CSDDD for Asset Managers

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The Corporate Sustainability Due Diligence Directive ("CSDDD" or the "Directive") came into force in July 2024, with its provisions first applying from July 2027 to the largest EU and non-EU companies in scope. The regime introduces "risk-based human rights and environmental due diligence" obligations for companies, aimed at identifying and assessing adverse impacts arising from their own operations, the operations of their subsidiaries, and the operations of their direct and indirect "business partners" where related to their "chains of activities", i.e., their supply and distribution chains.

We described the overall scope of CSDDD and the thresholds to determine whether an EU or non-EU company is in scope, by reference to the employee and turnover tests, in an earlier Debevoise In Depth.

In this note, we discuss the impact of CSDDD on asset managers—AIFMs and UCITS management companies. We consider questions of scope of application, including on holding structures, the impact on portfolio companies and how asset managers should determine their "chain of activities". However, it is important to bear in mind that the precise application of CSDDD will depend on how Member States transpose the Directive into national law (which they must do by 26 July 2026). In particular, CSDDD allows Member States to introduce more stringent provisions, including in relation to companies in the financial sector.

Application of CSDDD to Financial Undertakings

"Regulated financial undertakings", including AIFMs and UCITS management companies, are in scope of CSDDD, regardless of their legal form, if they exceed the relevant thresholds.

An **EU company** is in scope of CSDDD where it: (i) has more than 1,000 employees and net worldwide turnover of more than €450m in the last financial year (applied in the last two consecutive years); (ii) is the ultimate parent company of a group with more than 1,000 employees and net worldwide turnover of more than €450m on a

consolidated basis in the last financial year (applied in the last two consecutive years); or (iii) generated revenue of more than €22.5m in the EU pursuant to royalty agreements and has net worldwide turnover of more than €80m.

A **non-EU company** is in scope of CSDDD where it: (i) has net turnover in the EU of more than €450m in the last financial year (applied in the last two consecutive years); (ii) is the ultimate parent company of a group with net turnover in the EU of more than €450m on a consolidated basis in the last financial year (applied in the last two consecutive years); or (iii) generated revenue of more than €22.5m in the EU pursuant to royalty agreements and has net EU turnover of more than €80m.

CSDDD provides that parent companies and individual subsidiary companies can be in scope. Asset management groups will therefore need to determine which companies in their group are in scope of CSDDD by reference to the threshold tests. The threshold tests are applied on a group-wide basis for the "ultimate parent company of a group" (by reference to consolidated financial statements), and on a stand-alone basis for subsidiary companies. If an EU or non-EU subsidiary is large enough to be in scope, then it must separately carry out the due diligence obligations with respect to its own operations, its subsidiaries and those of its business partners in its chain of activities. As an alternative, parent companies may fulfil obligations under CSDDD on behalf of those subsidiaries in scope, although those subsidiaries remain liable for breach of CSDDD's requirements.

Asset managers which are in scope of CSDDD will need to identify their "subsidiaries" to determine the scope of their obligations. Asset managers will not generally treat funds' investee companies as subsidiaries, either for financial accounting or other purposes, but each structure requires specific analysis.

Application of CSDDD to Holding Companies

Asset managers will need to consider whether holding companies that they establish for their funds are in scope of CSDDD. It will be important for this purpose to determine whether a holding company prepares financial statements on a consolidated basis since the employee and turnover tests, at least for an EU ultimate parent company, are expressed by reference to the consolidated financial statements of a holding company and its subsidiary portfolio companies. For a non-EU ultimate parent company, only the turnover test applies on a consolidated basis, without regard to the employee test.

Where an asset manager establishes an EU or non-EU holding company to hold a fund's assets, questions arise whether the holding company, in place of the fund, should be treated as the "ultimate parent company" for CSDDD purposes. It is also unclear

whether it is necessary to check whether a holding company produces consolidated financial accounts to determine whether it is treated as an ultimate parent company.

CSDDD includes a limited form of exemption for EU and non-EU "ultimate parent companies" that have as their main activity the holding of shares in operational subsidiaries and that do not engage in taking management, operational or financial decisions affecting their groups or one or more of their subsidiaries. This exemption allows the ultimate parent company to designate an EU subsidiary to fulfil the ultimate parent company's obligations under CSDDD on its behalf, whilst remaining jointly liable with that subsidiary. EU and non-EU ultimate parent companies must apply to their EU state supervisory authority to use the exemption.

The implications of a holding company being in scope of CSDDD depend on the types of assets that it holds.

If it is a holding company that is the ultimate parent of a portfolio company group, then it may be brought in scope of CSDDD alongside the portfolio company group and may consider using the limited form of exemption referred to above. However, as mentioned, under the exemption, the holding company remains jointly responsible with its designated subsidiary for compliance with CSDDD.

If a holding company is established to hold financial assets, such as credit interests or interests in subsidiary portfolio companies, then the holding company will need to consider the relevance of the CSDDD due diligence obligations to its limited activities. There is no exemption in CSDDD for asset holding companies, including securitisation special purpose entities, although it seems likely that EU entities of this type will not meet the employee threshold to be in scope. Non-EU entities, which are only subject to a threshold of turnover in the EU and not an employee threshold may, however, find themselves in scope.

Chain of Activities for Asset Managers

CSDDD requires companies to perform due diligence in relation to the operations of their direct and indirect "business partners" where related to their "chains of activities". The "chains of activities" comprise:

- the activities of upstream business partners related to the production of goods or the provision of services by the company, including the design, extraction, sourcing, manufacturing, transport, storage and supply of raw materials and products (or parts) and the development of the product or service; and

- the activities of downstream business partners relating to the distribution, transport and storage (but not disposal) of the company's products, provided that the business partners carry out those activities for the company or on behalf of the company. Downstream business partners do not include distributors or customers in respect of services.

A recital to CSDDD confirms that financial sector undertakings' due diligence obligations only apply with regard to their "upstream" business partners, leaving "downstream" business partners, such as clients, borrowers and other users of their services, out of scope.

However, the Directive includes a review clause, which requires the Commission to report by July 2026 on the necessity of "additional sustainability due diligence requirements tailored to regulated financial undertakings with respect to the provision of financial services and investment activities". The review may be accompanied by a legislative proposal.

Many financial services firms perform human rights and environmental due diligence on their own operations and certain of their suppliers under existing supply chain due diligence requirements such as the UK Modern Slavery Act, and have developed policies to assess human rights and environmental risks at the level of their customers, including, for asset managers, their investments. However, most firms have not, to date, engaged with the concept of identifying their "upstream" and "downstream" chains of activities. "Upstream" chains of activities may include, for instance, suppliers of professional services, IT systems, market data and office facilities. Asset managers must also consider whether or not suppliers of services to their funds, which are often engaged by the manager, such as fund administrators, custodians and brokers, are in-scope business partners related to the manager's upstream chain of activities. Asset managers are also currently debating whether the delegation and sub-advisory models that are widely used (where, for instance, an EU alternative investment fund manager appoints a non-EU asset manager as its portfolio management delegate) also comprise part of their upstream chain of activities.

Obligations of Asset Managers in Scope

Asset managers are relieved from CSDDD's substantive due diligence obligations to identify, assess, prioritise, prevent, bring to an end and remediate impacts in their "downstream" chain of activities, including in relation to the investments held by their funds. However, they will need to consider how they approach due diligence at the level of their own operations, and in their "upstream" chains of activities. In particular, asset

managers may consider the general obligation to integrate due diligence in their own operations to include integration of human rights and environmental due diligence in their investment policies. For example, an asset manager should be mindful of the risk of enabling human rights and environmental impacts by, for instance, its direct lending activities, and its ability to perform due diligence on and influence investee companies.

In this regard, a recital to CSDDD points financial institutions towards the OECD Guidelines for Multinational Enterprises as a source of appropriate due diligence practices for their own operations, stating that "the MNE Guidelines provide indications of the types of measures that are appropriate and effective for financial undertakings to take in due diligence processes […] Regulated financial undertakings are expected to consider adverse impacts and to use their so-called 'leverage' to influence companies. The exercise of shareholders' rights can be a way to exercise leverage." The reference to the MNE Guidelines appears to be a reference to the OECD Responsible Business Conduct for Institutional Investors, which provides extensive guidance as to how investors carry out due diligence for responsible business conduct on their investments, including where investors may be said to "contribute to" impacts caused by their investee companies and may be responsible for remediation and where investors are "directly linked" to the impact and are expected to use their influence with the investee company to address the impact. The OECD Guidelines are a resource of best practice in this area according to CSDDD's recitals.

Requirement for Asset Managers to Adopt a Climate Transition Plan

All companies that are in scope of CSDDD must adopt and put into effect a climate transition plan, with emissions reduction targets for each significant category of their Scopes 1, 2 and 3 greenhouse gas emissions. The plan must aim to ensure, through best efforts, that the business model and strategy of the company are compatible both with the transition to a sustainable economy and with limiting global warming to 1.5°C in line with the 2015 Paris Climate Agreement. A recital to CSDDD describes the requirement as "an obligation of means and not of results", taking into account factors such as the complexity and evolving nature of climate change transitioning. If a company reports a transition plan under CSRD, it does not need to adopt and report a transition plan under CSDDD.

The key discussion point for asset managers is the application of the requirement to their funds' investment portfolios if the reference to adopting a transition plan for significant Scope 3 emissions is understood as including emissions at the portfolio level ("financed emissions"). Arguably, including emissions at the portfolio level in the transition plan is at odds with exclusion of downstream value chains from the key due

diligence obligations under CSDDD. Otherwise, the key challenge for the asset manager will be to ensure that its funds' investments have either adopted or will adopt a transition plan and to track the progress of the plan, including by obtaining emissions data from its investments. For most asset managers, adoption of a transition plan under one of the existing voluntary frameworks—such as under the Net Zero Asset Managers Initiative Commitment—will be the starting point. However, there are open questions as to whether adoption of one of the existing voluntary frameworks, which provide some flexibility to the asset manager as to the proportion of its funds' portfolio to which it applies the net zero commitment, will meet CSDDD's requirement. The prospective requirement to adopt a climate transition plan at the portfolio level remains a matter of key concern for asset managers in scope.

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Please do not hesitate to contact us with any questions.

Samantha J. Rowe
Partner, London
+44 20 7786 3033
sjrowe@debevoise.com

Patricia Volhard
Partner, Paris | Frankfurt | London
+33 1 40 73 12 12
pvolhard@debevoise.com

Jin-Hyuk Jang
Counsel, Frankfurt
+49 69 2097 5115
jhjang@debevoise.com

John Young
Counsel, London
+44 20 7786 5459
jyoung@debevoise.com

Ulysses Smith
ESG Senior Advisor, New York
+1 212 909 6038
usmith@debevoise.com

Christina Heil
Associate, Frankfurt
+49 69 2097 5221
cheil@debevoise.com

Jesse Hope
Associate, London
+44 20 7786 5420
jhope@debevoise.com

Harry Just
Associate, Frankfurt
+49 69 2097 5262
hjust@debevoise.com

Andrew H.W. Lee
Associate, London
+44 20 7786 9183
ahwlee@debevoise.com

Sophie Michalski
Associate, London
+44 20 7786 9060
smichalski@debevoise.com

Eike Björn Weidner
Associate, Frankfurt
+49 69 2097 5220
ebweidner@debevoise.com