from the Organisation for Economic Cooperation and Development;

(c) whether the Annex needs to be modified, including in light of international developments

(d) whether Articles 4 to 14 should be extended to adverse climate impacts.

Article 30

Transposition

1. Member States shall adopt and publish, by … [*OJ to insert: 2 years from the entry into force of this Directive]* at the latest, regulations and administrative provisions necessary to comply with this Directive. They shall forthwith communicate to the Commission the text of those provisions.

They shall apply those provisions as follows:

(a) from… [OJ to insert: 2 years from the entry into force of this Directive] as regards companies referred to in Article 2(1), point (a), and Article 2(2), point (a);

(b) from … [OJ to insert: 4 years from the entry into force of this Directive] as regards companies referred to in Article 2(1), point (b), and Article 2(2), point (b).

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

2. Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive.

Article 31

Entry into force

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Article 32

Addressees

This Directive is addressed to the Member States.

Done at Brussels,

For the European Parliament | *For the Council*
The President | *The President*

Acting Comptroller of the Currency Michael J. Hsu

November 8, 2021

"Five Climate Questions Every Bank Board Should Ask"

This year, there have been several notable reports and pronouncements regarding climate change. In August, the Intergovernmental Panel on Climate Change (IPCC) published the first installment of its Sixth Assessment Report (AR6).[1] It warns of faster warming and describes in sobering detail a range of adverse impacts from climate change on different regions of the world. In October, the Financial Stability Oversight Council (FSOC) released its first ever Report on Climate-Related Financial Risk. It acknowledged climate change as an emerging threat to the financial stability of the United States and offered a set of recommendations. And last week, as part of the COP26 activities in Glasgow, Scotland, the Network for Greening the Financial System (NGFS), a group of 100 central banks and supervisors, declared a commitment to action. Consistent with that, the OCC announced that we plan to issue high level framework guidance for large banks on climate risk management by the end of this year.

These words are extremely important. Bank action is even more so.

Today, I want to move the climate conversation from the offices of scientists, policymakers, and regulators to bank boardrooms. Specifically, I want to talk about five climate change-related questions that large bank boards of directors should be asking their senior management.

Bank boards have a critical role to play in turning words into action and, in doing so, can be a strong force for good. In board meetings, the questions that directors ask senior managers

[1] Sixth Assessment Report Climate Change 2021: The Physical Science Basis | IPCC (ipcc.ch)

can shift bank priorities, reveal hidden strengths, expose fatal weaknesses, and spur needed changes. The most influential board members—the ones who are highly effective in moving the needle and driving change—tend to ask the most probing questions and expect the most of their management team.

The questions below are designed to help board members promote and accelerate improvements in climate risk management practices at their banks. Given the early state of play, boards should not be surprised to hear management respond, "We don't know" to some, if not all, of the questions. Indeed, precise and confident responses should be met with healthy skepticism. Honest responses should prompt additional questions, rich dialogue, discussions about next steps, and management team commitments for action at future board meetings. By this time next year, management teams hopefully should be able to answer these questions with greater accuracy and confidence. The journey to get there will require large banks to build up their climate risk management and reporting capabilities. The OCC will help along the way.

Question #1: "What is our overall exposure to climate change?"

This is the core, animating question of climate risk management. To answer this question bank senior managers need to develop a framework, a risk taxonomy, metrics, data, scenarios, and a strong understanding of the first- and second-order impacts that physical and transition risks may have on the bank's portfolio.

Boards will naturally want to know how material the exposure is, as that will inform the magnitude of needed adjustments or other actions. You will ask, "Is our exposure manageable?" In contrast to most exposure-related questions, the answer here cannot be meaningfully summed up in a single number. For a large bank, there will need to be a suite of data points—some quantitative, some qualitative—to capture the *profile* of its exposures to climate change risks.

Boards should seek to balance "top-down" and "bottom-up" approaches to assessing their banks' exposures to climate change. To date, most discussions of climate scenario analyses have assumed a top-down approach. The FSOC report, for instance, analogizes climate scenario analysis to Comprehensive Capital Analysis and Review (CCAR) stress testing, while emphasizing the longer time horizon and exploratory nature of climate scenarios. NGFS has developed a range of policy scenarios and climate "pathways," all of which are macro in nature.[2] These and other top-down approaches are complex and will take time to mature, as acknowledged by Federal Reserve Board Governor Brainard in a recent speech.[3]

In the meantime, banks can and should engage in what I call "small s" scenario testing—that is, asking more granular "what if?" questions that directly affect parts of a bank's portfolio. For banks with strong risk management capabilities, this is bread-and-butter stuff. During the Greek debt crisis, for instance, large banks ran batteries of "what if?" scenarios: What if Greece defaults? What if a peripheral redenominates? What if there is a wave of restructurings? These bottom-up questions can be done more quickly, can illuminate material exposures (and data gaps), and can help build the climate risk management muscles that will be needed for large banks to succeed long term.

Boards should push senior management hard to develop scenario analyses, both top down and bottom up, as doing scenario analysis well takes time. But time is running out. We are racing against increasing numbers of costly extreme weather events. Since the beginning of

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[2] NGFS Climate Scenarios for central banks and supervisors | Banque de France (ngfs.net)

[3] Speech by Governor Brainard on building climate scenario analysis on the foundations of economic research | Federal Reserve Board (federalreserve.gov)

2017, the total cost of U.S. weather and climate disasters has exceeded $690 billion.[4] That is a record over any five-year period, and we still have two months left in 2021. This year will be the seventh consecutive year that the United States has experienced ten or more billion-dollar weather disasters.[5] The IPCC report notes that "[w]ith every additional increment of global warming, changes in extremes continue to become larger."[6] In other words, every half degree Celsius increase in global warming will result in an increasing occurrence of some extreme events unprecedented in the observational record.[7]

Understanding one's exposure to a given risk is foundational to monitoring and managing that risk effectively. By posing this question about climate change exposure directly and repeatedly to senior managers, boards will compel and support them in developing the frameworks, gathering the data, and building the teams and systems necessary to effectively manage risks from climate change.

Question #2: "Which counterparties, sectors, or locales warrant our heightened attention and focus?"

Climate change is going to significantly impact the creditworthiness of some borrowers and sectors. Both physical and transition risks can ultimately affect borrowers' solvency and the value of their underlying assets. *Physical risks* include the increased frequency, severity, and volatility of extreme weather and long-term shifts in global weather patterns and their associated impact on the value of financial assets and borrowers' creditworthiness. *Transition risks* relate

[4] Billion-Dollar Weather and Climate Disasters: Events | National Centers for Environmental Information (NCEI) (noaa.gov)

[5] Id.

[6] See note 1.

[7] Id.

to the adjustment to a low-carbon economy and include associated changes from government policy, technology, and consumer and investor sentiment. Identifying those borrowers and sectors most likely to see deterioration in their ability to repay or in their collateral values under potential physical and transition risk scenarios is a critical first step to prudently managing climate risk. This is particularly important with so-called "wrong way risk" exposures—where a borrower's probability of default (PD) and loss given default (LGD) both increase simultaneously under a particular stress.

The threat of certain physical risks may also have disproportionately large impacts on certain local economies. While communities and banks have withstood weather disasters for years, the higher frequency, increased severity, and broader scope of extreme weather events, such as hurricanes, floods, wildfires, and droughts, may inflict permanent damage on local economies or compel households and businesses to migrate.

Other communities may be particularly vulnerable to transition risks. For instance, those that are highly dependent on carbon-intensive activities for economic growth will be disproportionately affected by clean energy technological advancements, shifts in consumer and investor sentiment, and eventual policy interventions.

Assessing the potential impacts of climate change on specific counterparties, sectors, and locales is an important step to understanding and managing banks' overall exposures to climate change.

Question #3: "How exposed are we to a carbon tax?"

Transition risks are especially challenging to identify and quantify. While forecasting the weather accurately is not easy, forecasting technology breakthroughs, legislative actions, and consumer preferences is nearly impossible by comparison.

Banks must start their analysis somewhere. A boundary case, like the immediate adoption of a carbon tax, may serve as a good candidate.

A carbon tax puts a price on emissions of carbon dioxide and other greenhouse gases, encouraging people, businesses, and governments to produce less of them. Most economists agree that a carbon tax would be the most efficient way to transition to a zero carbon economy. Notwithstanding, the likelihood of the United States adopting a carbon tax in the foreseeable future is low.

So why ask management to estimate a bank's exposure to a carbon tax?

A carbon tax can be thought of as the transition risk equivalent of the "severely adverse" scenario in CCAR. It is a way to flesh out, at the aggregate level, the most significant exposures, the biggest concentrations of risk, and the most highly correlated positions. More important than the estimate itself, the exercise of coming up with a number will require processes, data, and calculations that will strengthen transition risk measurement practices more broadly. Those capabilities may, in turn, enable more refined assessments of more complex and more likely transition risks in the future.

Question #4: "How vulnerable are our data centers and other critical services to extreme weather?"

As the pandemic has shown, households, businesses, and the financial system rely heavily on banks to maintain continuous operations, despite external events. Understanding the potential effect of extreme weather on the continuity of large banks' critical operations is an important part of effective climate risk management.

Most large banks rely significantly on data centers to store, aggregate, process, and synthesize the data underlying their businesses. Some of these data centers may be located in areas with elevated risk to extreme weather, such as storms, tornadoes, and flooding. Risks include not only the risk of damage to physical facilities but also risks from staff inaccessibility to run those facilities.

As a corollary to this, banks increasingly are dependent on third-party vendors for a range of things, including critical services. To the extent that critical service providers are vulnerable to climate change, banks' abilities to continue critical operations may be affected.

Identifying and understanding such vulnerabilities is important for continuity and disaster recovery planning. While banks have been doing business continuity planning for years, changes in extreme weather caused by climate change may require banks to do additional analysis and adjust preparedness accordingly. Risk assessments and mitigation that take the full range of climate scenarios into account may prompt consideration of modifications to data center strategies or business continuity plans. Now is the time to start asking these questions.

Question #5: "What can we do to position ourselves to seize opportunities from climate change?"

It is important to remember that climate change presents opportunities, as well as risks. Banks that are poorly prepared to identify climate risks will be at a competitive disadvantage to their better-prepared peers in seizing those opportunities when they arise.

The low-carbon economy is going to look and function differently than today's economy. Renewables, carbon capture, electric vehicles, charging stations—these are the most obvious banking opportunities arising from climate change. Changes in agriculture, water infrastructure, consumer preferences, and investor sentiment will also create opportunities.

Banks with strong climate risk management systems and capabilities will not only be better prepared to withstand climate change events but will also have a better line of sight into the many business opportunities that will arise. Just as strong credit risk management capabilities can provide the assurance and confidence needed for a bank to make risky credit decisions prudently, strong climate risk management capabilities can enable the same prudent risk taking with regards to climate-related business opportunities.

The better a car's brakes, the faster you can safely drive it. The sooner large U.S. banks accept this, the more competitive they will be vis-à-vis their overseas peers.

Conclusion

We are at an important moment. Climate change poses significant risks to the financial system. Detailed reports have been published. Eloquent words have been spoken. It is time to convert those words into action.

Bank boards can play a pivotal role. By asking pointed questions of management about their institutions' exposures to climate change risks, bank boards can help put into motion the concrete steps that banks need to take to prudently manage climate risk.

We at the OCC are here to help and to do our part. We are currently developing high level supervisory expectations for large banks related to climate risk management. We expect to issue framework guidance by the end of this year, to be followed next year with detailed guidance for each risk area. The detailed guidance will build on a range-of-practices review that will launch this week, industry and climate groups' input, and lessons from other jurisdictions.

Our vision is that by working together, large U.S. banks will develop robust climate risk management capabilities over time. Doing so should improve their resilience and competitive positioning and enable them to address climate change more effectively.