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Including SMEs in the ESG framework

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SME's in the
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framework**

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Abbreviation

Environment, Social and Governance (“ESG”)

European Union (“EU”)

Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights (“Norms”)

Plan d'Action pour la Croissance et la Transformation des Entreprises (PACTE – Action Plan for Business Growth and Transformation)

Small and Medium Enterprises (“SMEs”)

Sustainable Finance Disclosure Regulation (“SFDR”)

United Nations (UN)

United Nations Guiding Principle (“UNGPs”)

I dedicate this dissertation to my family, who have supported me through this whole journey, even with an ocean separating us. To my fiancé, who has been on my side all the late nights while I was dedicating time to writing. I want to thank my friends in Lisbon; we have been a rock to each other, and this would not be possible without them.

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Abstract

On the recent years we have seen the development of a sustainable economy where companies integrate environmental, social and governance factors (ESG). Larger corporations have made significant changes to adapt the way of doing business to the new ESG practices, however small and medium enterprises (SMEs') face several challenges to adapt themselves to the new procedures. The principle objective of this thesis is to understand the challenges that might be faced by those enterprises and how the legal framework can be constructed and adapted to help the SMEs'.

In order to achieve the main objective, the thesis will analyse the existing gaps on the existing framework, the study provides insight on how a legal framework can be drafted to easy the adaptation of the ESG factors on their day-to-day operations.

To achieve its biggest aim, this thesis will conduct an extensive analysis of the current ESG framework in the European Union, it will analyse the elements of effective legal frameworks and how they have been be applied by the enterprises. By doing so, the analysis will identify what is still missing to make the framework applicable to small and medium sized companies, and what an effective framework must have to ensure that SMEs are able to put in place ESG standards.

Resumo

Nos últimos anos temos visto o desenvolvimento de uma economia sustentável onde as empresas integram fatores ambientais, sociais e de governança (ESG). As grandes empresas fizeram mudanças significativas para adaptar a forma de fazer negócios às novas práticas ESG, no entanto, as pequenas e médias empresas (PMEs) enfrentam vários desafios para se adaptarem aos novos procedimentos. O principal objectivo desta tese é compreender os desafios que essas empresas podem enfrentar e como o quadro jurídico pode ser construído e adaptado para ajudar as PMEs.

Para atingir o objetivo principal, a tese irá analisar as lacunas existentes no quadro existente, o estudo fornece informações sobre como um quadro jurídico pode ser elaborado para facilitar a adaptação dos fatores ESG nas suas operações quotidianas.

Por fim, esta tese irá realizar uma análise extensa do atual quadro ESG na União Europeia, irá analisar os elementos de quadros jurídicos eficazes e como eles têm sido aplicados pelas empresas. Ao fazê-lo, a análise identificará o que ainda falta para tornar o quadro aplicável às pequenas e médias empresas, e o que um quadro eficaz deve ter para garantir que as PME sejam capazes de implementar normas ESG.

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1. Introduction

There are no doubt that small and medium enterprises (“SMEs”) have been an immense part of today's economies; as detailed below, SMEs' numbers in the economies are awe-inspiring. Regardless of the large number of existing SMEs, there is no simple definition regarding this type of enterprise, and countries have different standards to define what is and what is not a SME¹.

Although there is no universal definition Arancha González, in her article “Leveraging Trade Facilities Reform,” teaches us that there are characteristics that all SMEs’ around the world hold:

SMEs are usually privately owned and lack sophisticated corporate governance structures, and they are usually thinly capitalized, making them less able to undertake larger expansions and more sensitive to macroeconomic shocks. From an operational perspective, SMEs are more likely to risk economic shock. From an operational perspective, SMEs are more likely to be risk-averse and dedicate fewer resources to strategic planning and market research. However, the small size of SMEs also allows them to react quickly to changing market realities and to be flexible in pursuing opportunities that larger firms may not. Traditionally, SME's focused sales on domestic and sometimes regional markets. This reality was based in part on the fact that, while SMEs could be competitive in narrow areas of production, they generally lacked the economies of scale needed to be efficient producers on an international level².

As this work will focus on the development of a framework, focusing on the small and medium enterprises located in the European Union (“EU”) and how those companies can implement into their daily basis internal procedures to ensure that their activities are Environment, Social, and Governance (“ESG”) compliant, the definition of SMEs that will be used is

¹ Rensmann, T. (Ed.). (2017). **Small and Medium-Sized Enterprises in International Economic Law (Online ed.)**. Oxford Academic. <https://doi.org/10.1093/acprof:oso/9780198795650.001.0001> . P. 40

² González, A. (2017). **Leveraging Trade Facilities Reform. In Small and Medium-Sized Enterprises in International Economic Law** (p. 41). Oxford Academic. doi:10.1093/acprof:oso/9780198795650.001.0001

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the one defined by the EU: where a company with up to 250 employees is classified as SME. Still, also the EU regulations allow companies with a turnover of up to € 50.000.000 (fifty million) to be classified as SMEs.³

The SMEs definition used by the EU came into force after the Council received a report in 1992 as a request of the Industry Council held on May 28th of 1990, in which it aimed to limited the different definitions of small and medium sized enterprises that were used by the different member states and market participants. The main concern expressed was that by having a single market was also important that the definitions regarding specific enterprise would be parametrize, in order to avoid inconsistence among different states.⁴

The Council understood that the fairest criteria to define the SMEs would be using the staff number. The Council acknowledge that while having a financial criterion it is important to understand the scale and performance of an enterprise, the different types of enterprise have higher or smaller turnover depending of the sector they operate, therefore the financial criteria could not be as precise as the number of employees.⁵ For that reason the Council them adopted as the defining criteria of the SMEs definition.

Building upon the definitions provided by the EU Commission to classify SMEs, it is stated that a micro company can have a maximum of 9

³ Rensmann, T. (Ed.). (2017). **Small and Medium-Sized Enterprises in International Economic Law (Online ed.)**. Oxford Academic. <https://doi.org/10.1093/acprof:oso/9780198795650.001.0001>. p. 40.

⁴ European Union. (2003). **Directive 2003/61/EC of the European Parliament and of the Council of 18 June 2003 amending Directive 97/9/EC of the European Parliament and of the Council on investor-compensation schemes** [PDF]. Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32003H0361>. Accessed on 11 August 2023.

⁵ Ibid.

employees, and no criteria exist for maximum turnover, annual balance sheet, or ownership by one or multiple enterprises.⁶

Alternatively, a small company must have a maximum of 49 employees, a turnover of 7 million euros, and an annual balance sheet of 5 million euros.⁷ The small companies also must be owned in a percentage of 25% by one or several enterprises that do not satisfy the same criteria. Finally, a medium company has at least 249 employees, with a turnover of 40 million euros and an annual balance sheet of 27 million euros.⁸ The medium companies, as the small ones, must be owned in a percentage of 25% by one or several enterprises that do not satisfy the same criteria.⁹

There is no question that SMEs do not attract media attention and do not make the same impact on the economy as the bigger enterprises. However, they still contribute considerably to the countries they are located at. As Spence and Schmidpeter explain in their article "*Social Capital and the Common Good*," SMEs make a local impact, acting as local employers and investors in their community.¹⁰

As an example of the impact of the SMEs in their local community, the International Labour Conference concluded in 2015 that SMEs account for two-thirds of all jobs and create the majority of new jobs.¹¹ It is also

⁶ Spence, L., & Schmidpeter, R. (2003). **SMEs, Social Capital and the Common Good**. *Journal of Business Ethics*, 45, 97. doi:10.1023/A:1024176613469

⁷ Ibid p. 97

⁸ Ibid p. 97

⁹ Ibid p. 97

¹⁰ Ibid. p.94.

¹¹ International Labour Organization. (2016, November 14). **SMEs and Human Rights: What is the current state of play, what are the opportunities and challenges, what kind of support is needed?** Retrieved from https://www.ilo.org/wcmsp5/groups/public/-/ed_emp/--emp_ent/--ifp_seed/documents/publication/wcms_535220.pdf Accessed 20 May 2023

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important to highlight that SMEs are part of the global supply chain as buyers and suppliers.¹²

The creation of jobs and the investment in the communities made by the SMEs also contribute to the development of the country's economy;¹³ for example, in the OECD economies, this type of enterprise accounts for 95% of all firms.¹⁴ In the European Union, SMEs represent 99,8% of all enterprises in the non-financial business sector; they have also been responsible for employing 84.9 million in 2022.¹⁵

Regardless of the impressive number they represent in the total amount of enterprises, the SMES stay behind when talking about productivity. In the OECD panorama, their contribution is between 20% to 40%;¹⁶ they also pay lower wages and are less export-oriented.¹⁷ However, even with the lower wages, the ILO reports indicate that over two-thirds of all employment is provided by small enterprises.¹⁸

¹² International Labour Organization. (2016, November 14). **SMEs and Human Rights: What is the current state of play, what are the opportunities and challenges, what kind of support is needed?** Retrieved from https://www.ilo.org/wcmsp5/groups/public/-/ed_emp/--emp_ent/--ifp_seed/documents/publication/wcms_535220.pdf, Accessed 20 May 2023

¹³ KHAN, MUKARAM & RATHORE, KASHIF & SIAL, MUHAMMAD. (2020). **Entrepreneurial Orientation and Performance of Small and Medium Enterprises: Mediating Effect of Entrepreneurial Competencies.** 14. 508-528. p. 509

¹⁴ OECD (2019), "**Fostering greater SME participation in a globally integrated economy**", in *Strengthening SMEs and Entrepreneurship for Productivity and Inclusive Growth: OECD 2018 Ministerial Conference on SMEs*, OECD Publishing, Paris, <https://doi.org/10.1787/400c491d-en>.

¹⁵ EUROPEAN COMMISSION. **Annual Report on European SMEs 2023.** Retrieved from <https://single-market-economy.ec.europa.eu/system/files/2023-06/Annual%20Report%20on%20European%20SMEs%202023.pdf>

¹⁶ Spence, L., & Schmidpeter, R. (2003). **SMEs, Social Capital and the Common Good.** *Journal of Business Ethics*, 45, 97. doi:10.1023/A:1024176613469 p.94.

¹⁷ ADLUNG, R., & SOPRANA, M. (2017). **Trade Policy for SMEs from a GATS Perspective.** In T. Rensmann (Ed.), *Small and Medium-Sized Enterprises in International Economic Law* (p. 15). Oxford Academic. doi:10.1093/acprof:oso/9780198795650.003.0002

¹⁸ International Labour Organization. (2019). **SMALL MATTERS: Global evidence on the contribution to employment by the self-employed, micro-enterprises, and SMEs.** Geneva: International Labour Office.

It is clear that SMEs significantly contribute to the overall economy in several countries. However, at the same time that SMEs constitute a substantial portion of the business landscape, they often lag behind more giant corporations in various critical areas. Therefore, governments and international bodies are, in many circumstances, responsible for bridging the existing gaps, fostering economic growth, and ensuring a more equitable environment for those enterprises.¹⁹

Although SMEs significantly impact the global economy, according to Kiaddo, they have not been an essential figure in the draft of the business and human rights strategy.²⁰ This can be observed in chapter 03, where several pieces of legislation on the business and human rights fields are analysed. Very few of them take into consideration the SMEs, usually taking it indirectly when applicable to larger companies. Also, the existent framework seems to not understand how the implementation of the standards and requirements are much harder for the smaller company, limiting themselves to state that the level of applicability should be adequate for the size of the company.

To implement an effective way to make profits and at the same time ensure that human rights, environmental and social criteria are respected involves several areas of the same company; what is more difficult or easier to implement depends on the size of the company, its operation, and the number of employees.²¹ However, as the United Nations Guiding

¹⁹ RENSMANN, T. (ED.). (2017). **Small and Medium-Sized Enterprises in International Economic Law** (Online ed.). Oxford Academic. <https://doi.org/10.1093/acprof:oso/9780198795650.001.0001>.

²⁰ ADDO, M. K. (2017). **Business and Human Rights and the Challenges for Small and Medium-Sized Enterprises**. In T. Rensmann (Ed.), *Small and Medium-Sized Enterprises in International Economic Law*. Oxford Academic. doi:10.1093/acprof:oso/9780198795650.003.0013. p. 313

²¹ Ibid p. 313

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Principle (“UNGPs”) explains, this does not mean that it cannot apply to all enterprises:

The responsibility of business enterprises to respect human rights applies to all enterprises regardless of size, sector, operational context, ownership, and structure. Nevertheless, the scale and complexity of the means through which enterprises meet that responsibility may vary according to these factors and with the severity of the enterprise’s adverse human rights impact.²²

Principle 14, above reproduced, makes clear that the responsibility to respect human rights must apply to all enterprises regardless of their size or sector; this means that not only parent or lead companies should be involved and implement their internal policies in a responsible way to conduct business, but that SMEs and subsidiaries must also be included into this procedure.

Even though the UNGPs makes it clear that its guidelines must be implemented by all companies regardless of their size, the legislation developed in the business and human rights fields does not successfully explain how the SMEs must implement it, and more than that, almost all of them do not apply to the SMEs’. The non-existing legislation regarding the SMEs, or the minimal one that is in development, is not limited to the international developments that have been taking place over the last few years, but the SMEs invisibility is also observed in the domestic point of view.

As Kiaddo mentioned in his article, it is possible to acknowledge that some jurisdictions understand SMEs as official instruments for the growth

²² Guiding Principle 14. United Nations. (n.d.). **United Nations Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework.** Retrieved from https://www.ohchr.org/sites/default/files/documents/publications/guidingprinciplesbusinesshr_en.pdf

of the economy and do not see them as valid to expose to external conversations. He also highlights that it is very much frequent to see governments create legislation and supervisory departments specific to them; what happens is that none of those legislations, departments, or agencies have the matter of human rights on the top of their agenda.²³

So, even though government bodies may have specific departments for the SMEs, those departments are not considering the need to develop specific guides and regulations for SMEs related to human rights and business developments.

Together with the absence of the government bodies' effort, as mentioned above, the SMEs present different characteristics, which makes it more difficult to draft laws and regulations regarding business and human rights, since it is not easy to have a single definition of a typical SMEs and typical human rights footprint that they create.²⁴

The two points mentioned above represent some of the issues that make it difficult for SMEs to be included in the existing legislation that has been developed in the business and human rights field.

The ILO report estimates that 91% of SMEs operate their business in the informal economy.²⁵ This number represents not only the difficulty to access those companies but also represents a more significant issue when

²³ ADDO, M. K. (2017). **Business and Human Rights and the Challenges for Small and Medium-Sized Enterprises**. In T. Rensmann (Ed.), *Small and Medium-Sized Enterprises in International Economic Law* Oxford Academic. doi:10.1093/acprof:oso/9780198795650.003.0013. p. 314.

²⁴ RENSMANN, T. (ED.). (2017). **Small and Medium-Sized Enterprises in International Economic Law** (Online ed.). Oxford Academic. <https://doi.org/10.1093/acprof:oso/9780198795650.001.0001>.

²⁵ International Labour Organization. (2015). **Small and medium-sized enterprises and decent and productive employment creation**. Retrieved from https://www.ilo.org/wcmsp5/groups/public/---ed_norm/---relconf/documents/meetingdocument/wcms_358294.pdf

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talking about responsible business and human rights issues, mainly because it well knows that the majority of cases that disrespect human rights usually happens in the informal economy.²⁶

The organizational structure of the SMEs can also represent a trick point when analysing the many different aspects that exercise influence on those enterprises. Regardless of the different aspects used to define the SMES that might be stipulated by the countries where the SMEs are located, they always have, or at least very often, the dominance of one person that exercises influence over the other employees; this manager is usually the owner and tends to be an entrepreneur.²⁷

As mentioned above, SMEs need more resources, which means that they need more financial resources, but also in other areas such as knowledge, qualified and trained staff, and experienced staff.²⁸ The absence of financial resources and human capital makes SMEs focus on more urgent matters. Some scholars have understood that the regulations on business and human rights are counterproductive²⁹ to them, as they would drive the SMEs apart from actually improving on the company behaviour, and it will only impose them to fill all the boxes on the matter. At the same time, other evidence shows that regulations on the topic are more effective than voluntary initiatives.³⁰

²⁶ ADDO, M. K. (2017). **Business and Human Rights and the Challenges for Small and Medium-Sized Enterprises**. In T. Rensmann (Ed.), *Small and Medium-Sized Enterprises in International Economic Law* Oxford Academic. doi:10.1093/acprof:oso/9780198795650.003.0013. p. 314 - 315.

²⁷ Ibid. p. 319 - 320

²⁸ Ibid. p. 319 - 320

²⁹ BADEN, D., HARWOOD, I., & WOODWARD, D. (2008). **The effect of buyer pressure on suppliers to demonstrate CSR: an added incentive or counterproductive?** *European Management Journal*, 27

³⁰ SPENCE, L. J. (1999). **Does size matter? The state of the art in small business ethics**. *Business Ethics: A European Review*, 8, 163-174. doi:10.1111/1467-8608.00144

When talking about human rights, it is no lie that following the guidelines and rules, that are already in place, will increase the time expended on the matter by the SMEs; for example, the UNGP demands that the enterprises know the risks that its business has on the subject, but it also needs to demonstrate that it knows the risks that might occur with its business partners,³¹ therefore, the SMEs must be aware not only of the risks of the activities directly linked to them but also the ones linked to their business partners.

All of that is time-consuming and increases the number of paperwork that the SMEs will have, despite that, the implementation of the UNGPs and other business and human rights legislation, as highlighted by the European Commission, may lead to increased revenue for the business.³²

The use of business cases to implement corporate responsibility in companies has been proven very successful over the years, however as Michael K Addo mentioned, the use of this approach to include the UNGP on SMEs for example, has not yet proven itself, mainly because there is no proof of the existence of several business cases in this field³³.

In order to answer how can the regulator include the SMEs into the ESG legal framework, this research aims to analyse the legislations that

³¹ Guiding Principle 14. United Nations. (2011). **United Nations Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework.** Retrieved from https://www.ohchr.org/sites/default/files/documents/publications/guidingprinciplesbusinesshr_en.pdf

³² European Committee of The Regions. (2019). **EU Policy for SMEs.** Retrieved from <https://cor.europa.eu/en/engage/studies/Documents/EU-SMEs/EU-policy-SMEs.pdf>
Accessed June 03, 2023.

³³ ADDO, M. K. (2017). **Business and Human Rights and the Challenges for Small and Medium-Sized Enterprises.** In T. Rensmann (Ed.), *Small and Medium-Sized Enterprises in International Economic Law* (p. 314 - 315). Oxford Academic. doi:10.1093/acprof:oso/9780198795650.003.0013

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already exist in the field of business and human rights (this also includes respect to the environment and social criteria) and assess the implications these legislations have for SMEs, to ensure for example if they are directly or indirectly applicable to them. By analysing the already existent legislation, the research will be able to identify what is still missing to ensure that the SMEs are included into the ESG framework.

In order to achieve this objective, first, it will analyse the concept of corporate responsibility to clarify that enterprises also have a duty to the communities they are placed in. Secondly, it will analyse the existing framework at the European Union on business and human rights. Thirdly, the dissertation aims to focus on the small and medium enterprises located in the European Union; therefore, it will be essential to discuss the main challenges those enterprises face. Finally, the dissertation aims to suggest government bodies across the European Union on how they could develop a framework, or adjust the one existent, to incorporate the needs of the SMEs across the European Union.

2. The Corporate Framework

Even though the SMEs' have their own criteria and some specifications as seen on the last chapter, the corporate legal framework in general is also applicable to them. Understanding the corporate legal framework, it is important to be aware of what are the duties and the responsibility that companies have towards the communities that they are a part of.

Before analysing the existent framework on the subject of ESG and SMEs' it is important to understand what are the responsibilities that companies might own towards the environment they are built at and how those responsibilities are related, if so, to the ESG framework.

Therefore, the aim of this chapter it is to give a background on the corporate framework so that on the following chapter it will be possible to analyse how are those responsibilities and duties are being implemented to ensure the ESG framework applicability.

2.1. The benefits of the separate legal personality

Although corporations can negatively impact human rights and the environment, their legal framework is widely used globally, mainly due to its benefits for business owners. One of these benefits is that companies have a separate legal personality from their owners and managers, which shields the owners from most of the company's liabilities. Having a legal personality allow a parent company to not be directly accountable for the actions and harm caused by its the subsidiary.³⁴

³⁴ Turner, J. S. (2019). **Business practices, human rights, and the environment**. In E. Daly (Ed.), *Human Rights and the Environment: Legality, Indivisibility, Dignity, and Geography* (pp. 376-385). Edward Elgar Publishing. doi:10.4337/9781788111461

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As a separate legal entity, the companies not only protect their owners and subsidiaries but also give their shareholders limited liability, therefore shareholder will only be responsible for the amount they have invested into the companies. This protects shareholders while also allowing companies to benefit from investments.³⁵

If a subsidiary of a large company is based in a third-world country with insufficient regulations to prevent work slavery or protect the environment, the parent company will not be held responsible for any harm caused by the subsidiary. Neither the shareholders nor owners of the company can be held liable for any damages.

Changing the worldwide liability system for companies may seem impossible. Still, it is crucial to develop alternative mechanisms to encourage companies to take responsibility for their actions and prevent environmental and human rights harm. On the recent days several justice systems around the world are starting to take the corporate veil of parent companies in order to make them liable for the harm caused by subsidiary or business partners. This change of perspective for certain influence the changes that are being made by the companies and rising the awareness related to ESG factors.

2.2. Directors' duty of care

As seen the separate liabilities one powerful characteristic to corporations, however not the only one. Another characteristic that is very important in the corporation's legal framework is the directors' obligations to make decisions that benefit the enterprise. This means those who

³⁵ Turner, J. S. (2019). **Business practices, human rights, and the environment**. In E. Daly (Ed.), *Human Rights and the Environment: Legality, Indivisibility, Dignity, and Geography* (pp. 376-385). Edward Elgar Publishing. doi:10.4337/9781788111461

manage the company have a legal obligation to make decisions that will make the company achieve financial success. However, in the path to increase the company's profit and drive the company to financial success, directors might look for opportunities to reduce some costs, which in many situations can result in human rights and environmental damage.³⁶

Directors must make decisions that serve the enterprise's best interests as per the duty of care principle. This principle is highlighted by McCorquodale, Rober, and Stuart Nelly in the paper "Directors Duties and human rights impacts: a comparative approach."³⁷ The principle mandates that directors focus on advancing the company's welfare; therefore, they owe a duty of care to the company. However, since the company is a legal entity with a separate legal personality, it is essential to understand the parties involved. Identifying the company's interest is crucial, whether it is aligned with the shareholders, the stakeholders, or both.³⁸

There are a few approaches that try to answer the issue raised in the last paragraph; as this dissertation is focused on the EU Framework, it will be analysed the approach taken by the European Union, known as the pluralist, where the duty is owed to the stakeholders as employee representatives will be on the board.³⁹ Nonetheless, it is essential to highlight that even though the pluralist doctrine considers a broader range of stakeholders, the interest of those stakeholders is, in the end, to promote the company's success.⁴⁰

³⁶Turner, J. S. (2019). **Business practices, human rights, and the environment**. In E. Daly (Ed.), *Human Rights and the Environment: Legality, Indivisibility, Dignity, and Geography* (pp. 376-385). Edward Elgar Publishing. doi:10.4337/9781788111461

³⁷ McCorquodale, R., & Nelly, S. (2021). **Directors Duties and human rights impacts: a comparative approach**. *Journal of Corporate Law Studies*.

³⁸ Ibid.

³⁹ Gerner-Beuerle, C., Paech, P., & Schuster, E.-P. (2013). **Study on Directors' Duties and Liability in Europe**. Available at SSRN: <https://ssrn.com/abstract=3886382> or <http://dx.doi.org/10.2139/ssrn.3886382>

⁴⁰ Ibid.

The director who breaches the legal duty to care may face a civil claim by the company. In the European Union, there is only one reason why the director may not face a civil claim. This might happen when the company is insolvent; in that situation, the director's duties are transferred to the company's creditor and not the company itself.⁴¹

The director's duty to care is a great approach to ensure that companies start to pay attention to the environmental and human rights damages they might leave behind. However, until recently, companies have been built on the concept that their success is related only to their profits, as Milton Friedman teaches in his book *Capitalism and Freedom*: *“There 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”*.⁴²

For several years, we have seen that stakeholders or shareholders have not questioned this kind of company purpose. For that reason, if we analyse the EU scenario, it is possible to see that most companies focus on short-term financial return rather than on long term-sustainable value creation.⁴³

⁴¹ Turner, J. S. (2019). **Business practices, human rights, and the environment**. In E. Daly (Ed.), *Human Rights and the Environment: Legality, Indivisibility, Dignity, and Geography* (pp. 376-385). Edward Elgar Publishing. doi:10.4337/9781788111461

⁴² Friedman, M. (1970, September 13). **The Social Responsibility of Business is to Increase its Profits**. *The New York Times Magazine*.

⁴³ European Commission. (2022). **Proposal for a Directive on corporate sustainability due diligence and annex**. Retrieved from https://ec.europa.eu/info/publications/proposal-directive-corporate-sustainable-due-diligence-and-annex_en

The European Commission announced the intention to have mandatory human rights and environmental due diligence requirements, and when they did so they demonstrated their acknowledgment of the importance of having a framework to ensure that corporate governance has a better-aligned view of sustainability; it stated that the framework would have to:

Aims to ensure that sustainability is further embedded into the corporate governance framework with a view to aligning better the long-term of management, shareholders, stakeholders, and society. It aims at improving the framework to incentivize corporate boards to integrate stakeholder interest properly, sustainability risk dependencies, opportunities, and adverse impacts in strategies, decisions, and oversight.⁴⁴

The development of the director's duties toward an objective different than only make profits have happened over the last few years. The development of legislation, for example, inspires the addition made in the UK Companies Act in 2013, that makes directors of quoted companies consider human rights issues when developing their annual strategic reports.⁴⁵

Aligned with the recent changes, the French Government Action Plan has also suggested that the Civil Code is changed to “*affirm the need for companies to take into consideration social and environmental issues inherent to their activity*”. By doing so, the French government is introducing into their civil code the responsibility towards human rights and the environment into their civil code, making that a part of the duty of care.⁴⁶

⁴⁴ EU initiative on Sustainable Corporate Governance. (2020). Ref. Ares. (2020) 4034032 - 30/07/2020.

⁴⁵ HMG. (2020). **Good Business: Implementing the UN Guiding Principles on Business and Human Rights**. Retrieved from <https://www.gov.uk/government/publications/implementing-the-un-guiding-principles-on-business-and-human-rights-may-2020-update>

⁴⁶ Jeffwitz, C. (2018). **Redefining directors' duties in the EU to promote long-termism and sustainability**. Frank Bold.

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The development of a new concept of company purpose and, therefore a new concept of directors' duty will develop a new set of companies' responsibilities towards the environment and human rights protection. As the director will have to work at the same time towards the company's increase of profits, but also towards a more sustainable way of doing business. As will be discussed in the next chapter, some legislations that are being developed under the business and human rights concept have adopted a system to ensure that directors are liable for the infringement of human rights and environmental damages.

3. Legal Analysis of Environmental Social and Governance Framework

Companies can at one hand boost the economy and generate employment opportunities, regardless of their size, they can make a good influence on the local community, but on the other hand, they may also be the cause of harm to the community they are part of.

There are several cases that can demonstrate the impact that companies can cause on the local communities that they are a part of. One of the most significant cases that have shown these two sides of the impacts that can be made by the enterprises is the Ranza Plaza building in Bangladesh. The building collapsed and took the lives of 1,134 factory workers that served several international and well-known brands.⁴⁷ The importance of these case is not only because it demonstrates the impact that can be caused, but because it was also the first case where the accountability of companies' responsibilities started to be discussed.

There has been a huge awareness growing among costumers regarding the consumption of products from companies that do have negative impacts on the communities where they operate. The consumer awareness has lightened a new treat to companies' reputational damage that comes with a consumer rejection of brands that have shown a bad impact. The impact can be related to human rights and the environment; for example, companies that do not contribute to the reduction of CO2 or contribute to the increase of pollution are not very good acceptable by the consumers.

⁴⁷ Bright, C., Marx, A., Pineau, N., & Wouters, J. (2020). **Towards a corporate duty for lead companies to respect human rights in their global value chains?** *Business and Politics*, 22(4), 667-697.

When these problems started to arise, and companies started to see that their profits could be affected by the damage they caused related to human rights and the environment, several of them started to develop internal policies that could address these reputational risks.⁴⁸ The development of internal policies without any development from the legislation can be interpreted as a way to avoid some more strict rules that could be developed and applied to the companies.⁴⁹

The construction of internal policies to mitigate the reputational risks mentioned above can be seen in larger companies; however, when observing smaller companies, they are not so much visible to the public, and the damage caused by them can be overseen.⁵⁰ Smaller companies, different from more prominent companies, sometimes do not have the same conditions to absorb the costs that come with the elaborations of internal policies.⁵¹

Because of the points highlighted above, it is clear that legislation on the topic is necessary. The legislation is important to prevent larger companies using the absence of it to develop internal policies and use them as a mechanism to avoid stricter rules that might apply to them but also to help the smaller companies to elaborate those policies. On the following topics, it will highlight the legislations already in place and what issues they addressed, observing the evolution of it, specifically if those legislation

⁴⁸ Bright, C., Marx, A., Pineau, N., & Wouters, J. (2020). **Towards a corporate duty for lead companies to respect human rights in their global value chains?** *Business and Politics*, 22(4), 667-697.

⁴⁹ Jenkins, Rhys. (2001). **Codes of Conduct: Self Regulation in a Global Economy.** *Corporate Codes of Conduct.*

⁵⁰ Ibid.

⁵¹ Ibid.

include provisions to support the new policies and procedures by the SMEs.

3.1. Historical Overview

In the 1990s it was possible to see the development of an international agenda that tried to define what corporate responsibility is. John Ruggie, in his book *Just Business: Multinational Corporations and Human Rights*, teaches us that the development of the subject started with the “*liberation of trade, domestic deregulation, and privatization throughout the world extended the scope, and deepened the impact of markets.*”⁵² Furthermore, John Ruggie explains that two main characteristics related to business and human rights stood out at this time of transformation:

It became clear that many governments were unable or unwilling to enforce their domestic law in relation to business and human rights, where such laws existed at all; and multinational firms were unprepared for the need to manage the risks of their causing or contributing to human rights harm through their own actives and business relationship.⁵³

With the government's absence of interest in the development of domestic legislation in relation to business and human rights, and with no interest of the multinational corporations in developing such a framework, communities and advocates for human rights began pressing companies that had left behind several social and human rights footprints. As an answer to the pressure made by communities and advocates, several multinational companies started to develop a corporate social responsibility program.

⁵² Ruggie, John G. 2013. **Just Business: Multinational Corporations and Human Rights (Norton Global Ethics Series)**. N.p.: W. W. Norton.p.18

⁵³ Ibid.

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The concept of corporate responsibility started to be discussed in the decade 1960; however, in the beginning, corporate responsibility was seen more as voluntarism. Nonetheless, it was in the 1990s that the UN Sub-Commission on the Promotion and Protection of Human Rights started to draft a document called *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights* (“Norms”), the final document was only presented to the Commission on Human Rights in 2003.⁵⁴

The Norms stated that companies should have the same human rights duties as states; this assumption triggered a huge discussion in the field of business and human rights; at the same time that the human rights advocates adored the Norms, companies demonstrated their frustration understanding that this imposition would result in the privatization of human rights and result in the allocation of state responsibility to private companies.⁵⁵

Regardless of the establishment of the Norms, the concept that corporations should have the responsibility to respect human rights was properly introduced after the unanimous endorsement of the UNGP in 2011 by the UN Human Rights Council.⁵⁶ The UNGP was elaborated with a broad stakeholder consultation; the document was coordinated by John Ruggie, who was at the time the Special Representative on Business and Human Rights.

⁵⁴ Ruggie, J. G. (2013). **Just Business: Multinational Corporations and Human Rights (Norton Global Ethics Series)**. W. W. Norton. p. 4

⁵⁵ Ibid.

⁵⁶Bright, C., Marx, A., Pineau, N., & Wouters, J. (2020). **Toward a Corporate Duty for Lead Companies to Respect Human Rights in Their Global Value Chains?** *Business and Politics*, 22(4), 667-697. doi:10.1017/bap.2020.15 p. 5

The UNGP was the first international document on business and human rights, it is not a binding instrument, and it is characterized as a soft law instrument that set several recommendations on the corporate responsibility to respect human rights.⁵⁷ The document was well accepted by the companies but not so much by the human rights advocates; several organizations opposed the UNGPs.⁵⁸

Unlike the Norms, the UNGPs are built on the assumption that states have obligations towards international human rights law; nonetheless, this does not exempt the corporation's responsibilities.⁵⁹ More specifically, the Guiding Principle 11 states that: *"Business enterprises should respect human rights. This means that they should avoid infringing on the human rights of others and should address adverse human rights impacts with which they are involved."*⁶⁰

This assumption may be interpreted in some way as holding back companies' responsibility towards the infringements that they may cause, making it clear why human rights advocates did not adore the document as much as companies did.

⁵⁷Macchi, C., & Bright, C. (2019). **Hardening Soft Law: The Implementation of Human Rights Due Diligence Requirements in Domestic Legislation**. In M. Buscemi, N. Lazzarini, & L. Magi (Eds.), *Legal Sources in Business and Human Rights - Evolving Dynamics in International and European Law* (Brill, 2020). Available at SSRN: <https://ssrn.com/abstract=3524488> or <http://dx.doi.org/10.2139/ssrn.3524488>

⁵⁸ López, C. (2013). **The 'Ruggie Process': from Legal Obligations to Corporate Social Responsibility?** In S. Deva & D. Bilchitz (Eds.), *Human Rights Obligations of Business: Beyond the Corporate Responsibility to Respect?* (pp. 58-77). Cambridge University Press. doi:10.1017/CBO9781139568333.006

⁵⁹ López, C. (2013). **The 'Ruggie Process': from Legal Obligations to Corporate Social Responsibility?** In S. Deva & D. Bilchitz (Eds.), *Human Rights Obligations of Business: Beyond the Corporate Responsibility to Respect?* (pp. 58-77). Cambridge University Press. doi:10.1017/CBO9781139568333.006

⁶⁰ UNGP Guiding principle 11. United Nations. (2011). **United Nations Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework**. Retrieved from https://www.ohchr.org/sites/default/files/documents/publications/guidingprinciplesbusinesshr_en.pdf

As the commentary of the guiding principle 11 explains that all business enterprises are expected to conduct their business respecting human rights wherever they are in the world. It also explains that businesses should not depend on the State's ability to accomplish their human rights obligations. The guiding principle 11 also demands that corporations should address their adverse impacts by “*taking adequate measures for their prevention, mitigation and, where appropriate, remediation*”.⁶¹

In addition to the United Nations Guiding Principles, it is also important to mention the United Nations Global Compact when discussing a corporation's social responsibility. The UN Global Compact was adopted in August 2005, there are 8.375 large companies affiliated with it, and it embodies ten principles on how business should be conducted. Human rights, labour, the environment, and anti-corruption are among the fundamental responsibilities of the Global Compact.⁶²

The UN Global Compact recommends that businesses take a precautionary approach to environmental challenges; (i) take initiatives to promote a more responsible approach to the environment; and (ii) encourage the development and diffusion of environmentally friendly technologies. In terms of human rights, the UN Global Compact urges

⁶¹ UNGPs Guiding Principle 11. United Nations. (2011). **United Nations Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework**. Retrieved from https://www.ohchr.org/sites/default/files/documents/publications/guidingprinciplesbusinesshr_en.pdf

⁶² Sales, A. (Ed.). (2019). **Corporate Social Responsibility and Corporate Change: Institutional and Organizational Perspectives**. Springer International Publishing. p. 166

businesses to (i) support and restrain the protection of internationally proclaimed human rights; and (ii) not be complicit in human rights abuses.⁶³

As it is possible to see, the corporation's responsibility nowadays should take into consideration how the business will affect the environment and community where the company has its activities. Companies should avoid the negative impacts, mitigate them, and, when necessary, should probably remedy them.

To ensure that companies started to apply the concept of corporate responsibility, legislation started to be developed at the international level, as seen on the paragraphs above, but also at the EU level, as it will be analysed further. However, before analysing the legislations that are being developed at the EU level, it is important to the deep more into the UNGPs and understand what boundaries are set on it to analyse further the legislations that have been created and inspired after it.

3.2. The UNGPs' the soft law that sets the boundaries

As mentioned before, the United Nations Guiding Principles were created to help and guide companies on how to conduct their business taking into consideration of the adverse impacts that their operations could cause. The UNGPs have three main pillars; (i) the state duty to protect against human rights abuse; (ii) corporate responsibility to respect human rights; and (iii) the need for victims to have access to effective remedies.⁶⁴

⁶³ UN Global Compact. (2005). **The Ten Principles**. Retrieved from <https://www.unglobalcompact.org/what-is-gc/mission/principles>

⁶⁴ Ruggie, J. G., Rees, C., & Davis, R. (2021). **Ten years after: From UN Guiding Principle to Multi-Fiduciary Obligations**. *Business and Human Rights Journal*, 6(2), 180. doi:10.1017/bhj.2021.8

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Guiding Principle number 01, alone shows that the UNGP does not make an exception for small and medium companies, by reading it is perfect clear that the protection by the state must include all third parties, regardless of their size or operation.⁶⁵

Furthermore, Guiding Principle number 03 gives directions on what States should do to meet their duty to protect the human rights. It hence States should: (i) create laws that require business enterprises to respect human rights and to assess the adequacy of such laws and address any gaps; (ii) States should ensure that corporate law, and other already existent laws, “*do not constrain but enable business respect for human rights*”; (iii) Guiding Principle number 03 teaches that States should give guidance to business enterprises in order to help them on creating procedures to make sure that the human rights are respected throughout their operations; and finally, (iv) States should encourage business enterprises to communicate how they address their human rights impacts.⁶⁶

The reading of these two Guiding Principles already makes it clear that the UNGPs, as soft law, does not put the responsibility only on one side, the state or the company, but ensures that both of them must work toward a more efficient system to protect the environment and the human's rights.

⁶⁵ States must protect against human rights abuse within their territory and/or jurisdiction by third parties, including business enterprises. This requires taking appropriate steps to prevent, investigate, punish and redress such abuse through effective policies, legislation, regulations and adjudication. United Nations. (2011).

⁶⁶ United Nations. (2011). **United Nations Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework.** Retrieved from https://www.ohchr.org/sites/default/files/documents/publications/guidingprinciplesbusinesshr_en.pdf

Following the criteria above, every state should develop legislation in order to ensure that the companies operating under their legislation are respecting human rights and developing measures to remediate its infringements when necessary. By reading the Guiding Principles above, it is possible to note that the States should also create mechanisms to help the enterprises.

Other Guiding Principles will be analysed further in the research, however, in an introductory perspective, it is important to mention Guiding Principle number 14:

The responsibility of business enterprises to respect human rights applies to all enterprises regardless of their size, sector, operational context, ownership, and structure. Nevertheless, the scale and complexity of the means through which enterprises meet that responsibility may vary according to these factors and with the severity of the enterprise's adverse human rights impacts.⁶⁷

Guiding Principle number 14 leaves no doubt that the need to respect human rights is not an obligation only to larger companies but an obligation to all of them. The commentary on Guiding Principle number 14 explains that the responsibility for it will be proportional to the size of the company, its structure, and other factors. However, it highlights how some small and medium companies might have difficulty in implementing process and policies, especially due to their informal management structure:

The means through which a business enterprise meets its responsibility to respect human rights will be proportional to, among other factors, its size. Small and medium-sized enterprises may have less capacity as well as more

⁶⁷ Guiding Principle 14. United Nations. (2011). **United Nations Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework.** Retrieved from https://www.ohchr.org/sites/default/files/documents/publications/guidingprinciplesbusinesshr_en.pdf

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informal processes and management structures than larger companies, so their respective policies and processes will take on different forms.⁶⁸

The changes of perspective that have been made by the UNGPs are huge, and after the implementation of the document, even as soft law, several corporations decided to adopt it. There has been an increase in the development of legislation on the issue of environment, human rights, and business. To achieve the main objective of this research, it will be analysed the development of legislation across Europe and how that development still needs to be improved so that the SMEs are included.

3.2. The Development of the Environmental Social and Governance Legislation in the European Union

Over the past few years, there has been a great development in the field of legislation regarding how companies should address their impacts on business and human rights and environmental issues. As mentioned earlier, the subject started to be developed with the United Nations Guiding Principles, at the European Union it has been possible to see the development of some local legislations, such as the French Vigilance Law, the UK Act or the Dutch Child Labour Law. Nonetheless, this dissertation will not focus on one specific member state. Still, it will analyse the developed legislation at the European Union level, with the objective of understanding what developments have been already done and what can still be made, especially towards the implementation of procedures and policies in the SMEs located in Europe.

⁶⁸ Commentary on Guiding Principle 14. United Nations. (2011). **United Nations Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework**. Retrieved from https://www.ohchr.org/sites/default/files/documents/publications/guidingprinciplesbusinesshr_en.pdf

The European Commission has published several initiatives in the context of its Sustainable Finance Action Plan.⁶⁹ The Sustainable Finance Plan was created into the scope of the UN 2030 Agenda for Sustainable Finance and the Paris Agreement signed in December 2015 by 195 countries, the second being the first universal deal on the global climate that hopes to limit global warming to below 2°C.⁷⁰ In 2016, the European Commission appointed a High-Level Expert Group on Sustainable Finance. In January 2018, the group published a final report that offered a vision of how to build a sustainable strategy for the EU.

The report published by the group tells us that sustainable finance has two important pillars “(i) *improving the contribution of finance to sustainable and inclusive growth by funding society’s long-term needs; (ii) strengthening financial stability by incorporating environmental, social and governance (ESG) factors into investment decision making.*” Based on these two pillars, the report gives the EU community eight recommendations that target the financial system sector.

The Sustainable Finance Disclosure Regulation (“SFDR”) of the European Parliament and of the Council of 27 November 2019; came into effect on March 10 of 2021. The SFDR imposes that the participants in the financial sector, for example, management institutions and investment funds, disclose sustainability-related information to end investors.⁷¹ The

⁶⁹ European Commission. (2020, August 5). **Renewed sustainable finance strategy and implementation of the action plan on financing sustainable growth**. Retrieved from https://ec.europa.eu/info/publications/sustainable-finance-renewed-strategy_en#action-plan Accessed 14 August 202

⁷⁰ European Commission. (2018). Communication From The Commission To The European Parliament, The European Council, The Council, The European Central Bank, The European Economic And Social Committee And The Committee Of The Regions Action Plan: **Financing Sustainable Growth (COM/2018/097 final)**.

⁷¹ EUR-Lex. (2019). **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** (Text with EEA relevance). Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32019R2088>

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SFDR was a game changer to the financial sector, as its characters had to start considering the sustainability issue in its investment decisions.⁷²

The primary objective of this regulation is that environmental impacts and social value are considered when a fund or management entity makes an investment decision.⁷³ The legislation also has some specific measures to avoid greenwashing, a common practice of misleading claims made by financial products that pretend to be environmentally friendly but are not. The measures taken by the SFDR are taken to safeguard the investor and prevent them from receiving misleading information.

The SFDR focuses on three different levels of transparency: (i) entity-level transparency; (ii) transparency by financial market participants; and (iii) transparency by financial advisers.⁷⁴ The first level demands that financial institutions and investment enterprises make available on their website the policies it has implemented and how the risk on sustainability is integrated into the investment decision they took (Article 04 of the SFDR).⁷⁵

The second level of transparency includes the products, and it can be divided into three different categories. Article 06 of the SFDR is directed to those products that do not have a sustainable objective but still have the sustainability risk considered in their investment decision. Article 08 is

⁷² Bengo, I., Boni, L., & Sancino, A. (2022). **EU financial regulations and social impact measurement practices: A comprehensive framework on finance for sustainable development. Corporate Social Responsibility and Environmental Management**, 29(4), 809– 819. <https://doi.org/10.1002/csr.2235>

⁷³ Ibid.

⁷⁴ EUR-Lex. (2019). **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** (Text with EEA relevance). Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32019R2088>

⁷⁵ Ibid.

directed to the investment with a sustainable purpose, making it mandatory that anytime a product has investment purposes, it must publish how the ESG characteristics are achieved and, if possible, identify the reference index. Finally, Article 09 is directed to the products with an environmental objective, demanding several disclosures to ensure the objectives are achieved.⁷⁶ Similar rules as the one above applies to financial participants that must also publish when their decision considers the ESG risks and factors.⁷⁷

The regulation represents a big step towards the disclosure of non-financial information, however, as the article 04, item 03 and 04, the financial markets participants that are obliged to publish whether they consider the sustainable impacts when making the investment decision of whether they apply *due diligence* to ensure that the sustainability factors are being achieved by the companies are those that have more than 500 employees⁷⁸, therefore, the SMEs' of the financial market are not obliged to disclose their non-financial information, at least in a first moment.

Even Though SMEs were not in the initial scope of application of the SFDR, however, in February of 2023 it came into force the Commission Delegated Regulation (EU) 2023/363 of 31 October 2022 amending and correcting the regulatory technical standards laid down in Delegated Regulation (EU) 2022/1288. The Delegate Regulation demands that all the financial market participants that are referred in Article 4(1), point a of the SFDR regulation publish whether they consider the sustainable impacts

⁷⁶ EUR-Lex. (2019.). **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** (Text with EEA relevance). Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32019R2088> Accessed 14 August 2022

⁷⁷ Ibid. Accessed 14 August 2022

⁷⁸ Ibid. Accessed 14 August 2022

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when making the investment decision of whether they apply *due diligence* to ensure that the sustainability factors are being achieved.

To complement the SFDR regulation on 18 June 2020, the European Parliament of the Council published the Taxonomy Regulation (EU) 2020/852 (EU Taxonomy Act).⁷⁹ The biggest aim of this regulation is to inform the investor that a certain economic activity is environmentally sustainable, the I regulation goal is also to sets common criteria for use across the EU.⁸⁰

There are three main objectives that the Taxonomy Act aims to achieve: (i) the act aims to achieve sustainable and inclusive growth by reorienting the capital flow; (ii) the act also aims to help how the financial risk related to sustainable issues are managed; (iii) to create long-term and transparency for financial and economic activity.⁸¹

To achieve this objective the article 18 of the Taxonomy Regulation demands that enterprises must implement procedures that are aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, the same article also demands that the enterprises must be aware of the principles identified in the Declaration of the International Labour Organization of Fundamental Principles and Rights at Work and the International Bill of Human Rights.⁸²

⁷⁹ EUR-Lex. (2020). **Taxonomy Regulation (EU) 2020/852**. Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852> Accessed 14 August 2022

⁸⁰ Ibid. Accessed 14 August 2022

⁸¹ Ibid. Accessed 14 August 2022

⁸² Ibid. Accessed 14 August 2022

The Taxonomy Act, very similar to the SFDR is not directly applicable to the SMEs', as per article 01 of the regulation the Taxonomy Act applies to:

(i) measures adopted by Member States or by the Union that set out requirements for financial market participants issuer in respect of financial products or corporate bonds that are made available as environmentally sustainable; (ii) financial market participants that make available financial products; and, (iii) undertakings which are subject to the obligation to publish a non-financial statement pursuant to Article 19a or Article 29a of Directive 2013/34/EU of the European Parliament and of the Council, respectively.⁸³

Nevertheless, the SMEs' can still be impacted by the Taxonomy Act when for example they are looking for partners to finance some of their activity, even though the regulation does not impose any duties on companies besides the public reporting requirements, the information can be used by the investor to ensure that they are allocating their capital in sustainable companies the reporting does not give enough details and some information can be left out.⁸⁴

The obligation of reporting the requirements can still make investor to leave the SMEs' left out as different from other companies they are not obliged to disclose any information (from the SFDR, for example) or to comply with any sustainable requirements (from the Taxonomy Act, for example). At the same time, the same obligation can make SMEs adapt themselves in order to also make part of the investor or business partners choice, however as we will see on the next chapter, the challenges for the SMEs to adapt themselves to these requirements are huge and what is really necessary is that the regulations are made to be directly to them.

⁸³ EUR-Lex. (2020). **Taxonomy Regulation (EU) 2020/852**. Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852> Accessed 14 August 2022.

⁸⁴ Ibid. Accessed 14 August 2022

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The European Union has recently developed a new directive on Corporate Sustainability Due Diligence; it addresses several issues related to environment and human rights. One of the subjects to be addressed by the Directive is that companies implement due diligence on human rights and environment impacts, and more important, the directive demands that the implementation of these due diligence procedures must not be implemented only on the primary company, but in its whole supply chain.⁸⁵ By demanding that enterprise implement due diligence procedures the directive aims to ensure that companies are aware of the ESG risks they are facing and that they take initiatives to prevent them or remediate it.

Overall, the objective of the directive is to (i) improve corporate governance practice to integrate risks of human rights and environmental impacts; (ii) create a more standardized process of due diligence requirements in the single market and create legal certainty for business and stakeholders; (iii) increase the accountability by enterprises for the adverse impact caused.⁸⁶

The Directive complements several existing legislations on the EU level. For example, it compliments Directive 2011/36/EU⁸⁷ on preventing and combating trafficking in human beings and protecting victims, which is a legal framework to combat all forms of exploitation in the European Union, including natural and legal persons, the directive addresses issues such as forced labor, sexual exploitation, and practices similar to slavery.

⁸⁵ European Commission. (February, 02 2022). **Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937**. Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071>

⁸⁶ Ibid

⁸⁷ European Parliament, & Council. (2011). **Directive 2011/36/EU of the European Parliament and of the Council of 5 April 2011**. Official Journal of the European Union, L 101, 1.

Moreover, the Directive also supplements the Employers' Sanctions Directive, which ensures that minimum standard sanctions and other measures that the Member States must apply to employers that employ irregular immigrants from third-country nationals.⁸⁸

On the topic of the value chain due diligence the Directive also complements the Conflict Minerals Regulation,⁸⁹ as it addresses the environmental impact and additional minerals not covered in the Conflict Minerals Regulation but still produce human rights, climate, and environmental adverse impacts.

Furthermore, the Directive demonstrates a hugely important role in combating the issue of the use of forced labour on the global value chains. The directive aims to cover domestic and imported products; it has a risk-based enforcement framework. The Directive also aims to build an international standard for due diligence.⁹⁰

It is important to point that recently the European Union parliament adopted amends to the original text of the Directive, nonetheless the first text of the Directive determined that it would be applied to EU and non-EU companies that meet certain criteria, which are based on the number of employees that the company has and the worldwide or EU net turnover. Article 02 also states that companies with more than 250 employees and a

⁸⁸ European Parliament, & Council. (2011). **Directive 2011/36/EU of the European Parliament and of the Council of 5 April 2011**. Official Journal of the European Union, L 101, 1.

⁸⁹ **Regulation (EU) 2017/821** of the European Parliament and of the Council of 17 May 2017. Official Journal L 130, 19.5.2017, p. 1–20.

⁹⁰ European Commission. (February, 02 2022). **Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937**. Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071>

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minimum of 40 million worldwide operating in high-impact sectors are also covered by the directive.⁹¹

However, the amendments made in June 2023, changed the criteria of the companies that are subjected to the Directive. Amendment 89 decreases the number of employees to 250 and also reduces the net worldwide turnover to EUR 40 million.⁹²

This change is very important since in the EU, companies with that number of employees are considered to be SMEs'; therefore, it is possible to state that the SMEs are now within the scope of the Directive. The main focus of the Directive is on the corporate due diligence obligation; the due diligence must cover the human rights and environmental adverse impacts that the company's activity may cause. The Directive also implements the Directors' duties, which have a close link to the due diligence obligations but also states how the directors are expected to act.⁹³

To achieve its goals, the Directive implements sanctions and civil liability towards the companies. The civil liability has different levels depending if it is related to the company's own operations or if it is related to a business relationship. If the relationship is with a company that the enterprises intend to maintain a long relationship with, if they verify that the company should have taken the necessary precaution to prevent, mitigate

⁹¹ European Parliament. (June, 01 2023). **Amendments(1) adopted by the European Parliament on 1 June 2023 on the proposal for a directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937.** Retrieved from https://www.europarl.europa.eu/doceo/document/TA-9-2023-0209_EN.html

⁹² Ibid.

⁹³ European Commission. (February, 02 2022). **Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937.** Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071>

any adverse impact caused by their business partners, then the company might be accounted for civil liability in the specific case. Nonetheless, if the company uses contractual assurance and has put in place measures to verify compliance, the company will not be liable for failing to prevent the harm.⁹⁴

Once a company fails to implement due diligence, the Directive states that the sanction applied must be proportionate. If a company fails to prevent harm, they should be given time to remediate the situation; only afterward they should be imposed a sanction; if a fine is applied the Directive determines that the amount should be based on the companies' turnover.⁹⁵

Even though the directive represents a huge advance on the legislation about the matter, it is important to highlight that initially it focused on larger companies and some specific sectors; this choice does not correspond to the scope of the UNGPs, as it does not distinguish the applicability because of the company's size. However, as Alp Cerrahoglu explains in his article, the restriction of the applicability of the Directive should not be understood as a limitation of all company's duties to respect and protect the environment and human rights⁹⁶.

Nonetheless, as the special rapporteur on human rights and the environment has taught, a legislation that does not include the SMEs fails to protect the majority of workers. He further explains that the exclusion of

⁹⁴ European Commission. (February, 02 2022). **Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive** (EU) 2019/1937. Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071>

⁹⁵ Ibid.

⁹⁶ Cerrahoglu, A. (2023, February 15). **Defining the Scope of a Corporate Sustainability Due Diligence Directive: Concerns, High-Impact Sectors and Financial Institutions**. Nova Centre on Business, Human Rights and the Environment Blog.

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the SMEs from human rights due diligence legislation can cause the following effects:

1) the proven capacity of some SMEs to implement sophisticated HREDD systems; (2) the potential advantages that some SMEs' proximity to rights holders and embeddedness within local communities and landscapes affords them when responding to adverse HRE risks; and (3) the pressing need to address the serious human rights and environmental abuses that many SMEs perpetuate.⁹⁷

Besides the effects that it can cause to the SMEs that are left out, leaving those companies behind will also facilitate several large companies to limit their liability as they will avoid a relationship with SMEs' by replacing small suppliers with larger entities that have a greater human rights due diligence procedure, reallocating the purchase activities to geographic that have a low human rights and environmental risk.⁹⁸

It is clear that even though there has been development in legislation regarding the impact of businesses on human rights in recent years, there are still very few, and superficially legislation that address the issue and include the SMEs into their scope. The legislations are not directed to small and medium companies and do not implement the recommendations of the United Nations Guiding Principles, however is also important to mentioned that SMEs' can be indirectly impacted by them as they require larger companies to perform due diligence in their whole supply chain, what means that they will require that their business partners, which most of times will include SMEs' also perform due diligence and also implement the requirements of those legislations.

⁹⁷ OHCHR. (2022). **Policy Brief No. 3: Essential elements of effective and equitable human rights and environmental due diligence legislation.** Retrieved from <https://www.ohchr.org/sites/default/files/documents/issues/environment/srenvironment/activities/2022-07-01/20220701-sr-environment-policybriefing3.pdf>.

⁹⁸ Ibid.

Nonetheless, by being indirectly impacted by those legislations SMEs' do not have the support from government bodies to implement the changes they must do in order to adapt their business to the new requirements imposed by those new regulations. Therefore, it is clear that there is a big gap regarding the development of legislation and, consequently, the study on how to address it for small and medium companies.

4. Identifying Gaps and Challenges for SMEs in ESG Compliance

To implement new procedures and internal policies, small and medium companies may face particular challenges, as it has been described in the previous chapter SMEs have a low level of formalization, and their management structure are usually very simple. The SMEs' simple structure and informal management make most SMEs rely on personal relationships over formal system structures.⁹⁹ This, combined with the high costs of implementing due diligence procedures,¹⁰⁰ represents some challenges SMEs face in implementing new due diligence procedures.

In 2016 a joint survey by IOE/ILO was answered for more than 250 SMEs from 32 countries. The survey showed that 65% of the SMEs knew what the UNGPs' were and 72% understood that the importance of human rights would increase in the future. In the survey, the SMEs also were able to identify some of the biggest challenges to meeting human rights responsibilities¹⁰¹:

- “(i) 46% of the respondents understood that a lack of resources would represent a challenge to meet the responsibilities;
- (ii) 36% understood that it would be a challenge to know what were the necessary obligations under the government duties;
- (iii) 36% of the respondents understood that the national law would not being enforced in practice would make it difficult for SMEs to achieve the necessary criteria;

⁹⁹ OECD. (2019). **Introductory Paper on SMEs and Responsible Business Conduct in the Garment and Footwear Sector. OECD Guidelines for Multinational Enterprises**. Retrieved from <https://mneguidelines.oecd.org/Introductory-paper-on-smes-and-responsible-business-conduct-in-the-garment-and-footwear-sector.pdf>.

¹⁰⁰ Idem 94.

¹⁰¹ SHIFT. (2019). **SMEs and the Responsibility to Respect Human Rights - A summary of a workshop with SMEs and IOE members on the UN Guiding Principles on Business and Human Rights**. Shift Project. Retrieved from <https://shiftproject.org/wp-content/uploads/2020/01/index.pdf>

- (iv) 31% of the SMEs' that participated in the survey, pointed that it would be difficult to operate in situations where fundamental economic, ecological, and social standards were not a part of national law; and,
- (v) 29% of the respondents understood it would be a challenge to translate policy commitments into relevant operational procedures."¹⁰²

On the chapter two of this dissertation, it has been discussed some major topics of the corporate legal framework, making it clear that besides all the specific criteria's that involve the SMEs, they also are involved by the same legal framework as larger company. Hence, is important to note that this is not the only similarity that those both different enterprise concept have. Like the majority of larger enterprises, SMEs also were built under the concept of the so-called shareholder primacy.

The concept is constructed on the idea that the primary purpose of an enterprise is to maximize the profits of their investor and shareholders, and it has been the prevailing ideology in most businesses for many years. However, as demonstrated in chapter 02 of this dissertation, in recent years there has been a shift from this view.¹⁰³ It became usual to see that corporations started to shift their view of operation to the stakeholders' perspective, considering the needs of their consumers, partners, employees, and society.¹⁰⁴

The shift in the perspective that companies must only focus on the maximization of profits from their investors and shareholders may be exemplified by multinational corporations such as IKEA and its commitment

¹⁰² SHIFT. (2019). **SMEs and the Responsibility to Respect Human Rights - A summary of a workshop with SMEs and IOE members on the UN Guiding Principles on Business and Human Rights**. Shift Project. Retrieved from <https://shiftproject.org/wp-content/uploads/2020/01/index.pdf>

¹⁰³ Fenwick, M., Joubert, T., van Wyk, S., & Vermeulen, E. P. M. (2022, May 2). **ESG as a Business Model for SMEs**. European Corporate Governance Institute - Law Working Paper No. 642/2022, Tilburg Law School Research Paper. Retrieved from <https://ssrn.com/abstract=4098644> or <http://dx.doi.org/10.2139/ssrn.4098644>

¹⁰⁴ Ibid.

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*“to be circular and climate positive by 2030 and to inspire than enable the many people to live a better everyday life within the boundaries of the planet”.*¹⁰⁵

At the same time that this shift of perspective is easily seen on larger corporations, is much harder to identify the same mindset change on smaller enterprises. SMEs are a very particular group of enterprises; even though they have so many different characteristics, they have a very heterogeneous size and structure.¹⁰⁶ Those companies do not have many distinctions in management roles, their employers usually have multitasking positions, and the main focus of the company is to solve day-to-day business issues.¹⁰⁷

Due to their management structure and its low level of formalization, SMEs may face a barrier to understanding the technical content and terminology of relevant information. This kind of structure can then delay the change of mindset of SMEs shareholder's from focusing on maximize the profits to start considering the needs of their consumers, partners, employees, and society.

The management structure of the smaller companies is not the only challenge that they have to face in order to implement new policies and internal procedures. As being less visible to the public in general, smaller companies tend to show less interest in some specific topics, as they do not draw the same attention as bigger companies and therefore are not as frequently public charged by their actions. Smaller companies also are less

¹⁰⁵ IKEA. (Year). **Transforming into a Circular Business**. Retrieved from <https://about.ikea.com/en/sustainability/a-world-without-waste>.

¹⁰⁶ Murillo, D., & Lozano, J. M. (2006). **SMEs and CSR: An Approach to CSR in their Own Words**. *Journal of Business Ethics*, 67, 227–240. doi:10.1007/s10551-006-9181-7.

¹⁰⁷ Spence, L., & Schmidpeter, R. (2003). **SMEs, Social Capital and the Common Good**. *Journal of Business Ethics*, 45, 93-108. doi:10.1023/A:1024176613469

able to spend money to increase their team and their team knowledge; they usually have more urgent issues to deal with than implementing internal policies.¹⁰⁸

SMEs are usually smaller than the size of their suppliers, what means that they do not represent a big part of their supplier's business, having this configuration results in lack of leverage by the SMEs'.¹⁰⁹ A company's leverage will be affected by its sourcing model, if it is direct or indirect. The leverage can also be affected by the company's relationship with its consumers.¹¹⁰ The lack of leverage owned by the SMEs also represent a challenge for them when implementing new requirements to a new business partner for example.

With this background, where more prominent companies have access to money and to people to implement the necessary procedures to incorporate into their practice the need to take care of environmental, social, and governance issues, when SMEs may face so many difficulties, can then create a discriminating effect and barriers to SMEs trade.¹¹¹

Nonetheless, if SMEs can create and implement those kinds of standards, it can put them in a position ahead of other SMEs in their home country, making them grow and giving access to different markets to those that do not implement any kind of standard.¹¹²

¹⁰⁸ Jenkins, R. (2001). **Codes of Conduct: Self Regulation in a Global Economy.** Corporate Codes of Conduct.

¹⁰⁹ Ibid.

¹¹⁰ Ibid.

¹¹¹ Deutsches Institut für Entwicklungspolitik. (2017). **Drivers and Constraints for Adopting Sustainability Standards in Small and Medium-sized Enterprises (SMEs).** Retrieved from https://www.idos-research.de/uploads/media/DP_21.2017.pdf.

¹¹² Ibid.

This chapter will analyse the challenges and the gaps that are faced by SMEs to implement standards on environmental, social, and governance responsibility. It will also be discussed by the end of it how implementing those can improve the growth of those companies. The chapter's main objective is to give an open view of the bad and good sides of ESG standards implementation so that the next chapter can address how governments can help those enterprises implement it.

4.1. Challenges Faced by SMEs in Implementing ESG Standards

4.1.1 The management problem

In larger enterprises the shareholders will allow the managers to be more independent, while on the SMEs' is very common that the shareholder impose how the managers will spend resources, for some researchers about the topic understand this is one of the important problems that small and medium enterprises might face.¹¹³

For another instance, in the joint survey of the IOE/ILO, some of the survey respondents understand that with good leadership and staff, SMEs can achieve the same levels of commitment as bigger companies.¹¹⁴

To solve the management problem that SMEs' face is necessary that their shareholders change their mindset, what therefore can be harder to solve than some of the other challenges that are faced by the SMEs'. If shareholders are moved by the profits that the companies make, a solution

¹¹³ Vyakarnam, S., Bailey, A., Myers, A., & Burnett, D. (1997). **Towards an Understanding of Ethical Behavior in Small Firms.** *Journal of Business Ethics*, 16(15), 1625–1636. <http://www.jstor.org/stable/25073032>.

¹¹⁴ SHIFT. (2019). **SMEs and the Responsibility to Respect Human Rights - A summary of a workshop with SMEs and IOE members on the UN Guiding Principles on Business and Human Rights.** Shift Project. Retrieved from <https://shiftproject.org/wp-content/uploads/2020/01/index.pdf>

would be to have a framework that associates an ESG performance to financial incentives for the enterprises. Alternatively, companies with a strong commitment to policies and procedures could receive benefits for their efforts.

4.1.2 High costs

To implement ESG activities in the business of the SME may be very costly to them. Even though producing a report will take the same amount of time in a big company as it will in a SME, for a bigger company to devote five employees to produce the report is completely possible, in an SME to devote one employee out of ten is almost impossible.¹¹⁵

Besides the issue with the time expenditure by the staff, many SMEs also point out the fact that there is an administrative burden associated with the complaint of the standards. As it has been demonstrated before, the operations of the SMEs are simpler than larger companies, therefore dealing with all the paperwork that comes with being compliant with ESG standards, can be a millstone.¹¹⁶

Besides the need to deal with a lot of paperwork and not have enough employees to implement the policies to comply with the standards, SMEs also tend to deal with day-to-day problems,¹¹⁷ stopping everything to start working on the development of new reports and policies might not be an interesting thing to the SMEs.

¹¹⁵ Fitjar, Rune. (2011). **Little Big Firms? Corporate Social Responsibility in Small Businesses that Do Not Compete Against Big Ones.** *Business Ethics: A European Review*, 20, 30-44. DOI: 10.1111/j.1467-8608.2010.01610.

¹¹⁶ Ibid.

¹¹⁷ Ibid.

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Besides the high costs of implementing ESG in smaller companies, smaller companies' payoffs on this issue are also lower than those for larger companies. Bigger companies are more visible in the capital, labour, and product markets.¹¹⁸ Therefore their reputation matters in each of those markets, making the amount spent on ESG implementation worth it.

The EU Directive on Corporate Sustainability highlights the difficulty that SMEs may face in implementing the due diligence obligations on sustainability. The Directive also mentions that even though SMEs may not be obliged by law to implement certain regulatory policies, they can be exposed through their business relationships with larger companies. In this scenario, the Directive demands that bigger companies that have SMEs as their business partners might need to support those smaller companies with the fulfilment of the due diligence requirements.¹¹⁹

4.1.3. Reputation

The reputation of a company has different aspects and results depending on the market that they are placed in. For example, consumers will pay a higher price for products that they know have been manufactured under decent working conditions.¹²⁰ However, SMEs may not have this kind of visibility once they are usually local or national companies,¹²¹ besides that SMEs usually do not sell directly to the consumers; they

¹¹⁸ Graafland, J.J., Eijffinger, S.C.W., & Smid, H. (2004). **Benchmarking of corporate social responsibility: Methodological problems and robustness**. *Journal of Business Ethics*, 53(1-2), 137-152.

¹¹⁹ European Commission. (February, 02 2022). **Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937**. Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071>

¹²⁰ Auger, P., Burke, P., Devinney, T.M., et al. (2003). **What Will Consumers Pay for Social Product Features?** *Journal of Business Ethics*, 42, 281–304. doi:10.1023/A:1022212816261.

¹²¹ Fitjar, Rune. (2011). **Little Big Firms? Corporate Social Responsibility in Small Businesses that Do Not Compete Against Big Ones**. *Business Ethics: A European Review*, 20, 30-44. DOI: 10.1111/j.1467-8608.2010.01610.

usually sell to other companies.¹²² The absence of public visibility does not give SMEs the same return as it gives to larger companies when implementing ESG policies this, therefore, may result in a smaller interest from those enterprises in the implementation of those policies.

For other instance, in the labour market a good reputation will be important when recruiting new employees.¹²³ Some scholars even state that companies that are viewed as more ethical companies may be able to attract employees with a lower salary and the same companies also have a more cooperative workplace.¹²⁴ However, implementing ESG procedures may be easier for larger companies with well-established corporate structures. On the other hand, it can be challenging for small and medium-sized enterprises to achieve the same level of employee attraction and motivation.¹²⁵

SMEs tend to achieve financial aid from the banks and the government, therefore, it is not common them to get involved in the capital market, where is also essential to have a good ESG reputation, as a way to gain access to capital.¹²⁶

As it was discussed above, there are several issues that can make harder for SMEs to implement new policies and procedures. However, their simple and smaller structure can also give them an advantage over larger

¹²² Lepoutre, J., & Heene, A. (2006). **Investigating the Impact of Firm Size on Small Business Social Responsibility: A Critical Review**. *Journal of Business Ethics*, 67, 257–273. doi:10.1007/s10551-006-9183-5.

¹²³ Fitjar, Rune. (2011). **Little Big Firms? Corporate Social Responsibility in Small Businesses that Do Not Compete Against Big Ones**. *Business Ethics: A European Review*, 20, 30-44. DOI: 10.1111/j.1467-8608.2010.01610

¹²⁴ Nyborg, K., Brekke, K. A., & Brekke, K. A. (2004, October). **Moral Hazard and Moral Motivation: Corporate Social Responsibility as Labor Market Screening**. University of Oslo Economics Working Paper, 25/2004. Retrieved from <https://ssrn.com/abstract=645741>

¹²⁵ Ibid.

¹²⁶ Ibid.

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enterprises. Since SMEs are a lot more integrated with their local communities, they have a much closer relationship with their stakeholders than larger companies.¹²⁷ This relationship can benefit directors and managers when implementing new policies and procedures.

Also because of the structure that SMEs' have, it is possible to see that their owners and managers are more sensitive to activities connected with their immediate internal stakeholders.¹²⁸ This relationship makes the SMEs to act more carefully towards those stakeholders.

There is no doubt that there are many challenges that must be faced by the SMEs' before they implement new policies and procedures, specially ESG procedures since the legislation is still in development and it is still difficult to obtain the necessary data. The absence of employees and the need to resolve day-to-day problems can make it harder for SMEs. Nonetheless, the issue is getting more importance, and if SMEs want to compete with larger companies, they must implement the policies and procedures necessary.

4.2. Advantages of ESG implementation

It was clear that SMEs may face a few challenges to implement the new policies and procedures that are being implemented by larger companies in order to adequate their actives into ESG compliant. However, passing through those challenges and implementing those procedures and policies can also have advantages for those enterprises.

¹²⁷ Fitjar, Rune. (2011). **Little Big Firms? Corporate Social Responsibility in Small Businesses that Do Not Compete Against Big Ones.** *Business Ethics: A European Review*, 20, 30-44. DOI: 10.1111/j.1467-8608.2010.01610

¹²⁸ Ibid.

A study published by McKinsey demonstrates that invest into ESG policies can increase a company's cash flows, the study demonstrates that this growth in cash flow can be demonstrated into five different ways:

(i) a growth in the sell of products when a company starts to have some sustainable products;

(ii) the growth in cash flow can also be explained by a reduction in energy and water use, since a company that starts to apply ESGs' procedures, like due diligence, towards other companies they also start to apply inside their own operations;

(iii) the ESG topics are being discuss in several levels, inside the companies and also into the government bodies, and another way that companies can beneficiate themselves with is by having their cash flow increased by some regulatory interventions that gove companies benefits;

(iv) another way that investing into ESG procedures increase a company cash flow is that those companies are more attracted to the employment market, therefore they can hire best talents and is some way increase their production; and, finally the McKinsey studies state that the investment into ESG procedures also will increase a company's investments. ¹²⁹

¹²⁹ Henisz, W., Koller, T., & Nuttall, R. (2019, November). **Five ways that ESG creates value.** McKinsey. Retrieved from <https://www.mckinsey.com/~media/McKinsey/Business%20Functions/Strategy%20and%20Corporate%20Finance/Our%20Insights/Five%20ways%20that%20ESG%20creates%20value/Five-ways-that-ESG-creates-value.ashx> Accessed 09 of July 202

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Therefore, even though implementing ESG procedures on SMEs can be a big challenge, the positive outcomes are immense and can increase the companies' profits.

That is why government bodies must work on the development of frameworks that can increase the accessibility of SMEs to the topics, helping them on the development and implement policies and procedures, to do that is important that the frameworks developed acknowledged the difficulties and challenges of those enterprises.

In the next chapter, this dissertation aims to demonstrate what are the main topics that must be approached by a framework that includes the SMEs, not only as an additional to the larger companies - like some of the existing legislation - but that in facts acknowledges the needs of the SMEs and creates an environment where they can learn and implement the new policies and procedures related to ESG.

5. Proposed Framework for Inclusive Legal Framework for SMEs

As was discussed in the previous chapter there is no doubt that the issues evolving the concepts of responsible business conduct with respect to the international framework and principles on the environmental social and governance are becoming a subject of more importance between large enterprises and government bodies.

The subject has also presented some growth among smaller enterprises, and some legislations are already including small and medium enterprises under their scope of application; however, the application is very minimal, and it usually ensures that larger companies that are in a relationship with smaller one, help them on making the adaptations and necessary transitions to a more responsible business.

Nonetheless, as was demonstrated in the last chapter, the SMEs have a bigger challenge to implement new procedures and develop new internal policies; therefore, it is still necessary that the government bodies and international bodies start to develop a framework that not only have as objective to develop the concept of business that focus on ESG procedure, but small and medium size business and how they can include the ESG concepts on their daily business operations and still make profits.

5.1. EU Directive on Corporate Sustainability almost a perfect framework

In the previous chapter, we discussed how the EU is developing legislation related to human rights, sustainability, and business. However, there is currently insufficient guidance on how these standards should be applied to small and medium-sized companies based in the EU.

In the recent amendments adopted by the EU Commission on the EU Draft Directive on Corporate Sustainability Due Diligence, the scope of application of the directive has been redacted to apply to companies with 250 employees and a net turnover of 40 million.¹³⁰

It is important to remember that, in the context of the EU regulation, SMEs are those companies that have up to 250 employees or those that have up to 50 million net turnovers.¹³¹ Therefore, the recent amendments to the EU Directive turn the regulation applicable to SMEs located in the EU, and that fit in the description above. The directive also includes SMEs when they demand that larger companies ensure that the standards are being applied to their whole supply chain, meaning that if a larger company has a business relationship with SMEs, they have to ensure that the SMEs also have the same standard.

However, the EU Directive does not make it clear how SMEs should implement the Due Diligence procedures or how they should adapt themselves to implement those new standards, nonetheless, the EU Directive states that the companies should respect the human rights and implement due diligence procedures adapting it to their size, sector and operational context:

All companies should respect human rights, as enshrined in the international conventions and instruments listed in the Annex, Part I, Section 2, and those under the scope of this Directive should be required to conduct due diligence and should take appropriate measures to identify and address adverse

¹³⁰ European Commission. (February, 02 2022). **Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937**. Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071>

¹³¹ Rensmann, T. (Ed.). (2017). **Small and Medium-Sized Enterprises in International Economic Law** (Online ed.). Oxford Academic. <https://doi.org/10.1093/acprof:oso/9780198795650.001.0001>.

human rights impacts along their value chain. The extent and nature of due diligence can vary according to the size, sector, operating context, and risk profile of the company.¹³²

Even Though the EU Directive does not specifically state how should the SMEs adapt the need to their size, on the recital 34(a) the EU Directive demands that companies that have SMEs into their supply chain should also proportionate financial and administrative support to help them implement the code of conduct or prevention action plan.¹³³

However, as seen before, even though the SMEs can apply the procedures adapting it to their size, this implies that those companies must contract new employees that have knowledge on the subject, or make its employees aware of it, what represents a cost increase that some SMEs might not be able to afford.

It appears that the EU Directive has recognized this matter. In its recital 46, it states that member states and companies must receive guidelines from knowledgeable bodies about due diligence procedures:

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, the European cross-industry and sectoral social partners and other relevant stakeholders, including civil society organizations, the European Union Agency for Fundamental Rights, the European Environment Agency, the

¹³²European Commission. (February, 02 2022). **Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937**. Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071>

¹³³ Recital 34 (a) (...) 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 financial and administrative support for an SME with which they have a 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. European Commission. (February, 02 2022). Ibid.

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European Labour Authority, the European External Action Service, the European Innovation Council and the Small and Medium-Sized Enterprises Executive Agency (EISMEA), the European Food Safety Authority, and where appropriate the OECD and other international bodies having expertise in due diligence, should issue clear and easily understandable guidelines, including general and sector specific guidance, in order to facilitate compliance in a practical manner.¹³⁴

Even though the access to guidelines might facilitate the implementation of new procedures for SMEs, it also implies that the hour expanded into something else will have to be directed to the development and implementation of those new procedures which can also imply an increase of costs to the SMEs, as is very likely, from what has been discussed at chapter 04, the SMEs will have to hire more employees so they can still operate their day-to-day business and dedicate hours to the implementation of new policies.

The EU Directive in its recital 47, acknowledges that even though the SMEs are not included in the obligations set forth, they can be impacted by provisions on contracts with companies that fit on the directive scope, and therefore they might be indirectly affected by the *due diligence* requirements imposed by the EU Directive. Therefore, the same recital states the member states should build tools and projects to help with the *due diligence* implementation:

Recital 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 the 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, with the support of the Commission, should set up and operate, either individually or jointly, dedicated user-friendly websites, portals or platforms, and Member States should also financially support SMEs and help them build capacity. Such support should

¹³⁴ European Commission. (February, 02 2022). **Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937**. Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071>

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 and use fair, reasonable, non-discriminatory and proportionate requirements vis-a-vis the SMEs. SMEs should also have the possibility to apply this Directive on a voluntary basis and should for that purpose be supported through adequate measures and tools, and be incentivised.¹³⁵

In the following recital, number 48, the Commission also makes a statement that helping the implementation of the due diligence procedures on the SMEs should not only be a burden for the larger companies that work with them or for the member states, it is a burden that must be shared by the stakeholders involved including the Commission.¹³⁶

Even though the Commission makes clear its intention on helping the implementation of the Directive on the SMEs, it does not address how state governments will help the SMEs with the financial cost of implementing new procedures. The implementation of new procedures on SMEs can have a huge impact on the cash flow of those enterprises; the EU Directive address this issue in a very briefly way; it states that larger companies must ensure that SMEs receive the financial and administrative support:

Companies shall be required to take appropriate measures, including the following actions, where relevant:
(d) provide targeted and proportionate financial and administrative support for an SME with which the company has a business relationship¹³⁷

¹³⁵ European Commission. (February, 02 2022). **Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937**. Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071>

¹³⁶ Recital (48): In order to complement Member State support to companies in their implementation, including SMEs, the Commission should build on existing EU tools, projects and other actions helping with the due diligence implementation in the EU and in third countries. It should 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. Ibid.

¹³⁷ Article 7, paragraph 2, line d. European Commission. (February, 02 2022). Ibid.

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As seen above the EU Directive emphasizes the importance of respecting human rights and implementing due diligence procedures to ensure its respect. From the analysis of its articles and recitals it is clear that the directive lacks to address how the SMEs can adapt the standards to their size, sector and operational context. Nonetheless, it would be unfair to state that the EU Directive does not address any of the issues or that when it does, it places the burden only on the larger companies to help the SMEs.

The EU Directive by suggesting that larger companies must provide financial and administrative help to the SMEs' they have a business relationship with, it makes clear that the Commission acknowledges the burden that SMEs may have to overturn. The EU Directive also puts the responsibility at the member states and at the EU Commission itself, by stating that those two figures also must encourage the development of the due diligence procedures on the SMEs'.

Even though the EU Directive clear acknowledges the challenges that might be faced by the SMEs', it is narrow on how the member states should address the gaps and challenges faced by the SMEs; under this scenario, it is important that a framework is constructed to adapt to the real needs of the SMEs'.

5.2. What a framework needs to have to include in the right way the SMEs

The previous chapter has demonstrated that more and more legislation and government bodies are putting the SMEs into the spectrum of obligations regarding human rights and environmental responsibilities that they care for alongside their activities, being the EU Directive on

Corporate Responsibility the biggest one so far. Despite the efforts that are being made, there is still no framework that is constructed to adapt the needs of the SMEs.

There is no question that businesses, regardless of their size, have responsibility towards the community they are located in, the environment, and that they have to ensure the protection of human rights throughout their whole supply chain. However, it is necessary first to recognize that the duty to protect human rights and the environment is, at the same time it is a business duty, it is also a state duty and that the States are the ones that must protect human rights against business enterprises abuses:

States must protect against human rights abuse within their territory and/or jurisdiction by third parties, including business enterprises. This requires taking appropriate steps to prevent, investigate, punish and redress such abuse through effective policies, legislation, regulations and adjudication.¹³⁸

Therefore, it is a state duty to guarantee that the business enterprises do not commit abuses against human rights. So, the States must ensure that there are legislations protecting human rights against any violations that might be caused by business activity.

The UNGPs commentary on the Guiding Principle 01, makes clear that even though the State is not responsible for human rights abuses that might be caused by a private actor, they are responsible for preventing that no abuse is practiced:

Therefore, States are not per se responsible for human rights abuses by private actors. However, States may breach their international human rights law obligations where such abuse can be attributed to them, or where they

¹³⁸ Guiding Principle 01 United Nations. (2011). **United Nations Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework.** Retrieved from https://www.ohchr.org/sites/default/files/documents/publications/guidingprinciplesbusinesshr_en.pdf

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fail to take appropriate steps to prevent, investigate, punish and redress private actors' abuse. While States generally have discretion in deciding upon these steps, they should consider the full range of permissible preventative and remedial measures, including policies, legislation, regulations and adjudication. States also have the duty to protect and promote the rule of law, including by taking measures to ensure equality before the law, fairness in its application and by providing for adequate accountability, legal certainty, and procedure and legal transparency¹³⁹

The UNGPs makes it clear that the States are responsible to ensure that the business enterprises, and by that all business enterprises regardless of its size or sector, are responsible for the human rights impact that they may cause as a consequence of their activities. However, they are also clear that the State must ensure that governmental departments, agencies, and other institutions that shape business practices are aware of the State's human rights obligations and that they provide companies with the support needed to implement procedures to avoid the infringements of those rights.¹⁴⁰

To ensure that the business enterprises respect human rights while practicing their activities and getting profits, the States must find the perfect balance between having the laws that ensure to implement what is internationally recognized as human rights and supporting departments and agencies to cast the business enterprises.¹⁴¹

¹³⁹ Commentary on the Guiding Principle 01. United Nations. (2011). **United Nations Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework**. Retrieved from https://www.ohchr.org/sites/default/files/documents/publications/guidingprinciplesbusinesshr_en.pdf

¹⁴⁰ States should ensure that governmental departments, agencies and other State-based institutions that shape business practices are aware of and observe the State's human rights obligations when fulfilling their respective mandates, including by providing them with relevant information, training and support. Ibid.

¹⁴¹ Comment to the guiding principle 08 United Nations. Ibid.

The UNGPs makes it clear that to build an effective framework and to ensure that business enterprises respect human rights the collaboration of various stakeholders is essential to build an effective framework.

Before the publication of the EU Directive on Corporate Sustainability, the European Parliament and Commission made a consultation with stakeholders to evaluate the knowledge among the stakeholders and understand their needs. The consultation reached a few conclusions on how stakeholders had acknowledged the need for an EU legal framework for due diligence.¹⁴²

Overall, it showed that the stakeholders detain a general acknowledgment for an EU legal framework. The consultation states that specifically larger companies demonstrated the need for harmonization in the area of due diligence. Regarding civil society, the consultation demonstrated that they were not satisfied with the frameworks in place and understood them as ineffective to ensure corporate accountability for negative impacts on human rights and environment.¹⁴³

Regarding the approach, the consultation demonstrates that overall, all stakeholders' respondents were in favour of a horizontal approach, including 81,8% of the SMEs' answered the consultation. With reference to an enforcement mechanism, the stakeholder's group indicated that the preferable system would be a supervision by competent national authorities with an EU cooperation/collaboration, 86.4% of the SMEs were in favour of this system.¹⁴⁴

¹⁴² European Commission. (February, 02 2022). **Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937**. Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071>

¹⁴³ Ibid.

¹⁴⁴ Ibid.

The consultation showed that the stakeholders preferred a horizontal approach to due diligence rather than a sector specific approach. All the stakeholders indicated that the preferable enforcement mechanism would be supervision by the national authority.¹⁴⁵

Therefore, a beneficial framework for the SMEs would have the characteristics described above, but it is also necessary to make those approaches accessible to those enterprises and that is the challenge that none of the existing have reached in full. As discussed previously the EU directive gives some direction on how to address some of the challenges faced by the SMEs, however there are still some points that are lifted out, and others are put over the larger companies and enterprises shoulders.

To address some of these issues, the IOE/ILO survey has identified some of the most useful support to SMEs to respect human rights. The IOE/ILO report references pillar one of the UNGPS and also acknowledges that the States must fulfil their duty to protect human rights, and it addresses that some way to do it is by labour law and inspections, to ensure that the enterprises are complying with the regulations.¹⁴⁶

The report demonstrates that a way to encourage the SMEs to implement and comply with human rights and environment regulations is by giving incentives to the SMEs that have greater performance on avoiding, protecting and remedying the human rights and environmental

¹⁴⁵ SHIFT. (2019). **SMEs and the Responsibility to Respect Human Rights - A summary of a workshop with SMEs and IOE members on the UN Guiding Principles on Business and Human Rights.** Shift Project. Retrieved from <https://shiftproject.org/wp-content/uploads/2020/01/index.pdf>

¹⁴⁶ Ibid.

impact of their activities.¹⁴⁷ The IOE/ILO report also highlights the important role of the employers organizations in supporting the SMEs' to implement the UNGPs and other human rights and environment duties, it states that those organizations can raise the standards and expectations of business, it can help by given the training necessary for the employees at the SMEs.¹⁴⁸ Finally, the IOE/ILO report also states that peer-learning could be a great opportunity for the SMEs to expand their opportunities outside of their country and industry.¹⁴⁹

Therefore, a legislation that is constructed focusing on the SMEs must include on the practical basis: (i) a horizontal approach; and (ii) the enforcement mechanism should be exercised by a state authority. Forums and workshops can be a great alternative to overcome the issue related to the financial costs of the implementation of new standards and policies on SMEs, Consultations like the ones mentioned above, should be implemented on a regular basis so that the member states and regulatory authorities are aware of the difficulties and challenges that are being faced by those enterprises.

The framework must be able to help the SMEs on the implementation of the process, the Annex of the framework should also provide the SMEs with models of questionnaires for the Due Diligence, should have models on the way to report the information. The EU Regulation 2022/1288, for example, has in its Annexes the model of the information that must be published, as well as a description of the data that must be collected by the

¹⁴⁷ SHIFT. (2019). **SMEs and the Responsibility to Respect Human Rights - A summary of a workshop with SMEs and IOE members on the UN Guiding Principles on Business and Human Rights.** Shift Project. Retrieved from <https://shiftproject.org/wp-content/uploads/2020/01/index.pdf>

¹⁴⁸ Ibid.

¹⁴⁹ Ibid.

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financial market's participants, this for sure facilitates the applicability by the SMEs of the standards there defined.

In 2019 the UN Working Group published a report where it highlights those gaps and inconsistencies can cause misunderstanding and different interpretations on the implementation of a new framework,¹⁵⁰ for that reason is very important that there is a policy coherence. To avoid those gaps the working group highlights a few suggestions that can be done by the states to implement a policy coherence, even though the measures focus themselves into the implementation of national actions plans, some of the suggestion can also be applied on the implementation of a legal framework on the implementation of ESG duties to SMEs.¹⁵¹

Also, the working group highlights the importance of having training and awareness-raising to build the knowledge of business and human rights standards across all the parties involved. To avoid any gaps the working groups states the importance of all the government bodies passing the same information when they are interacting with business. Finally, the working group also highlights the importance of having a monitoring and reporting evaluation.¹⁵²

Therefore, the framework to be effective must ensure that there is a policy coherence, and that there is also a due diligence and reporting

¹⁵⁰ Office of the United Nations High Commissioner for Human Rights. (2019). **Executive Summary: Policy coherence and the role of the state in the implementation of the United Nations Guiding Principles on Business and Human Rights** (Document No. GA74report_EN.pdf).

¹⁵¹ Ibid.

¹⁵² European Commission. (February, 02 2022). **Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937**. Retrieved from <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071>

mechanism. But it is also important that the framework makes the SMEs' comfortable to implement it, by making the implementation easy and with no damage to SMEs financials.

The SMEs make a huge impact on the economy of the States they are located at, the same way their impact can help economies grow, they can also damage the community they are inserted at, therefore a framework directed to the implementation of ESG standards on the SMEs are still not existing, however, it is much needed to avoid the damages that can be caused by the SMEs. Also, as being part of the value chain of bigger companies, SMEs are already affected by some of the existing frameworks, however implementing them and the procedures they demand can be very difficult, therefore it is essential that a framework is constructed to help those companies surpass the gaps and challenges they can face.

A framework focused on SMEs might be hard due to their so many different characteristics, but it is essential. The framework must understand the necessity of the SMEs, it must understand the gaps that the SMEs may face and help them to overcome. The framework focus on the SMEs must focus on the knowledge of those companies, and the necessary help to them. However, at the same time the framework must ensure that the companies fulfil their duty.

6. Conclusion

The rise of consumer awareness to ESG issues involving the companies they buy from has risen up the concern of companies on how to avoid the infringements of such issues and also how to implement policies and procedures that can make their day-to-day operations a more respectful one towards the community they are at.

The self-regulation that came from the movement expressed on the last paragraph increased the development of legislation and doctrine in the area of business and human rights.

These changes and developments are contributing to the construction of a new way of doing business and changing the social concept of business from only making profit, to making profits while still respecting human rights and the environment.

The phenomenon is largely seen in bigger corporations as the law that have been already developed and implemented are applied to them. Such as the SFDR, which ensures that companies who are part of the EU financial market publish their non-financial information. Or the EU Directive that obliges companies to implement *due diligence* procedures through out their whole supply chain in order to avoid sustainable impacts.

Nonetheless, if from one point of view, these developments are very important and make a huge impact in such corporations, the absence of developments that take into consideration the SMEs, might drive them apart from implementing the same policy and procedures.

Legislations that only include larger companies, but at the same time make them responsible for the impact that their whole supply chain makes, can make those companies look for supplier with a more developed compliance system than a SMEs; therefore, this might decrease the production of the SMEs as they might lose some contracts with larger companies. Or by being indirectly impact by those legislations SMEs' will also start to implement new policies and procedures, sometimes without the supported or knowledge needed, what can them cause gaps and controversies.

That being stated, it is necessary to develop or update the already developed legislation to include the SMEs. But to do so, it is important to have in mind that for SMEs to include new process and procedures into their daily operations is much harder than larger enterprises.

SMEs may face several challenges, they do not have the same structure of larger companies, SMEs usually are focus on solving the day-to-day issues, they do not have employee with the knowledge, they also have lower capital to adapt themselves to the new regulatory demands.

Therefore, a legislation that is constructed focusing on the SMEs must include on the practical basis: (i) an horizontal approach; (ii) the enforcement mechanism should be exercised by a state authority. To overcome the issue related to the financial costs of the implementation of new standards and policies on SMEs, especially on the education of the employment on these new subjects, member States and International Government bodies should proportionate Forums and workshops to help those enterprises.

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To ensure that the framework is being implemented, the government and international bodies should also make regular consultations to ensure that the difficulties and challenges are being addressed. Also, as discussed in the last chapter, a way to incite the implementation of the new policies and procedures, the member states should implement programs that create benefits to enterprises that demonstrate the implementation of procedures and policies related to the ESG.

The topic on the business and human rights is getting a lot of attention recently, government bodies must use of this to develop and engage as many corporations as they can on the subject. The need to make profits and respect the human rights is more than necessary and it must be done as soon as possible. It is essential to ensure that the corporations are aware of their impact and they take the necessary measures to reduce it.

The biggest aim of this research was to give a back ground on the ESG framework and demonstrate how the SMEs are not yet included, but should be so that could be a development of framework that really includes all parties in the value chain.

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