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The Role of the EU Directive on Non-financial Disclosure in Human Rights Reporting

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1. INTRODUCTION

The 2013 collapse of the Rana Plaza – a building housing clothing factories situated in Bangladesh's capital Dhaka – sparked indignation throughout the European Union and beyond. In spite of the building's severe construction flaws, European transnational corporations ('TNCs') had been sourcing materials from the Rana Plaza factories; thereby effectively keeping in place economic incentives for continued commercial use of the building which eventually led to a human rights tragedy of unprecedented scale for the garment industry. The incident resulted in thousands of casualties of which over 1,100 were fatal, causing questions to arise regarding supply-chain oversight by European TNCs.[1]

Over the past decades, business involvement in human rights violations as laid bare by cases such as *Rana Plaza*, has led (alliances of) companies, non-governmental organizations ('NGOs') and governments to introduce legal and non-legal mechanisms with the aim of enforcing corporate responsibility to respect human rights.[2] The most recent step taken by the European Union is included in the Directive on non-financial disclosure ('the Directive').[3] The Directive contains the obligation for large public-interest entities with more than 500 employees to include in the management report a non-financial statement containing information relating to human rights – describing which policies have been pursued regarding human rights matters, the outcome of those policies and the principal risks relating to those matters.[4]

A recent study conducted by The Economist Intelligence Unit in collaboration with a range of companies, stakeholders and (inter)governmental organizations such as the UN Working Group on Business and Human Rights, shows that whereas the vast majority (83%) of companies agree on the importance of human rights for business, only 11% of the surveyed group indicate to annually report on human rights related issues.[5] In the light of this apparent dichotomy between private awareness and public disclosure, several questions arise with regard to the Directive: Is mandatory human rights reporting desirable? Can disclosure lead to enforcement of corporate responsibility to respect human rights? What are the effects of human rights reporting on disclosing parties? In short: What role can the Directive play in human rights reporting by European TNCs? In pursuit of answering this question, the desirability of mandatory reporting as a regulatory tool will be discussed, covering the limitations of voluntary reporting and the manner in which a mandatory regime could function in view of current market conditions. The resulting position on human rights reporting will then be contrasted with the Directive.

2. MANDATORY REPORTING

Desirability of mandatory reporting rests on the premises that: (i) a certain purpose cannot be achieved by voluntary disclosure, and that (ii) disclosure is effective as a regulatory or conditioning mechanism. The first premise regards the extent to which problems arising from a status quo of voluntary disclosure can be mitigated by imposition of reporting requirements, whereas the second premise concerns the interplay between disclosure and external enforcement mechanisms. In order to assess these premises in a human rights context, it is important to understand mandatory reporting as a regulatory tool. Mandatory reporting is a species of 'informational regulation': regulation aimed at

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1 A. Hatchuel, 'Rana Plaza, la mort de l'industrie', *Le Monde* 26 May 2013 (www.lemonde.fr/economie/article/2013/05/26/rana-plaza-la-mort-de-l-industrie_3417734_3234.html).

2 Examples include the UN Global Compact, the OECD Guiding Principles for Multinational Corporations and the UN Framework- and Guiding Principles on Business and Human Rights.

3 Directive 2014/95/EU of 22 Oct. 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups (2014) OJ L 330/1.

4 Article 19a(1) of the Directive.

5 The Economist Intelligence Unit, *The Road from Principles to Practice: Today's Challenges for Business in Respecting Human Rights* 16 Mar. 2015, 12 & 16 (www.economistinsights.com/business-strategy/analysis/road-principles-practice).

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transparency rather than direct enforcement of substantive norms.[6] Although enforcement of substantive norms falls outside the ambit of informational regulation, mandated transparency can be used in a purposeful way by targeting specific ends: the disclosure requirements can be drafted so as to achieve public policy purposes without imposing substantive obligations.[7] Even so, targeted informational regulation cannot independently reach its aims, but depends on external mechanisms for norm-creation and – enforcement.[8] The following subparagraphs explore this dynamic by analysing the reasons for mandatory disclosure (§2.1) and its functioning (§2.2-2.3).

2.1. The Limitations of Voluntary Reporting

Voluntary non-financial reporting entails the (periodic) disclosure of non-financial performance information which is primarily induced by non-legal incentives.[9] In spite of this field historically being thinly regulated, non-financial information – predominantly related to employee rights and sustainability – has become a recurring presence in corporate external communication.[10] These disclosure initiatives can be understood to form part of a legitimation strategy and reflect a shift in corporate responsibility thinking.[11] Absent public enforcement and assuming rational disclosers, the disclosees' views determine the extent to which companies opt for disclosure. Hence, it is apparent that within the amorphous group of end-users of corporate information, the view famously put forward by Milton Friedman holding that 'the only business of business is business'[12] has become successfully challenged by the notion of a broader non-legal corporate responsibility following from the company's *social licence to operate* ('SLO'); a philosophy holding that society tacitly licences companies (in a way analogous to state concession) based on the core condition that those companies meet or are subject to the legitimate expectations of society.[13]

Based on the SLO philosophy, arguments in favour of non-financial disclosure are not uncommonly ethically and morally inspired (e.g., the virtue of informed democratic processes).[14] The demand for human rights reporting, however, is not limited to abstract notions of duties to society, but is being voiced by an increasing number of relevant market actors (§2.2). For this reason, it is important to address the question whether voluntary reporting can cater for this call for transparency. Voluntary corporate disclosure has been subject to substantial criticism. The principal objection remains that the disclosed content is dependent on the discloser's self-interest, which is regarded to be misaligned with the (public) interest of the disclosee, leading to a situation where disclosure is providing publicity rather than transparency (a phenomenon often dubbed 'greenwashing' for its incidence in environmental reporting).[15] Although misalignment of interests should not be groundlessly assumed, several factors seem to indicate that the market is prone to underprovide information on human rights conduct. Firstly, disclosure of information to which companies are (or can be) privy involves costs on the side of the discloser. Direct costs of 'gathering, analysing, drafting and disseminating information' as well as indirect costs following from exploitation of disclosed information by competitors and other market actors can lead companies to refrain from information collection and communication.[16] These incentives make for a 'cohesive overall group interest in keeping disclosure to a minimum'.[17] On the other side, the effectiveness of targeted transparency is dependent on the existence of a 'moral community in which members share common values'.[18] However, the disclosee group can suffer from collective action problems and for that reason can experience difficulties in engaging in enforcement based on shared values. These collective action problems consist mainly of coordination difficulties since the number of actors to whom human rights are of importance is (in theory) unlimited and

6 D.W. Case, *Corporate Environmental Reporting as Informational Regulation: A Law and Economics Perspective*, 76 U. Colo. L. Rev. 379, 383 (2005); D. Weil et al., *The Effectiveness of Regulatory Disclosure Policies*, 25 *Journal of Policy Analysis and Management*, 1, 155 (2006).

7 S.K. Park, *Human Rights Reporting as Self-interest: The Integrative and Expressive Dimensions of Corporate Disclosure*, in *Law, Business and Human Rights: Bridging the Gap* (R.C. Bird et al., eds, Edward Elgar 2014).

8 The term enforcement as used in this article may include judicial enforcement based on other legal grounds (e.g., torts), but is not limited to the legal courts and can take form as private enforcement or through the 'courts of public opinion'. The 'external mechanisms' can thus be external to a disclosure regime as well as to any regime dependent on judicial enforcement.

9 Case 2006, p. 386.

10 'Wood for the trees', *The Economist* 78 (6 Nov. 2004).

11 W. Bradford, *Beyond Good and Evil: The Commensurability of Corporate Profits and Human Rights*, 26 Notre Dame J.L. Ethics & Public Policy 141, p. 187 (2012); L. Gherardi, J. Guthrie & F. Faneti, *Stand-alone Sustainability Reporting and the Use of GRI in Italian Vodafone: A Longitudinal Analysis*, 164 Procedia – Social and Behavioral Sciences 1, 14 (2014).

12 '[T]here is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud.' (M. Friedman, *Capitalism and Freedom* 133 (U. Chi. Press 1982)).

13 A.J. Eijsbouts, *Corporate Responsibility, beyond Voluntarism. Regulatory Options to Reinforce the Licence to Operate* 34 (Inaugural Lecture Maastricht University 20 Oct. 2011); A. Giner, *Las Empresas Transnacionales y los Derechos Humanos*, 19 Lan Harremanak 67, 71–72 (2008); Case 2005, p. 391.

14 Case 2005, p. 414.

15 *Ibid.* 394–395; Weil et al. 2006, p. 156.

16 Park 2014, p. 51.

17 D. Weil, 'The Benefits and Costs of Transparency: A Model of Disclosure Based Regulation', *Working Paper, Transparency Policy Project, John F. Kennedy School of Government, Harvard University* 12 (2002) (ssrn.com/abstract=31645).

18 Park 2014, p. 55; A. Fung, M. Graham & D. Weil, *Full Disclosure: The Politics, Perils and Promise of Targeted Transparency* 30 (Cambridge U. Press 2007).

cross-cuts geographical as well as sectorial borders. A lack of coordination in this regard leads to fragmentation of the disclosee group and to a consequent loss of its influence over the extent to which companies choose to disclose.[19]

The possibly structural information asymmetry between discloser and disclosee following from these incentives has been cited as a ground for government intervention.[20] However, bridging the information gap by mandatory disclosure does not independently lead market participants to hold companies to account. An argument put forward against mandatory disclosure holds that in spite of the information discrepancies being levelled and a coherent moral community of disclosees existing, it is questionable whether full disclosure will lead end-users to act in such a way that a social optimum of accountability is reached. [21] The latter can only be the case where the efficient market hypothesis holds true for the market of human rights information, that is to say that all disclosed information would be wholly and effectively processed and used by market actors. Nonetheless, actual market conditions are limited by the bounded rationality of actors processing and using information, for which reason the disclosed information might not be used to its full potential. This would entail that the full efficiency needed for achieving a social optimum is not likely to arise.[22] Although this criticism is not devoid of rhetorical appeal for its focus on a social optimum, it does not regard mandatory reporting as a complement to alternative forms of regulation, but instead limits itself to the question whether it can serve as a substitute.[23] Yet, by only assessing mandatory human rights reporting as a panacea, its positive effects are too easily overlooked.[24]

2.2. Enforcement of the Responsibility to Respect Human Rights: Looking beyond the State

For these positive effects to materialize, mechanisms which can enforce the responsibility to respect human rights need to be in place. In this regard, two problems arise: (i) the SLO insofar as it concerns the responsibility to respect is only marginally backed by laws and treaties, and (ii) international legal instruments dealing with human rights fall short in legal enforceability vis-à-vis TNCs. [25] By mandating human rights reporting, the aid of (socially responsible) market participants can be enlisted in order to fill this 'governance gap'.[26] Market actors can serve as a mechanism to enforce unwritten SLO as well as codified non-legal instruments. In this respect, the UN Guiding Principles on Business and Human Rights ('UNGP') are the dominant standard and therefore the most likely to play an important role in any effective regime of human-rights targeted transparency.[27] This manner of regulating human rights responsibility, involving both public and private norms and actors, follows a wider trend in corporate governance regulation where norm-creation and enforcement are increasingly disembedded from the traditional top-down legislative approach.[28]

The private actors whose involvement mandatory reporting aims to enlist, are both actors who are institutionally connected to the company (e.g., shareholders) and those who are linked to the business through market participation (e.g., financial institutions, suppliers, clients, competitors and rating agencies).[29] The relationship between these actors and the discloser can be characterized within the theoretical framework of 'Coasean bargaining'.[30] According to Ronald Coase's theory of social cost, parties can reach a socially optimal outcome through bargaining, given *inter alia* the absence of transaction costs (i.e. costs for using the market).[31] If the transaction costs keeping companies and socially responsible market participants from bargaining are negated, a socially optimal allocation of benefits involved with human rights related conduct (e.g., reputational gains for companies and increased human rights respect as societal gain) becomes attainable. Because mandatory reporting can diminish the importance of the transaction costs discussed (§2.1) by countering the incentives for withholding information through prescription, the outcome of bargaining between private actors and the discloser can further approximate full enforcement of the responsibility to

19 Weil 2002, p. 12.
20 Weil et al. 2006, p. 156.
21 Park 2014, p. 56.
22 R.J. Shiller, *Human Behavior and the Efficiency of the Financial System*, in *Handbook of Macroeconomics* vol. 1, 1305–1340 (J.B. Taylor & M. Woodford (eds.) 1999); I. Brunet, F. Baltar & A. Gregori Gomis, 'L'anàlisi transaccional de l'empresa', (2001) 96/4 *Papers* 1363, 1364–1366; D. Campbell, *The Incompleteness of our Understanding of the Law and Economics of Relational Contract*, 2 Wis. L. Rev. 645, 666–667 (2004).
23 Case 2005, 386–387, 417, 422–423.
24 R. Baldwin, M. Cave & M. Lodge, *Understanding Regulation*, 157 (Oxford U. Press 2012). *Cf.* J. Farrell, *Information and the Coase Theorem*, 1 J. Econ. Persps 113, 125 (1987).
25 E. De Brabandere, *Non-State Actors and Human Rights: Corporate Responsibility and the Attempts to Formalize the Role of the Corporation as Participants in the International Legal System*, in *Participants in the International Legal System. Multiple Perspectives on Non-State Actors in International Law*, 268–283 (J. d'Aspremont (ed.) Routledge 2011). *Cf.* Park 2014, 53.
26 Case 2006, 383.
27 J. Harrison, *An Evaluation of the Institutionalisation of Corporate Human Rights Due Diligence*, 18 University of Warwick Legal Studies Research Paper, 2 (2012); The UN Guiding Principles on Business and Human Rights (www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf).
28 P. Zumbansen, *Neither 'Public' nor 'Private', 'National' nor 'International': Transnational Corporate Governance from a Legal Pluralist Perspective*, 38 J. L. & Soc. 50, 70 (2011); C. Scott, F. Cafaggi & L. Senden, *The Conceptual and Constitutional Challenge of Transnational Private Regulation*, 38 J. L. & Soc. 1, 8 (2011); J. Black, *Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a 'Post-Regulatory' World*, 54 Current Leg. Problems 103, 145 (2001); Case 2005, p. 418.
29 Case 2005, p. 391.
30 *Ibid.* 420–421.
31 *See* R.H. Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1 (1960).

respect. However, whether countering transaction costs by mandatory reporting leads to bargaining depends on the disclosee group's willingness to negotiate; it depends on the existence of actors willing to hold companies accountable.[32] Although no clear reference point exists for determining the optimal market conditions for Coasean bargaining in a business and human rights context, there are indications that the market is bringing forth an increasing number of socially responsible actors who – as proxies for the wider group of disclosees – can enforce the SLO-responsibility to respect human rights in general, and the UNGP specifically.

A number of these socially responsible actors involved with corporate human rights conduct can be distinguished. Firstly, community interest groups such as NGOs can fulfil a facilitating role as 'watchdog', providing other parties with insights in disclosed information.[33] This signalling function can affect consumer behaviour, although the extent to which retail consumers are driven by such concerns as human rights conduct is debatable.[34] Alongside these traditional forms of enforcement, the range of involved actors is expanding. The main market platforms through which these players operate are business-to-business contracts, public procurement, the equity markets and the debt markets. In business-to-business contracting and in public procurement, the contracting companies and public bodies have legitimation-related incentives – the SLO or corporate reputation and democratic legitimacy concerns respectively – to act in a socially responsible manner, taking into account human rights conduct of counterparties.[35] Regarding the equity markets, enforcement – often referred to as socially responsible investing ('SRI') – has attracted a sizeable share of public interest.[36] Equity SRI generally occurs when institutions with a degree of public exposure, such as public pension funds, are involved.[37] However, human-rights related SRI is not restricted to equity markets and is gradually gaining clout in bank financing as well, most importantly via the Equator Principles ('EPs').[38] The EPs is a framework for socially responsible risk decision making by financial institutions, which has been adopted by a growing number of major institutions active in the European market.[39] The EPs' last revision, EP III, entered into force in 2014.[40] Aside from broadening the EPs' scope, EP III importantly introduced human rights due diligence based on the UNGP as a mandatory principle.[41] As a result hereof, project finance involving European financial institutions (be it fully or through participation in syndicated facilities) is showing signs of becoming more socially responsible. Although it is not clear to which extent the EPs are enforced in practice, the use of the UNGP in finance does provide a starting point from which other policymaking can depart, possibly leading to a growing importance of debt markets as enforcement platform.

These examples demonstrate that alternatives to the traditional landscape of NGO activism and meagre customer involvement are on the rise, and could prove to become an effective counterweight to well-organized TNCs. This levelling of the degree of organization can lead to the willingness necessary for Coasean bargaining. Moreover, the fact that socially responsible market participants are organizing themselves around the UNGP could lead to a more coherent multi-platform moral community, thereby tying individual instances of bargaining together to form a more effective mechanism for enforcing the responsibility to respect.

2.3. Internal Effects, Procedures and Frameworks

To portray disclosing companies as singular entities whose behaviour is influenced by internal processes similar to those of natural persons would be an oversimplification of reality. TNCs in particular are often complex organizations in which multiple decision-making processes operate simultaneously. For this reason, it is important to recognize that human rights reporting has, apart from the communicative dimension stressed in the previous paragraph, a reflexive dimension.[42] Targeted informational regulation can only be effective when the communicated information becomes embedded in disclosers' decision-making systems.[43] There are two ways in which the responsibility to respect becomes embedded in these processes, viz.: human rights due diligence and mutual learning.

The UN Framework for Business and Human Rights defines human rights due diligence as 'the steps a company must take to become aware of, prevent and address adverse human rights

32 Case 2005, 420–421.
33 *Ibid.* 420–421; Scott, Caffagi & Senden 2011, 8.
34 Harrison 2012, 11; Baldwin, Cave & Lodge 2012, 120.
35 C. McCrudden, *Using Public Procurement to Achieve Social Outcomes*, 28 Natural Resources 257 (2004); M.P. Vandenbergh, *The New Wal-Mart Effect: The Role of Private Contracting in Global Governance*, 54 UCLA L. Rev. 913, p. 925 (2006/2007).
36 *See* E. Escrig-Olmedo, et al., *Sustainable Development and the Financial System: Society's Perceptions About Socially Responsible Investing*, 22/6 Business Strategy and the Environment 410 (2013); Y. Belghitar, E. Clark & N. Deshmukh, *Does it Pay to Be Ethical? Evidence from the FTSE4Good*, 47 J. Banking & Fin. 54 (2014).
37 M. Jansson & A. Biel, *Motives to Engage in Sustainable Investment: A Comparison Between Institutional and Private Investors*, 19 Sust. Dev. 135, 136 (2011); Park 2014, p. 62.
38 J.M. Conley & C.A. Williams, *Global Banks as Global Sustainability Regulators? The Equator Principles*, 33 L. & Pol. 4, 546 (2004).
39 E.g., Bank of America, BNP Paribas, Banco Santander, Barclays, HSBC, JPMorgan and Lloyds (www.equator-principles.com/index.php/members-reporting).
40 www.equator-principles.com/index.php/ep3.
41 Equator Principles, preamble (www.equator-principles.com/resources/equator_principles_III.pdf), 2.
42 Park 2014, 58.
43 Weil et al. 2006, 158.

impacts'.[44] In relation to mandatory reporting, this encompasses the internal discovery and analysis of data on human rights conduct in view of subsequent use in periodic external communication.[45] In general terms, human-rights specific due diligence requires TNCs to be involved in three practical due diligence steps: firstly, acquiring information about countries where the company has business and understanding the manner in which possible human rights concerns are related to country-specific context; secondly, analysis of business practice and policy carried out by the company as well as the actual and possible impact thereof on human rights; and lastly, refraining from contribution to, or keeping in place of activities carried out by the company's contract parties which infringe or pose the risk of infringing human rights.[46] This procedure helps TNCs in assessing the extent to which public statements are matched by actual conduct.[47] Moreover, because of the routine character of mandated reporting, due diligence allows 'companies to address human rights issues during the process of policy development and reflection on existing practice, rather than primarily engaging with human rights only when they are subject to external challenge'.[48]

The resulting human rights reporting, in turn, does not only serve the mentioned market participants (§2.2), but also provides other TNCs with valuable information about the way in which competitors fulfil their responsibility, creating the foundation for comparison-based mutual learning.[49] The reflexive dimension of mandatory reporting is therefore based on both self-reflection and comparison. Nevertheless, these processes, however valuable they might appear, are likely to produce suboptimal results if not facilitated by instruments such as specific reporting frameworks.

The UNGP have been criticized for being too generic and therefore not providing sufficient guidance to facilitate useful and comparable reports; a criticism which has been underscored by the lack of a corresponding uniform system of external assurance.[50] These criticisms have not gone unnoticed by actors involved with human rights reporting.[51] A noteworthy development regarding UNGP reporting is the joint project of Shift, a non-profit chaired by the former UN Representative for Business and Human Rights John Ruggie, and accounting firm Mazars. The Shift/Mazars project consists of two pillars: the creation of a UNGP reporting framework and a corresponding assurance framework.[52] The first pillar – the UN Guiding Principles Reporting Framework (the 'Framework') – was published in February 2015, whereas the finalization of the second pillar is planned for 2016.[53] The Framework comprises a number of guiding questions, subdivided in 'overarching questions' (directed at all companies) and 'supporting questions' (directed at companies with experience in human rights reporting), as well as principles covering the manner in which the Framework's implementation should be approached. In keeping with one of the leading methods of corporate governance regulation, the Framework is based on the 'comply or explain' –principle, holding that companies are allowed not to disclose, provided they 'indicate the nature of the information (. . .) omitted and explain [their] reasons for the omission'.[54] The Framework questions can resolve two issues formerly considered inherent to UNGP reporting. Firstly, they provide companies and third parties with a practical substantiation of the UNGP, allowing for useful and to-the-point reporting. Secondly, a standard set of questions, if widely applied, can diminish the lack of comparability among human rights reports and therewith lead to more effective enforcement and increased mutual learning. In conjunction with an assurance framework which can enhance reporting reliability, the Framework could render the UNGP not merely the dominant, but also the most practicable standard for human rights reporting.

In view hereof and considering the themes discussed, some preliminary conclusions can be drawn. Firstly, voluntary disclosure lacks the efficacy necessary in a business and human rights setting since independently, the market is prone to underprovide relevant information. Conversely, the market conditions for a well-functioning system of mandatory reporting are in a process of improvement. The increasing number of market participants willing to engage in Coasean bargaining on multiple platforms, the processes of embedding human rights in corporate decision-making, combined with the crystallization of a robust groundwork for informative UNGP-based reporting, constitute an environment in which mandatory reporting can form an appropriate step toward the enforcement of the responsibility to respect. Given this desirability, the question is to what extent the Directive can facilitate such regime.

44 Protect, Respect and Remedy: a Framework for Business and Human Rights – Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises, John Ruggie 2008 (www.reports-and-materials.org/sites/default/files/reports-and-materials/Ruggie-report-7-Apr-2008.pdf), 17.

45 *Cf.* T.E. Lambooy, *Corporate Due Diligence as a Tool to Respect Human Rights* (www.jus.uio.no/ifp/english/research/areas/companylaw/events/lunches/Lambooy.pdf), 11.

46 Giner 2008, 79.

47 Park 2014, 58.

48 Harrison 2012, 3–4.

49 Park 2014, 58.

50 Harrison 2012, 8; Park 2014, 62.

51 An example of an important existing framework for sustainability reporting is the Global Reporting Initiative (www.globalreporting.org).

52 www.shiftproject.org/project/human-rights-reporting-and-assurance-frameworks-initiative-rafi.

53 UN Guiding Principles Reporting Framework (www.ungpreporting.org/wp-content/uploads/2015/02/UNGuidingPrinciplesReportingFramework_withimplementationguidance_Feb2015.pdf), 2.

54 Framework Principle G.

3. THE DIRECTIVE: SHORTCOMINGS AND RECOMMENDATIONS

The Directive states that it aims 'to increase the relevance, consistency and comparability of [disclosed] information'.[55] As discussed (§1), it contains the obligation for large public-interest entities to disclose information relating to human rights – describing policies pursued, their outcome and the principal risks relating to those matters.[56] These descriptions are subject to a 'comply or explain'-principle, allowing companies who do not 'pursue policies in relation to one or more of those matters' to alternatively provide an explanation. Member States are to provide that the mandatory reporting regime apply by 2017.[57] According to the Commission, it will cover approximately '6,000 large companies and groups across the EU'.[58] Although bringing about human rights reporting on a supranational level and being claimed to do so on a significant scale, the Directive contains a number of salient aspects suggesting the positive effects it aims to achieve on human rights reporting could be limited. The main weaknesses of the Directive can be divided in two categories: (i) lack of harmonization regarding integrated reporting and assurance, and (ii) an excess of possibilities for companies to deviate from reporting requirements.

3.1. Integrated Reporting and Assurance

The Directive does not contain provisions introducing integrated reporting on a supranational level, nor does it prescribe assurance of non-financial disclosure. Integrated reporting concerns the practice of integrating 'social, environmental, financial and governance information' into one annual report, as opposed to stand-alone reports for specific non-financial matters.[59] It is for Member States to decide whether to introduce any obligation on this matter.[60] As Monciardini indicates, this goes against the global trend toward integrated reporting and is moreover a remarkable choice, since in 2011 the Commission expressed the objective of ensuring 'that companies have a process in place to integrate social (...) concerns in their business operation and strategy'.[61] Furthermore, a large majority of respondents approached in the impact assessment regarding the (proposal for) the Directive indicated to be in favour of integrated reporting.[62] Notwithstanding the Commission's omittance, integrated human rights reporting has two advantages over stand-alone reporting, both deriving from the virtue of embedding human rights considerations in regular business conduct.[63] By combining both strands of information, integrated reporting brings human rights issues closer to business considerations internally, as well as offering third parties an improved understanding of how the two interrelate, thereby facilitating external enforcement.

Secondly, the impartial check on the reliability of human rights reporting third-party assurance providers can guarantee is not included in the Directive, but left for the Member States to regulate. For human rights reporting to be taken into account and acted upon by the enforcement mechanisms discussed, concerns about a publicity-transparency discrepancy ('greenwashing') should be diminished by safeguarding a minimal level of trust in the market of disclosed information.[64] Such improvement of reliability and consequent safeguarding of trust can be provided by independent verification of non-financial disclosure, yet is not facilitated by the Directive.

3.2. Questionable Solidity and Rigid Flexibility

The Directive leaves companies a considerable margin for influencing the quality of their human rights reporting. Also, the porous character of the Directive could lead to Member State level divergence and an ensuing undermining of a properly functioning reporting system. The first point on which the Directive leaves companies room for derogation is disclosure of supply-chain information. Article 19a (1)(d) states that 'the non-financial statement should include (...) the principal risks related to [human rights] matters linked to the undertaking's operations including, *where relevant and proportionate*, *its business relationships* [emphasis added]'. It seems that, based on this exception, compliance with the reporting requirements set by the Directive does not necessarily imply that the management report will contain sufficient information on the company's supply chain. The term 'business relationships' leaves room for an interpretation which does not include (indirect) relationships of first-tier suppliers and therefore would not extend further down the supply chain. Also, the Directive does not state who is to assess whether information disclosure on conduct in supply chains is relevant and proportionate, for which reason the possibly detrimental effect of the inclusion of these open norms depends on the manner of

55 Preamble (21) of the amending Directive.
56 Article 19a (1) of the Directive.
57 Article 4 of the amending Directive.
58 Commission, 'Disclosure of non-financial and diversity information by large companies and groups – Frequently asked questions', MEMO (14) 301, 2.
59 C. de Villiers, L. Rinaldi & J. Unerman, *Integrated Reporting: Insights, Gaps and an Agenda for Future Research*, 27 Acctg. Auditing & Accountability J. 1042, 1043 (2014).
60 Preamble (6) of the Directive.
61 D. Monciardini, *Regulating Accounting for Sustainable Companies: Some Considerations on the Forthcoming EU Directive*, 11 Eur. Co. L. 121, 122 (2014). *Cf.* Commission, 'A Renewed EU Strategy 2011-14 for Corporate Social Responsibility', COM (2011) 681 final.
62 Commission Staff Working Document, 'Impact assessment', SWD (2013) 127 final, p. 44.
63 P. Ibáñez-M. & V. Ordóñez-S., *Papel de las Empresas y de los Estados en la Debida Diligencia en Derechos Humanos* 24 Revista Colombiana de Derecho Internacional 219, p. 228 (2014).
64 Park 2014, 61–62. For trust in the market to arise, assumptions as to the incentives of TNCs to disclose dishonestly by exploiting information asymmetry should be institutionally counteracted (*cf.* G.A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 Q. J. Econ. 488 (1970)).

implementation by Member States. If 'relevant', 'proportionate' and 'business relationships' are substantiated on a national level, the open-ended character of the provision need not be problematic. However, if a supply-chain exception finds its way into national legislation by transposition of the wording used in the Directive, this paragraph could emerge to be a considerable loophole, given that the impact of TNCs on human rights often extends beyond the corporate structure as exemplified by the Rana Plaza case.

The second issue relates to flexibility in framework choice. Pursuant to Article 19a(1) Directive, 'Member States shall provide that undertakings *may* rely on national, Union-based or international frameworks [such as the UNGP[65]], and if they do so, *undertakings shall specify which frameworks they have relied on* [emphasis added]'. It follows from this article that companies enjoy a 'double freedom': both the question of choosing to apply a framework and the question of which framework to apply are left to the company's discretion. The wording of this double freedom (see emphasis) indicates this to be an instance of maximum harmonization: Member States are not allowed to limit either freedom by national legislation.[66] As a result hereof, the uniformity gains envisaged by the Directive appear to have been sacrificed for company-level flexibility. This flexibility can lead to a fragmented playing field of companies following differing reporting frameworks, if any, which drives up transaction costs and therefore makes enforcement of the responsibility to respect less likely to occur; an unwelcome rigidity given the fact that the UNGP provide a well-established set of norms which will be buttressed by separate frameworks for reporting and assurance in advance of the Directive's transposition date.

Lastly, the Directive allows Member States to opt into a system where companies are allowed to refrain from disclosure when the commercial interest of the company so requires. If transposed, such exemption would consist of three elements. Firstly, the omitted disclosure should relate to 'impending developments or matters in the course of negotiation'. Secondly, omittance is only allowed in 'exceptional cases where (. . .) the disclosure of such information would be seriously prejudicial to the commercial position of the undertaking', which is to be decided by 'the members of the administrative, management and supervisory bodies' collectively under joint responsibility. Thirdly, the omission of non-financial information must 'not prevent a fair and balanced understanding of the undertaking's development, performance, position and impact of its activity'. The inclusion of this safe-harbour provision in the Directive could in theory lead to systems where the mandatory elements of the disclosure requirements are subject to the commercial interest of the company. If Member States choose to opt into this provision and if companies engage in a liberal usage of the exception, the safe-harbour clause could have a detrimental impact on the effectiveness of the Directive. Whether such scenario would manifest itself in practice, however, is debatable. The provision sets a high bar by requiring consent of both the management and the supervisory function and its relatively strict wording ('exceptional cases', 'seriously prejudicial') implies its conditions should not be met easily. Moreover, the provision can be regarded to be in line with the principle that company directors are not merely bound and guided by the needs of society, but generally owe a fiduciary duty to the company. It would appear that if the continuity of the company is threatened, the interest of the company should prevail over reporting requirements if infringement of the latter could avert such threat. For these reasons, the extent to which the safe-harbour provision can be expected to water down the Directive's efficacy is hard to assess a priori, although the risk of the provision undermining the Directive's aims appears limited.

3.3. Recommendations

Given the aforementioned, the Directive contains a number of shortcomings. Since its harmonization efforts do not cover integrated reporting and third-party assurance, the Directive falls short in facilitating comparability, reliability and thus utility of reporting. Also, the leeway the Directive gives for withholding information on the impact of related parties' conduct in the company's supply chain could constitute an undesirable regulatory gap. Finally, the compulsory flexibility in terms of framework choice is too rigid given the timely availability of functional and widely accepted standards for human rights reporting. These missed opportunities are lamentable, but do not rule out all possibilities for improvement on Member State level.

Firstly, the Directive leaves Member States discretion to impose national rules on third-party assurance and integrated reporting. Since an assurance framework for UNGP reporting is set to be available before long, third-party assurance could be fruitfully implemented in national legislation. The question of integrating financial and non-financial reporting on Member State level, however, could lead to concerns regarding a possible fragmentation of the legal playing field in which less stringent reporting regimes would be more attractive as country of incorporation; a prospect which could discourage Member States from any intervention.[67] However, given the positive stance of the market on integrated reporting as demonstrated in the Commission's impact assessment, such concerns should not be overstated. Therefore, it is recommendable that in spite of the failure to legislate on supranational level, integrated reporting be introduced in national legislation.

Secondly, the ambiguous language used in the supply-chain disclosure provision should be mitigated by substantiating its open

65 Preamble (9) of the Directive.

66 A-C. Mittwoch, *Vollharmonisierung und Europäisches Privatrecht: Methode, Implikationen und Durchführung* 39–40 (De Gruyter 2013).

67 *Cf.* Baldwin, Cave & Lodge 2012, p. 361.

norms in national transposition processes so as to prevent any unwelcome constraint on transparency. The Directive does not bar Member States from providing for such specification. National initiatives substantiating said norms can provide the basis for reflexive governance; a regulatory approach where 'diversity of practice among Member States is a resource which (. . .) provides a basis for experimentation and mutual learning'.[68] Following this method, future supranational regulation of supply-chain reporting can be inspired by norms formed in national legislation and jurisprudence.

On the last point of reporting framework prescription, however, similar Member State legislative action is impeded by the Directive, for the chosen degree of harmonization leaves this choice explicitly to corporate discretion. Nonetheless, the choice for maximum harmonization was made with the explicit aim of providing companies with flexibility.[69] For this reason it is allowed for Member States to take action insofar as it does not encroach on this flexibility. A way for Member States to prescribe UNGP reporting without infringing the Directive is to include this framework prescription in a Corporate Governance Code ('CGC'). The main reason for doing so is that CGCs are generally based on a 'comply or explain' –principle, making any inclusion of a rule in such CGC fall within the boundaries of flexibility set by the Directive. Moreover, although human rights references until recently were only scarcely included in European CGCs, corporate social responsibility and corporate governance can be seen to converge; a development to which the inclusion of UNGP reporting in CGCs would be well attuned. [70] Although CGC applicability is generally limited to listed companies,[71] the assumable overlap between listed companies and public-interest entities makes CGC prescription the best alternative to the ruled-out option of legislation.

4. CONCLUSION

Human rights reporting has found a long-awaited foothold in European regulation. The market conditions taking shape in the combination of an increasing number of socially responsible market participants and the maturing frameworks for UNGP reporting make for an environment in which mandatory reporting can successfully provide the necessary impetus for bringing about effective enforcement of the corporate responsibility to respect human rights. The question of whether the Directive fully succeeds in fulfilling this role, however, cannot be answered in an unqualified affirmative way.

The significant positive step which the Directive represents should be viewed without disregard of its shortcomings and possible remedies thereof. The opportunity of introducing integrated reporting and third-party assurance is yet to be taken and the combination of ambiguous open norms and full harmonization of company-level flexibility leaves important blanks left to be filled. To a considerable extent, such filling can take place on a decentralized level by nationally introducing the former and substantiating the latter so that human rights reporting can take form based on well-established frameworks, providing the market with the means for effective enforcement. The Directive holds promise for increasing the efficacy of human rights reporting in the EU. If its shortcomings are counterbalanced by Member State initiative or future amendments, the Directive could play a pivotal role in the enforcement of the corporate responsibility to respect human rights.

68 S. Deakin, *Reflexive Governance and European Company Law*, 3/5 CLPE Research Paper (ssrn.com/abstract=1002678), 1–4 (2007).
69 MEMO (14) 301, 1.
70 D.G. Szabó & K.E. Sørensen, *Integrating Corporate Social Responsibility in Corporate Governance Codes in the EU*, 10/28 *Nordic & European Company Law Working Paper*, 24 & 43 (2013) (ssrn.com/abstract=2081611).
71 E.g., §161 (1) Aktiengesetz (Germany), Preamble (2) Dutch Corporate Governance Code (the Netherlands), Listing Rule 9.8.6 (United Kingdom), Art. 540 (1) Ley de Sociedades de Capital (Spain).