EU investor due diligence: ensuring finance works for people and planet

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What has the EU done so far?

The EU's Action Plan on Financing Sustainable Growth (FSGAP) called for the mainstreaming of sustainability issues (also referred to as Environmental, Social and Governance (ESG) issues) in investors' risk management. The subsequent legislative proposal for a Regulation on Disclosures Relating to Sustainable Investments and Sustainability Risks[i] (DSR Regulation) introduces disclosure obligations on how investors integrate ESG factors in their risk processes. However, disclosure only will not lead to the necessary reform of the financial sector the EU needs to respond to the sustainability challenges in society. The EU should be more ambitious and set up requirements to ensure investors carry out due diligence to incorporate sustainability risks in their investment decisions. Investors need to be able to identify whether the assets or companies they are investing in will have any negative impacts on sustainable development and then prevent and mitigate those impacts. Investors have very sophisticated systems for managing and mitigating financial risk - now they need to do the same for sustainability risks. While an ever-increasing group of mainstream investors is integrating sustainability within their internal decision-making[ii], many others are failing to do so. The DSR Regulation should ensure all investors are required to carry out due diligence as part of their risk management systems.

What is "Due Diligence" and why should investors do it?

Due diligence describes the processes investors use to systematically manage sustainability risks. Due diligence encompasses a range of different processes, specific to each investor, and together they add up to a systematic approach to sustainability risk management. In 2017, the OECD agreed with a range of institutional investors on a definition and explanation of due diligence for investors, defining it as: **the ongoing process through which investors can "identify, prevent, mitigate and account for how they address their actual and potential adverse impacts as an integral part of business decision-making and risk management systems**"[iii]. We suggest that the EU uses this definition to reinforce consistency and align with existing market practice.

Due diligence has long been used by companies and their lawyers to describe a range of investigative processes carried out to identify risks *to* a company before entering into a business transaction. However, in connection with sustainability risks, the term "due diligence" has taken on a whole new meaning: it is used to describe the processes to **identify, and *prevent,mitigate and account for* risks and impacts** created ***by* the company** across a full range of **environmental, social and governance (ESG) /sustainability issues rather than risks *to* the company and the investor**. Due diligence is an important feature in the UN Guiding Principles on Business and Human Rights (UNGPs) and the OECD Guidelines on Multinational Enterprises (OECD Guidelines).

There is substantial overlap between what investors should do under the DSR Regulation and due diligence as defined by these international standards. However, the DSR Regulation proposal does not explicitly require investors to carry out due diligence, but rather relies on mandatory disclosure of the processes implementing a form of due diligence. By requiring investors to carry out due diligence, the EU would take a much bigger steps towards ensuring the financial sector contributes to managing impacts on people and the environment and not just impacts on itself. It will help improve consistency among investors and coherence with other related EU legislation, for example, the EU Directive on Disclosure of Non-Financial Information that is grounded in the due diligence concept, and forthcoming work on corporate governance under the FSGAP, Action 10.

Why should investors do due diligence?

There are a number of reasons why due diligence benefits investors' financial "bottom line":

- Achieving **higher risk adjusted returns:** There is an increasingly wide range of research documenting the correlation between corporate attention to ESG risk/impact and corporate financial performance[iv].
- **Risk management measure**: to reduce the probability of ESG risks impacting financially on investment portfolios, to respond quickly if problems arise, and to avoid potential complicity in unlawful or unsustainable activities.
- **Beneficiaries** are increasingly demanding to know whether investors are managing their money in line with their values
- **Increased reporting requirements** on how investors are managing ESG issues; they therefore need a comprehensive risk management system including due diligence to be able to gather and understand how they are managing ESG issues

What due diligence are investors already doing?

Investors are increasingly using a range of approaches to address sustainability risks, all of which form part of due diligence processes to identify, prevent, mitigate and account for risks and impacts. The key points to consider are whether those approaches manage risk to the environment and people as well as to the investor, and the quality of the processes.

- **Exclusionary screening**: Excludes companies, sectors or countries involved in activities that do not align with the moral values of investors or with global standards around human rights, labour practices, the environment and anti-corruption.
- **Positive screening**: Tilts portfolio towards: Best in class: companies outperforming peers in ESG measures, ESG momentum: companies improving ESG measures more quickly than peers or Thematic investing; companies solving specific ESG challenges (climate change, gender diversity, etc.)
- **Integration:** Integrating ESG issues into investment analysis and decision-making using a range of strategies (such as fundamental, quantitative, smart beta or passive strategies). Investment decisions are made considering all material factors, including ESG factors[v].
- **Active Ownership:** Entails engaging with companies and voting company shares on a variety of ESG issues to initiate changes in behaviour or in company policies and practices[vi].

What is key objective of due diligence?

To achieve the EU's climate and sustainable development objectives, the investment process must drive companies towards mitigating their climate change and other sustainability impacts on the ground. Therefore, sustainability risks need to considered at all stages in the investment value chain, down to identifying and managing risks and impacts where they happen.

In order to be able to inform end-investors about sustainability risks & how they are managed, the other steps need to be in place →

The draft DSR Regulation currently focuses only on this level, without being specific about the need to drive attention to the risks and impacts on the ground →

Investors must be clear that the investee company should prevent, mitigate & report risks and impacts to the environment/society& to itself →

Investee companies should carry out their own due diligence to identify, prevent and mitigate impacts on the environment & people on the ground – this is where sustainability concerns originate so this is where addressing them starts →

Figure 1: The Need to Address Sustainability Risks at Every Level

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What are the five steps in due diligence?[1]

Drawing on the OECD Guidance, "due diligence" for investors involves a six-step approach to ensure these processes are effective:

1. **Embedding** attention to sustainability into relevant investor **policies, strategies and management systems**;
2. **Identifying** actual and potential (risks) adverse impacts on sustainability within investment portfolios and potential investments;
3. **Seeking to prevent or mitigate adverse impacts, including by using leverage** to influence investee companies causing adverse impacts **to prevent or mitigate** those impacts,
4. **Accounting for** how adverse impacts are addressed, by: (i) **tracking performance** of the investor's own performance in managing sustainability risks and impacts in its portfolio; and (ii) by **communicating results**, as appropriate;
5. Having processes in place to **enable remediation** in instances where an investor has caused or contributed to an adverse impact.

[1] *The OECD has issued several sets of guidance on applying the OECD Guidelines for Multinational Enterprises and in particular on the due diligence steps in the Guidelines. Helpfully, it developed guidance, together with institutional investors, specifically targeted to applying the Guidelines to investments - "Responsible business conduct for institutional investors: key considerations for due diligence under the OECD Guidelines for Multinational Enterprises, (2017). The OECD more recently issued general guidance on due diligence - OECD Due Diligence Guidance for Responsible Business Conduct (2018) that provides additional guidance on the due diligence process for all sectors. The general due diligence guidance uses a six-step process instead of the five-step process in the institutional investor guide. The general due diligence guidance did not add a step - it simply split out the step on "accounting" for actions taken that appears in the institutional investor guidance into its two sub-steps ("tracking" and "communicating") to provide more detail on each step. There is no substantive difference between the steps in the two guidance documents and it is expected that every company, including investors, will adapt and incorporate the steps into their own management systems.*

Annex: Example Investor Due Diligence Questions for a Forest or Agribusiness Investment

This annex provides examples of the kinds of questions that an investor can ask as part of its due diligence processes when investing in a forest or agribusiness investment[vii]. This due diligence questionnaire was developed by Rainforest Action Network and demonstrates in practice how possible it is for investors to carry out necessary investigations to understand the key impacts a business (and a sector) may have on the ground. Through this information, the company and the investor will be better placed to understand what needs to be done to prevent or mitigate these negative impacts – and potentially also create positive impacts.

<table>
<tr><td>Risk Identification and Exposure</td><td>
How does the company identify ESG risks in its forest-risk commodity supply chain?
Has the company mapped its supply chain?
Has it mapped its total land-bank / concession areas?
Does it operate in / source from countries / areas with a high risk of the following?
corruption
illegal logging
deforestation
land tenure conflicts
child and forced labour
presence of armed groups and / or conflict
Are any of the following affected by its supply chain activities?
High Carbon Stock (HCS) forests, High Conservation Value (HCV) areas and peatlands
Indigenous and customary rights-holders within the company's / suppliers' concessions
International Labour Organization (ILO) core labour rights
Does the company or its suppliers have legally acquired permits to use the land (including recognition of indigenous and / or customary tenure rights)? Can they prove they have acquired the free, prior and informed consent from potentially affected communities for the project to go ahead?
What are the company's annual greenhouse gas emissions related to forest-risk commodities, including land use and land cover change, especially on peat?
Has the company (or its subsidiaries / parent entities) been involved in any significant legal claims, complaints, or disputes?
What percentage of the company's revenue is dependent on forest-risk commodities?
</td></tr>
<tr><td>Risk Management</td><td>
Does the company have a global responsible sourcing policy for forest risk commodities? Is it committed to NDPE[viii]? Does it have a time-bound implementation plan to comply with its policy? How is this supported by internal management systems?
How does the company conduct due diligence on its supply chains and ensure supplier compliance with its policy? Does it identify suppliers of all raw materials and assess ESG risks and impacts at a company group level?
Does the company have clear & credible action plans for addressing the following issues in its own plantations and/or its upstream supply chains?
</td></tr>
</table>

	○ Protection and restoration of HCS forests, HCV areas and peatland ecosystems, including those damaged by past operations? ○ Protection of rare and endangered species. ○ Free, Prior and Informed Consent of all affected Indigenous Peoples and communities with legal or customary rights. ○ ILO core labour rights, including child labour, forced labour, human trafficking, and freedom of association. ○ Conflicts with local communities over land tenure and use of resources. , including guidelines on engagement with dissenting voices to ensure their protection from attacks/threats • Does the company have a system to track and demonstrate progress in relation to problem issues, on an (at a minimum) annual basis? • Does the company have a system to track and monitor the origin of raw materials for the selected commodities? • What percentage of the supply is traceable to mills and to origin (plantation estates / concession)? • Does the company have a long-term sustainable and responsible supply of commodities to meet operational needs?
Transparency and Risk Assurance	• Does the company publish supply chain maps, including all suppliers and associated plantation estates/concessions? • Does the company disclose information on ESG risks in its forest risk commodity supply chain and how it monitors its impacts? • Does the company report on the implementation of its policy? Are implementation outcomes independently monitored and verified by a third party? Does it publish documentation to substantiate supply chain claims? • What is the percentage of supply and/ or suppliers that are third party verified and/or certified? • Are corrective actions immediately taken and/or supply contracts terminated when significant nonconformities or unauthorized activities are identified? • What grievance process does the company have and is it accessible to affected stakeholders? Does it publicly disclose its grievances and corrective actions taken? • Does it actively engage with civil society organizations as part of its stakeholder engagement? What external initiatives and activities does the company participate in to support implementation of its policy? • Are whistle-blower mechanisms, policies and protections in place?

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[i] COM (2018) 354 final

[ii] As evidenced, for example by the rapid growth in the membership of the UN backed Principles for Responsible Investment, which has grown from 100 members when it started in 2006 to 1800 members currently.

[iii] Building on the OECD (2017) Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises: https://www.oecd.org/corporate/RBC-for-Institutional-Investors.pdf, as well as Human Rights Due Diligence, as described by the UN Guiding Principles of Business and Human Rights:

[iv] See the compilation of meta-evaluations and other research on the financial value of incorporating sustainability in Annex Three of Aviva Investors, "Investment Research: Time for a Brave New World," (2017). (Annex Three: Academic Evidence of ESG and Performance).

[v] As noted in a recent PRI paper: A practical guide to ESG integration for equity investing (2016)

[vi] State Street Advisers, "Understanding & Comparing ESG Terminology," (2017) and CFA Institute, "Environmental, Social and Governance Issues in Investing: A Guide for Investment Professionals," (2015)

[vii] Rainforest Action Network, Every investor has a responsibility: a forests and finance dossier (2017) page 10.

[viii] Corporate commitments to "No Deforestation, No Peatland, No Exploitation