3rd Floor, North Wing
Guildhall, Basinghall Street
London EC2P 2RJ

+44 (0) 20 4522 9190
email@fmlc.org
www.fmlc.org

22 February 2023

Directorate-General for Justice and Consumers
European Commission
1049 Brussel
Belgium

Dear Ana Gallego, John Berrigan and Lucrezia Busa

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

On 23 February 2022, the Commission adopted a proposal for a directive on corporate sustainability due diligence ("**CS3D**"). On 1 December 2022, the Council adopted its negotiating position on CS3D (the "**Proposal**").

Issues of Legal Uncertainty

The Proposal potentially brings into scope a number of types of financial services institutions but significant uncertainties exist as to how the directive is intended to apply to, and the precise scope of the obligations imposed on, these institutions.

We outline below some of the issues with the text as currently drafted.

Whether "regulated financial undertakings" ("**RFU**s") should be in the scope of CS3D has been the subject of intense debate and various Member States have argued for an entire exclusion from scope for these entities, which are already covered by the Sustainable Finance Disclosure Regulation ("**SFDR**") in respect of some aspects of sustainability due diligence. The scope of the Proposal in respect of RFUs remains uncertain despite the Council's attempts to address these debates.

1. Application to upstream services

While the application of CS3D to RFU's downstream financial services is left for Member States to decide (see paragraph 2 below), the application to upstream services (i.e. in relation to those who supply goods and services to RFUs) appears to be treated differently. The Council states in its prelude to its Proposal that if "the Member State does not decide to apply the Directive to the provision of the financial services by regulated financial undertakings (to cover the downstream part of the chain of activities), the chain of activities for regulated financial undertakings should be the same as for the rest of the companies from different economic sectors", suggesting that RFUs are still in scope for their upstream activities even where a Member State has not chosen to implement the CS3D in relation to RFUs. However, on a plain reading of the construction of new Article 2(8), there is an alternative reading that RFUs are fully excluded from the scope of CS3D, and that Member States may opt to apply the Directive to RFUs, and additionally, optionally, also include their downstream services. While this reading is not consistent with the Council's commentary, the drafting should more clearly reflect the intent. The application to RFU's upstream activities should be clarified in the proposed CS3D text.

2. Application to downstream financial services and investee / portfolio companies

As raised above, the Proposal leaves for Member States to decide whether to apply the due diligence obligations to provision by the RFU of a limited range of downstream financial services as listed in Article 3(g), which are then (but only then) to be considered as part of the RFU's "chain of activities".

Article 3(g) states that the services which could, at the option of the Member State, be covered include "the activities of legal entities receiving directly lending, provision of guarantees and commitments from the regulated financial undertaking". Whilst the Proposal's prelude states that this excludes "investment activities", recital 19 specifically notes that this definition does "capture activities that allocate capital to the real economy". As drafted it is unclear whether, and if so when, an investment fund manager will need to have regard to a portfolio / investee company. For example a fund manager purchasing newly issued shares in an investee company, whether or not that results in a controlling position, appears as if it would be subject to the due diligence obligations of CS3D in respect of that investment, since it results in new capital for the company, whereas a manager purchasing shares on the secondary market would not, as no new capital is being allocated to the portfolio company. The application of these provisions to such entities is therefore not only unclear but potentially arbitrary.

Since the SFDR and other sectoral legislation (for example, UCITS and AIFMD Regulations as recently amended) already governs sustainability aspects of the investment activities of these RFUs, imposing different and potentially conflicting obligations, it would add significant uncertainty to regard these investment activities as within scope of a directive which is based on and the extension of a corporate reporting regime, driving data for disclosures already mandated by the sector-specific legislation.

In addition, where investment funds hold a majority share in an investee company, the investee company may meet the definition of a "subsidiary", with significant implications for the extent of the fund's (or its manager's) due diligence obligations. The obligations may therefore vary dramatically depending upon whether the investor is a minority or a majority investor.

With regard to the potential application of extensive due diligence obligations in relation to majority-controlled investee companies, it is uncertain how these are intended to apply to the investment manager, who is unlikely to have the requisite operational control and/or expertise to identify and mitigate sustainability risks and doing so may give rise to conflict with the duties of the portfolio company's board. It is clear that responsibility for environmental and human rights due diligence currently rests with the board of directors of the investee company (or the board of directors of the top company in the corporate group). Application to an investment manager also runs counter to existing accounting rules which do not generally require or allow investee companies to be consolidated if the shares are held for investment purposes, on the basis that it would be misleading to do so.

3. Choice of law

Giving Member States the option to include certain investment activity within the chain of activities of an RFU means there will be a potential patchwork of laws across the EU. Article 17 provides that non-EU companies will be regulated by the competent supervisory authority in the Member State where the company has a branch, or where it generated most of its EU turnover in the relevant year. At the same time, non-EU entities without any establishment in the EU must appoint an authorised representative in the EU, which can be in any Member State where it operates. This need not be the same as the Member State where it is supervised, as the non-EU entity will have a range of considerations in deciding where to appoint the authorised representative. In the event of a violation, since the authorised representative provides a point of contact for enforcement action; a number of complex scenarios arise, where you could have an authorised representative in one Member State, a supervisory authority in another Member State, and an investment in a third country, with the extent of diligence differing between the three Member States. One conclusion is that the law of the Member State of the company receiving the investment would apply, but on the other hand, it may be the Member State where the EU entity is established or the non-EU entity is supervised that most naturally can claim jurisdiction. This uncertainty should be clarified to the extent this optionality remains in the CS3D text.

4. **Paris-aligned business planning**

   The CS3D contains a requirement for entities to adopt a plan to ensure their "business model and strategy" is compatible with the 1.5 degree temperature rise in line with the Paris Agreement and the EU's 2050 climate neutrality goal. The extent of this obligation should be further clarified; for example whether for managers, this applies to their portfolio and investment decision-making. If the obligation is intended to apply to investment activity, this could conflict with existing client mandates, creating significant uncertainty.

   We also believe that it is unclear whether this requirement applies equally to non-EU entities within the scope of the Directive; given the significant extraterritorial reach, if this is intended, it should be clearly started in the text.

Next steps

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me should you wish to arrange a meeting or if you have any questions.

Yours sincerely,

Brian Gray

Chief Executive[1]

[1] The FMLC is grateful to Simon Witney (Travers Smith LLP) for his help in drafting this letter.