RESPONSIBLE BUSINESS CONDUCT

Responsible business conduct for institutional investors

Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises

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FOREWORD

This paper, *Responsible Business Conduct for Institutional Investors: Key Considerations for Due Diligence under the OECD Guidelines for Multinational Enterprises*, helps institutional investors implement the due diligence recommendations of the OECD Guidelines for Multinational Enterprises in order to prevent or address adverse impacts related to human and labour rights, the environment, and corruption in their investment portfolios. The paper identifies key actions for asset managers and asset owners under each step of the due diligence process and includes discussion of key considerations, such as challenges, existing practices, or regulations specific to the investment sector which may impact due diligence approaches.

By carrying out due diligence in line with the OECD Guidelines, investors will not only be able to avoid negative impacts of their investments on society and the environment, but also avoid financial and reputational risks, respond to expectations of their clients and beneficiaries and contribute to global goals on climate and sustainable development. Increasing, failing to consider long-term investment value drivers, which include environmental, social and governance issues, in investment practice is seen to be a failure of fiduciary duty. Since the introduction of the Paris Climate Agreement in 2015, investors have been facing increasing expectations to manage climate risks in their portfolios. International financial institutions have also signalled plans to mobilise USD 400 billion towards achieving the Sustainable Development Goals (SDGs). Strong due diligence processes can help ensure that investments are put towards projects and companies that behave responsibly and ultimately help achieve the objectives of the SDGs.

This paper has been developed through close consultation with a multi-stakeholder advisory group of over 50 representatives from the financial sector, including leading investment institutions, government, civil society, international organisations and other experts. It has also benefited from input provided by investment practitioners during expert working sessions in London on 23 October 2015 and New York on 23 February 2016. The OECD Working Party on Responsible Business Conduct approved the paper on 23 January 2017, followed by the OECD Investment Committee on 8 February 2017.

This paper is part of the work the OECD undertakes to clarify expectations of responsible business conduct in the context of enterprises operating in the financial sector. The OECD has also developed tailored guidance to help enterprises carry out due diligence in other sectors, specifically: extractives, and particularly minerals from conflict affected and high-risk areas; garment and footwear; and agriculture.

TABLE OF CONTENTS

Boxes

Tables

Figures

INTRODUCTION

Background

The OECD Guidelines for Multinational Enterprises (hereafter the "OECD Guidelines"), are the most comprehensive international instrument on responsible business conduct (RBC) (Box 1).

Box 1. About the OECD Guidelines for Multinational Enterprises

The OECD Guidelines for Multinational Enterprises (hereafter "OECD Guidelines") are one of four parts of the 1976 OECD Declaration on International Investment and Multinational Enterprises, (hereafter "Declaration"). In the Declaration, Adherents recommend that multinational enterprises (MNEs) observe the principles and standards set out in the OECD Guidelines, which aim to ensure an open and transparent international investment environment and to encourage the positive contribution of MNEs to economic and social progress. The OECD Guidelines, which have been revised several times, most recently in 2011, provide voluntary principles and standards for RBC, consistent with applicable laws and internationally recognised standards, although Adherents make a binding commitment to implement them. There are currently 47 Adherents to the Declaration - 35 OECD countries and 12 non-OECD countries. The understanding that the OECD Guidelines are voluntary has implications for the use of key terms such as 'application' and 'scope' of the OECD Guidelines. The OECD Guidelines have been revised several times, most recently in 2011.The OECD Guidelines are the most comprehensive set of government-backed recommendations on what constitutes RBC and cover all major RBC areas, such as: information disclosure, human rights, employment and industrial relations, environment, combatting bribery and corruption, consumer interests, science and technology, competition, and taxation. They are fully aligned with the recommendations of the UN Guiding Principles for Business and Human Rights (UNGPs). They include an expectation that businesses avoid and address adverse impacts that they cause, or contribute to, and seek to prevent or mitigate adverse impacts directly linked to their products, operations or services by a business relationship. To that effect, businesses carry out due diligence for adverse impacts in their own operations and throughout their business relationships.

Pursuant to the Decision of the Council on the OECD Guidelines for Multinational Enterprises, each Adherent is required to set up a National Contact Point (NCP) to further the effectiveness of the OECD Guidelines by undertaking promotional activities, handling inquiries, and contributing to the resolution of issues that arise relating to implementation of the OECD Guidelines.

While the OECD Guidelines apply to all industries and sectors of the economy, they do not make direct reference to the financial sector directly. Some of the language used in the OECD Guidelines is more targeted to suppliers and buyers in supply chains (e.g. in manufactured products), rather than investors and investee companies in an investment value chain. The relationship between an investor and an investee company is qualitatively different from the relationship between purchaser and supplier companies. In the former, there are no direct operational or contractual ties between the two, but the investor can seek to influence the investee through ownership. However recommendations of the OECD Guidelines apply across all sectors, including the financial sector and commercial investment enterprises.

The OECD project on Responsible Business Conduct in the Financial Sector supports financial sector enterprises in implementing the OECD Guidelines by elaborating practical and relevant approaches for different types of financial service providers to carry out due diligence as recommended in the OECD Guidelines, building on their existing practices and reflecting practical realities, regulations and special characteristics of the sector. This paper represents one outcome of this project and discusses key considerations for institutional investors, as a category of financial service provider, in carrying out due diligence as recommended by the OECD Guidelines.

Objective

This paper provides a resource for institutional investors and their stakeholders to help investors implement the recommendations of the OECD Guidelines along the investment value chain. Specifically, it seeks to assist institutional investors by explaining what due diligence under the OECD Guidelines entails and discussing key considerations for investors at each step of the process.

Due diligence has a specific meaning under the OECD Guidelines that differs from how it is commonly perceived in the context of institutional investment Under the OECD Guidelines, "due diligence" is a process for identifying, preventing, mitigating and accounting for so-called "adverse impacts" on matters covered by the OECD Guidelines (e.g. human rights, labour, environment, bribery and other integrity impacts, etc.). Due diligence under the OECD Guidelines should be continuous and ongoing, and aimed at avoiding and responding to risks related to issues covered in the OECD Guidelines. In the context of investment however, due diligence is generally thought of as a process which is conducted prior to making certain investments or appointment of an asset manager to identify and assess legal and financial risks. Readers of should be aware of different meanings given to the same terms as these can lead to confusion and misunderstanding between investment professionals and stakeholders discussing RBC issues (see also Annex I).

Scope

This paper describes due diligence approaches relevant for institutional investment managers and asset owners. It does not outline specific approaches for entities that facilitate investment (e.g. market research providers, investment banks that provide research on listed companies and execute trades, underwrite new security issuance and provide research for initial public offerings, stock exchanges, index providers etc.). However, it may be a useful reference for these entities as well since the recommendations of the OECD Guidelines are also applicable to them.

Where relevant, this paper seeks to distinguish, between approaches that may be specifically relevant for asset owners and investment managers, as well as specific asset classes, including: public equity (shares in companies listed on a stock exchange); corporate bonds (company debt or loans); private equity (shares in unlisted companies); infrastructure (unlisted funds investing in assets such as airports, roads or renewable energy facilities, or direct investments in these assets); and real estate (unlisted property investment funds, or direct investments in real estate). Annex 3 provides background information on these asset classes. In practice, investors may use a combination of investment strategies and asset classes and the line between these categories may be blurred in some cases. In these situations, a combination of approaches may be used.

Finally, while investment institutions can cause or contribute to adverse impacts through their own activities, just like any other enterprise (e.g. adverse labour impacts with respect to their own employees), this paper focuses on carrying out due diligence with respect to adverse impacts associated with investee companies. (See also *Understanding relationship to impact* in Section 2.3.)

Benefits

Expected benefits of carrying out due diligence under the OECD Guidelines include:

- Increased ability to implement the OECD Guidelines, as well as the UN Guiding Principles on Business and Human Rights (UNGPs) and other relevant frameworks, such as the UN-supported Principles for Responsible Investment (PRI);

- "Knowing and showing" that the investor meets expectations under the OECD Guidelines, and makes a positive contribution to sustainable development;

- Increased ability to meet expectations of clients (in the case of investment managers) and beneficiaries/members (in the case of asset owners such as pension funds) related to RBC standards (e.g. the OECD Guidelines);

- Increased understanding and management of investment risks that may be material (see *Recognising alignments between financial materiality and RBC risks* in Section 2.1).

Nature of this document

This paper is not intended to create new standards of conduct but outlines practical considerations for institutional investors seeking to carry out the due diligence recommendations of the OECD Guidelines, taking into account the complexities of various business relationships, as well as the legal, policy and market contexts in which investors operate. The scope and application of the term "business relationships in the financial sector" under the OECD Guidelines has previously been examined by the OECD Working Party on Responsible Business Conduct (Box 3).

The approaches in this paper are without prejudice to legal obligations of institutional investors, including in the context of corporate governance obligations and fiduciary duty or the prudent person principle. Under the OECD Guidelines "[o]beying domestic laws is the first obligation of enterprises […]. In countries where domestic laws and regulations conflict with the principles and standards of the OECD Guidelines enterprises should seek ways to honour such principles and standards to the fullest extent which does not place them in violation of domestic law."[1]

Specific approaches to implementing the recommendations of the OECD Guidelines may vary across enterprises. Financial institutions should consider the appropriate manner in which observance of the OECD Guidelines could successfully be implemented in their business strategies. The approaches suggested in this paper aim to help investors observe the OECD Guidelines.

Structure

The introduction of this paper provides context on the background, objective, scope and nature of this paper as well as potential benefits to investors of carrying out due diligence.

Section 1 provides a high-level overview of the main recommendations of the OECD Guidelines.

Section 2 the core of this paper, describes the key components of due diligence and considerations for investors to implement the OECD Guidelines and carry out due diligence. Each

[1] OECD Guidelines for Multinational Enterprises (2011), Chapter I, Concepts and Principles, paragraph 2

sub-section corresponds to a different step of the due diligence process or important processes to support due diligence, and provides a list of examples of recommended actions under each step, adapted specifically to the context of investors. These include:

- RBC policy and management systems
- Identifying actual and potential adverse impacts
- Seeking to prevent and mitigate actual and potential adverse impacts
- Accounting for how adverse impacts are addressed by (a) tracking due diligence and progress; and (b) and communicating on efforts and results through public reporting and engagement with impacted stakeholders as appropriate
- Remediation where an enterprise is causing or contributing to an adverse impact

Each subsection also includes a description of key considerations for implementing these actions in the context of investment and, where relevant, an overview of how these actions may vary in practice across asset owners and managers and across different investment classes and strategies.

Finally, the paper includes several annexes to provide additional background on: 1) distinctions in terminology used in the OECD Guidelines and in the context of institutional investment generally (Annex I); 2) common investment value chains (Annex II); 3) different investment strategies and asset classes (Annex III).

These annexes are intended to provide explanatory information for stakeholders such as OECD National Contact Points (NCPs),[2] policy-makers, workers, trade unions and civil society who are not investment practitioners but may be interacting with issues of RBC in the context of institutional investment.

[2] In accordance with the Decision of the Council on the OECD Guidelines for Multinational Enterprises, as amended in 2011, National Contact Points are set up to further the effectiveness of the Guidelines by undertaking promotional activities, handling enquiries and contributing to the resolution of issues that arise relating to the implementation of the Guidelines in specific instances. This paper may be used by National Contact Points to promote the OECD Guidelines but is not intended to serve as a basis for the submission of specific instances. See also OECD Guidelines, Commentary on the Implementation Procedures of the OECD Guidelines for Multinational Enterprises, paragraph 25.

1. UNDERSTANDING KEY RECOMMENDATIONS UNDER THE OECD GUIDELINES

This section provides an overview of the principal recommendations to enterprises under the OECD Guidelines. These recommendations are relevant for all sectors of the economy, including institutional investors. However, their application in practice will vary according to the characteristics of the enterprise implementing them (e.g. its sector, size, risks). Where relevant, the general descriptions of the Guideline's recommendations are followed by a discussion of the broad implications for institutional investors. Section 2 provides additional detail regarding the application of the recommendations in the context of institutional investment, and provides explanation of potential approaches specific to asset owners and managers.

1.1 "Business relationship" under the OECD Guidelines

The OECD Guidelines were revised in 2011 to introduce new recommendations on RBC, aligned with the UNGPs. The OECD Guidelines state that enterprises should:

- "Avoid causing or contributing to adverse impacts on matters covered by the Guidelines through their own activities and address those impacts where they do occur"; and

- "Seek to prevent or mitigate adverse impacts where they have not contributed to that impact, when the impact is nevertheless directly linked to their operations, products or services by a business relationship. This is not intended to shift responsibility from the entity causing an adverse impact to the enterprise with which it has a business relationship."[3]

In the context of this paper, responsible business conduct risk, or "RBC risk", refers to a risk of adverse impacts on issues covered by the OECD Guidelines (Box 2). Investors often use the term "ESG risk". "RBC" and "ESG" criteria both relate to environmental, social and governance considerations. However, RBC risk refers specifically to the risk of adverse impacts with respect to the issues covered by the OECD Guidelines — in other words, the risks to society and the environment, not to the company itself.[4] There may be some difference in scope between ESG and RBC risks, so investors should seek to understand the content of Guidelines and assess the differences to ensure they understand the overlaps and differences.[5] (See also Box 2 and Annex I).

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3 OECD Guidelines for Multinational Enterprises, Chapter II, paragraphs 11-12

4 Identification of ESG risk is often used by investors as a measure to calculate costs and potential impacts on share price whereas identification of RBC risk is a component of due diligence and used to trigger proactive action to respond to those risks.

5 For an overview of the OECD Guidelines, see Responsible Business Conduct Matters, http://mneguidelines.oecd.org/MNEguidelines_RBCmatters.pdf

Box 2. Adverse Impacts under the OECD Guidelines for Multinational Enterprises

The OECD Guidelines set out principles and standards on RBC, as well as the steps that enterprises are expected to take to avoid and address involvement with adverse impacts across a range of societal concerns. These include, inter alia, issues related to sustainable development, disclosure, human rights, workers and industrial relations, the environment, good governance and ethical conduct in the form of combating bribery, bribe solicitation and extortion, and consumer interests. The OECD Guidelines chapters provide more detail on the kinds of potential impacts (risks) and actual impacts enterprises should avoid and address. The starting point therefore for any investor seeking to implement the OECD Guidelines should be to read them in order to understand the full range of issues covered in each chapter, against which the investor would conduct due diligence on its portfolio.

For many enterprises, the term "risk" means primarily risks to the enterprise – financial risk, operational risk, reputational risk, etc. Enterprises are concerned with their position in the market, vis-à-vis their competitors, their image and long-term existence, so when they look at risks, it is typically risks to themselves. The OECD Guidelines however are about the risks of adverse impacts enterprises create, contribute to, or to which they are directly linked (and the consequences for society and the environment if those risks materialise) – so it is an outward facing approach.[1]

[1] See OECD Guidelines for Multinational Enterprises (2011), Commentary on General Policies, paragraph 14.

The expectation of the OECD Guidelines that enterprises *seek to prevent or mitigate impacts* directly linked to their operations, products or services through business relationships increased the scope of enterprise's responsibility beyond their own operations and activities to their value chains as well. The OECD Guidelines specify that this recommendation is not intended to shift responsibility from the entity causing or contributing to an adverse impact to the enterprise with which it has a business relationship.[6] This is an important limit on the responsibility of companies vis-a-vis their business relationships. It recognises that enterprises may not be able to address themselves adverse impacts caused or contributed to by another entity, but nonetheless should seek to influence or encourage that entity to prevent or mitigate the adverse impacts, based on prioritisation (in the context of investors, see Sections 1.3 and 2.3 for more information).

Specifically, the OECD Guidelines recommend enterprises, "acting alone or in co-operation with other entities, as appropriate, *to use their leverage to influence the* entity causing the adverse impact to prevent or mitigate that impact."[7] Leverage is considered to exist "where the enterprise has the ability to effect change in the wrongful practices of the entity that causes harm."[8] In practice this is meant to include a broad range of practical measures that enterprises may undertake themselves and together with others.

6 OECD Guidelines for Multinational Enterprises, Chapter II, paragraphs 11-12

7 OECD Guidelines for Multinational Enterprises, Chapter II paragraph 12, Commentary on General Principles, paragraph 20; Chapter IV paragraph 3, Commentary on Human Rights, paragraph 43. Leverage under the OECD Guidelines has a different meaning than in the context of investment, where it can refer to the state of financing of a firm rather than the act of influencing or encouraging (see also Annex I).

8 OECD Guidelines for Multinational Enterprises, Chapter II, Commentary on General Principles, paragraph 19.

Therefore, under the OECD Guidelines, each enterprise in a value chain has responsibility for their own actions and impacts. Enterprises or, in this case, investors, are not generally responsible for the actions of the entity which with they have a business relationship but rather for their own conduct, including their efforts to influence or encourage that entity. The expectation that enterprises seek to prevent or mitigate impacts linked to their activities by business relationships is distinct from, and complementary to, the responsibilities of the entities causing the adverse impacts. Essentially, an enterprise's efforts should reinforce the efforts to respond to responsibilities of the entities in their value chain who may be causing or contributing to the impacts, rather than duplicate or subvert them.

Business relationship responsibilities in the context of institutional investors

The OECD has previously concluded in a paper on the scope and application of business relationships in the financial sector that a relationship between an investor and investee company including a minority shareholding can be considered a "business relationship " under the OECD Guidelines.[9] (See Box 3 for relevant language on this issue.) Hence investors, even those with minority shareholdings, may be directly linked to adverse impacts caused or contributed to by investee companies as a result of their ownership in, or management of, shares in the company causing or contributing to certain social or environmental impacts. In other words, the existence of RBC risks (potential impacts) or actual RBC impacts *in an investor's own portfolio* means, in the vast majority of cases there is a "direct linkage" to its operations, products or services through this "business relationship" with the investee company.[10] (See also *Understanding relationship to impacts* in Section 2.3)

As a result, investors are expected to consider RBC risks throughout their investment process and to use their so-called "leverage" with companies they invest in to influence those investee companies to prevent or mitigate adverse impacts. However, investors are not responsible for addressing those adverse impacts themselves. (See also Section 2.3.)

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9 See "Scope and applications of 'business relationships' in the financial sector under the OECD Guidelines for Multinational Enterprises". This interpretation has been supported by experts on the OECD Guidelines and UNGPs who have reached the same conclusions. See "Expert letters and statements on the application of the OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights in the context of the financial sector", 2014. These papers are available at http://mneguidelines.oecd.org/rbc-financial-sector.htm.

10 In some limited circumstances, adverse impacts caused by companies associated with an investment will not be directly linked to an investor's own operations, products or services (e.g. their own portfolio). For example, in circumstances where an investor buys shares or other equity in a joint venture (JV) company, it will have an investor-investee business relationship with that JV company. However, if one of the JV partners is causing/contributing to adverse impacts (e.g. forced labour) through a separate, unrelated project (i.e. which the investor has no investment, ownership or other connection with), the investor is not directly linked to the forced labour impacts through its investment in the JV. However since there may be a risk of similar behaviour in the projects operated by the JV company, if the investor becomes aware of this situation, it should trigger 'heightened ongoing due diligence' on the JV.

Box 3. Scope and application of "business relationships" in the financial sector under the OECD Guidelines for Multinational Enterprises

The paper Scope and application of 'business relationships' in the financial sector under the OECD Guidelines for Multinational Enterprises was approved by the OECD Working Party on Responsible Business Conduct at its meeting on 20 March 2014. The paper includes the following analysis:

- "[S]ince the Guidelines are recommendations and not legally enforceable [..] open-ended descriptions of what is meant by the term 'business relationships' can be used. Since the Guidelines are recommendations, and adhering countries are committed to their widest possible observance, a precise definition is not necessary.''

- ''The Guidelines contain an expansive description of the term 'business relationships'. Since the Guidelines operate with non-exhaustive descriptions of key terms, their possible use or "scope" is not limited by sector, to certain kinds of enterprises or to certain kinds of business relationships. A minority shareholding can therefore in principle be seen as a business relationship under the Guidelines, even if this is not spelled out in the text of the Guidelines itself.''

- ''Although observance of the Guidelines by enterprises is voluntary and not legally enforceable, this does not reduce the expectations that the Guidelines should be observed. Financial institutions should consider the appropriate manner in which observance of the Guidelines could successfully be implemented in their business strategies.''

"As concerns the issue of financial institutions in their role as minority shareholders, including sovereign wealth funds and central banks, due regard must be paid to the sector-specific characteristics and practical and legal concerns and restrictions. This is important for our understanding of how the Guidelines could be observed within the financial sector."

In some jurisdictions, investors may not be permitted to formally "influence" the boards or management of their investee companies due to anti-trust concerns. However, even in these cases investors can nevertheless promote RBC through engagement with their investee companies to express issues and concerns regarding RBC risks, as is already common practice. The OECD Guidelines recognise that the first obligation of all enterprises is to obey domestic law and therefore, where recommendations of the OECD Guidelines are in conflict with local regulations, they should make efforts to honour the recommendations of the OECD Guidelines to the fullest extent which does not put them in violation of domestic law. However, the OECD Guidelines recognise that their recommendations extend beyond the law in many cases.[11]

The approaches investors can employ to use their leverage to influence companies they invest in are broad in scope. These are not limited to direct engagement with investee companies but could also involve, as appropriate, directing capital towards responsible investee companies over time, involvement in industry initiatives targeting certain RBC risks, collective action on specific geographic or company-specific issues, etc. What is appropriate will vary according to the characteristics of an investor, the investment strategy (e.g. active vs. passive investments) and relevant regulatory obligations. It is important that such leverage is also exerted within the framework of good corporate governance (Box 4). These issues are discussed in more detail in Section 1.2.

[11] OECD Guidelines for Multinational Enterprises (2011), Chapter I Concepts and Principles, paragraph 2

Box 4. Business relationships in listed equities and the G20/OECD Principles of Corporate Governance

The OECD Guidelines recommend that enterprises apply good corporate governance practices drawn from the G20/OECD Principles of Corporate Governance.[1] The principles call on the board of the parent entity to ensure the strategic guidance of the enterprise, the effective monitoring of management and to be accountable to the enterprise and to the shareholders, while taking into account the interest of stakeholders.

A company is a separate legal entity from its shareholders. This entity is managed by a board appointed by – and representing - all the shareholders. In turn, the board has an independent control function towards the managers of the company on behalf of all the shareholders. Likewise, the general assembly is the platform for ensuring that the voice of all the shareholders may be heard in decision-making. As company management and boards must act on behalf of all shareholders, a minority shareholder cannot direct the company to take particular actions.

The G20/OECD Principles of Corporate Governance states that: "As a practical matter […] the corporation cannot be managed by shareholder referendum. The shareholding body is made up of individuals and institutions whose interests, goals, investment horizons and capabilities vary. Moreover, the corporation's management must be able to take business decisions rapidly. In light of these realities and the complexity of managing the corporation's affairs in fast moving and ever changing markets, shareholders are not expected to assume responsibility for managing corporate activities. The responsibility for corporate strategy and operations is typically placed in the hands of the board and a management team that is selected, motivated and, when necessary, replaced by the board.''[2]

However the G20/OECD Principle of Corporate Governance also recognise that ''[t]he effectiveness and credibility of the entire corporate governance framework and company oversight depend to a large extent on institutional investors' willingness and ability to make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest."

"For institutions acting in a fiduciary capacity, such as pension funds, collective investment schemes and some activities of insurance companies, and asset managers acting on their behalf, the right to vote can be considered part of the value of the investment being undertaken on behalf of their clients. Failure to exercise ownership rights could result in a loss to the investor who should therefore be made aware of the policy to be followed by the institutional investors."[3]

''Voting at shareholder meetings is, however, only one channel for shareholder engagement. Direct contact and dialogue with the board and management, represent other forms of shareholder engagement that are frequently used […] Such a dialogue between institutional investors and companies should be encouraged."[3]

In sum, while the G20/OECD principles of corporate governance recognise that investors do not have operational control over their investee to companies, it also recognised that they have a responsibility to exercise their shareholder rights and ownership function through engagement with their investee companies.

Notes

1 The G20/OECD Principals for Corporate Governance focus on publicly traded companies, both financial and non-financial. To the extent they are deemed applicable, they might also be a useful tool to improve corporate governance in companies whose shares are not publicly traded.

2 G20/OECD Principals for Corporate Governance (2015), Chapter II: The rights and equitable treatment of shareholders and key ownership functions.

3 G20/OECD Principals for Corporate Governance (2015), Chapter III. Institutional investors, stock markets, and other intermediaries.

1.2 Carrying out due diligence under the OECD Guidelines

As noted above, the OECD Guidelines set out principles and steps that enterprises are expected to take to avoid and address involvement with adverse impacts across a range of societal concerns. The OECD Guidelines expect enterprises to carry out "due diligence" to avoid and address their involvement with such adverse impacts. Due diligence is understood as the process through which enterprises 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" (emphasis added).[12] Due diligence is a key aspect of RBC as it enables businesses to "know and show" that they are acting responsibly under the OECD Guidelines.

In line with the OECD Guidelines, due diligence involves: 1) identifying actual and potential adverse impacts; 2) preventing or mitigating adverse impacts; and 3) accounting for how adverse impacts are addressed, by (a) tracking performance and (b) communicating results. Given the flexibility foreseen in the OECD Guidelines for companies to adapt and tailor the recommendations taking into consideration a number of factors, the communication aspect of "account" plays an important role, whereby companies publicly report or communicate on how they have addressed their adverse impacts in order to demonstrate their implementation of the OECD Guidelines – i.e. "showing" what they are doing.

Embedding RBC into relevant enterprise or investment policies and management systems helps to ensure that due diligence processes are effective and credible. Therefore, getting this right is an important pre-cursor to carrying out due diligence.

Having processes in place to enable remediation in instances where an enterprises has caused or contributed to an adverse impact is also a supporting element necessary to enable and complement due diligence.

Additionally, stakeholder engagement is an independent expectation of responsible business conduct and also an important process for supporting due diligence. This is discussed further below.

Due diligence is an on-going, proactive and reactive, and process-oriented activity; it is to be carried out throughout the entire life-cycle of operations, products and services because circumstances change and so will adverse impacts. This means that due diligence should not be limited to an initial investigation of a potential business relationship or transaction, but should also be applied proactively through establishment of systematic measures to identify RBC risk and prevent or mitigate potential adverse impacts, as well as through on-going monitoring of business relationships and related operations.

Under the OECD Guidelines, "the nature and extent of due diligence, such as the specific steps to be taken, should be appropriate to a particular situation and will be affected by factors such as the size of the enterprise, context of its operations, the specific recommendations in the OECD Guidelines, and the severity of its adverse impacts."[13]

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12 OECD Guidelines for Multinational Enterprises, Commentary on General Policies, paragraph 14.

13 OECD Guidelines for Multinational Enterprises, Chapter II, Commentary, paragraph 15

Due diligence for adverse impacts associated with investee companies

The core of this paper, the following section, focuses on explaining due diligence approaches that may be used in the context of institutional investment with respect to adverse impacts associated with investee companies. Importantly this does not mean that investors are expected to carry out due diligence on behalf of their investee companies – each investee company should be carrying out its own due diligence as well. Instead, they are expected to undertake due diligence to identify, prevent and mitigate RBC risk and impacts in their own portfolios.

Due diligence with respect to institutional investors will involve a number of practical steps as well as supporting measures to ensure due diligence is effective:

- embedding RBC into relevant policies and management systems *for investors;*
- identifying actual and potential adverse impacts *within investment portfolios and potential investments*;
- as appropriate, *using leverage to influence investee companies* causing an adverse impact to prevent or mitigate that impact and;
- accounting for how adverse impacts are addressed, by (a) tracking performance *of the investor's own performance in managing RBC risks and impacts in its portfolio* and (b) communicating results, as appropriate;[14]
- having processes in place to enable remediation in instances where an investor has caused or contributed to an adverse impact.

Furthermore due diligence processes should be complementary across business relationships. As long as all entities in the investment value chain carry out due diligence and communicate about it to the other entities in the value chain who are relying on that due diligence, then the due diligence does not need to be duplicated. However, it will be for each entity in the value chain to judge the quality and reliability of due diligence undertaken by others in the value chain and whether supplementary action is needed. For example:

- Identification of risks through screening of investment portfolios does not need to be done by both asset managers and asset owners, as long as one party is effectively and appropriately conducting risk identification and communicating to the other party.
- If an investor has investments in companies operating in high- risk sectors that can demonstrate they are adequately carrying out due diligence, the investor may not need to further identify risks with regard to those companies. Reporting on due diligence is increasingly becoming a regulatory requirement for companies operating in or from leading economies. [15]

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[14] See Section 2.4 for more information on appropriate communication.

[15] See, for example, the *EU Directive on disclosure of nonfinancial and diversity information* which calls for corporate reporting on supply chain due diligence, among other issues, the 2015 UK Modern Slavery Act which mandates that companies report on their due diligence processes to manage risks of slavery and human trafficking within their operations and supply chains; Section 1502 of the US Dodd-Frank Act which provides that companies must report on whether they source certain minerals from conflict areas.

In the context of investment the nature and extent of due diligence also may depend on the nature of an investment entity, the size and nature of its investment portfolio and relationship to specific investments (e.g. the ownership share in the company, tenure of investment, access to relevant information and the likelihood that meaningful influence may be exercised). Due diligence approaches may vary according to the type of institutional investor in question as well as the type of asset class and investment strategy in question. Differences in due diligence approaches according to asset class and investment strategy are explored further in Section 2.

1.3 Prioritisation based on risk under the OECD Guidelines

It may not always be possible for enterprises to identify and respond to all adverse impacts associated with their business relationships immediately. In this respect, the OECD Guidelines also clarify that where "enterprises have large numbers of suppliers, they are encouraged to identify general areas where the risk of adverse impacts is *most significant* and, based on this risk assessment, prioritise suppliers for due diligence".[16] Therefore the OECD Guidelines expect enterprises to prioritise their due diligence efforts using a "risk-based approach".

The significance, or severity, of an adverse impact is understood as a function of its scale, scope and irremediable character.

- **Scale** refers to the gravity of the adverse impact.
- **Scope** concerns the reach of the impact, for example the number of individuals that are or will be affected or the extent of environmental damage.
- **Irremediable character** means any limits on the ability to restore the individuals or environment affected to a situation equivalent to their situation before the adverse impact.

The OECD Guidelines themselves do not attempt to rank the severity of adverse impacts. It is not necessary for an impact to have more than one of these characteristics to be considered 'severe', although it is often the case that the greater the scale or the scope of an impact, the less it is 'remediable'. Severe impacts may include hazardous working conditions that are common in a certain sectors, or extensive environmental degradation which threatens the livelihood and health of local communities.

What constitutes the most severe impacts will be specific to the enterprise, its sector and its business relationships.

A risk-based approach also recognises that enterprises seeking to respect the OECD Guidelines may not be able to implement all of their recommendations at once. Enterprises are thus asked to prioritise the most severe risks and, over time, work towards systematically expanding their application.

While enterprises should prioritise their due diligence based on significance of risk, *how* they respond to identified risks will depend on "practical limitations on the ability of enterprises to effect change in the behaviour of their suppliers[…] Other factors relevant to determining the appropriate

[16] OECD Guidelines for Multinational Enterprises, Chapter II, Commentary, paragraph 16.

response to the identified risks include the severity and probability of adverse impacts and how crucial that supplier is to the enterprise."[17]

Risk-based prioritisation for investors

Investors will often have large numbers of investee companies in their portfolios, or be assessing a wide range of companies for investment and as such, will find prioritisation crucial to identify general areas where the risk of adverse impacts is most significant and, based on this risk assessment, prioritise investee companies for further due diligence. Investor policy on RBC will be important in shaping and communicating a strategy on which risks are prioritised and why. (See also Section 2.1)

Under the OECD Guidelines, investors should prioritise investee companies for due diligence taking into account the severity or significance of adverse impacts, to the extent that such an approach complies with domestic legal obligations, for example on fiduciary duty. (See also *Recognising alignments between financial materiality and RBC risks* in Section 2.1). In addition when considering *how* to respond to identified risks, investors may take into account the importance of the investee company to the investor and potential limitations on leverage over investee companies, in addition to the significance of the adverse impact. (See also *Prioritisation of actions* in Section 2.3).

1.4 Engagement with relevant stakeholders under the OECD Guidelines

Under the OECD Guidelines, enterprises are encouraged to "[e]ngage with relevant stakeholders in order to provide meaningful opportunities for their views to be taken into account in relation to planning and decision making for projects or other activities that may significantly impact local communities."[18] "Stakeholder engagement involves interactive processes of engagement with relevant stakeholders through, for example, meetings, hearings or consultation proceedings. Effective stakeholder engagement is characterised by two-way communication and depends on the good faith of the participants on both sides."[19]

While stakeholder engagement is a key expectation of RBC, it is also an important means of implementing due diligence. Stakeholders themselves can contribute important knowledge to help identify potential or actual impacts on themselves or their surroundings. The values and priorities of impacted stakeholders are vital considerations in evaluating impacts and identifying appropriate avoidance or mitigation steps.

Engagement with stakeholders by investors

Direct stakeholders of institutional investors will include their beneficiaries. These entities should be involved to the extent possible in shaping due diligence approaches and RBC policy. Additionally, stakeholders may include those most impacted by the behaviour of investee companies, although the extent of an investor's engagement with these stakeholders will depend on how due diligence is prioritised. Where appropriate, and where there are significant risk of severe adverse impacts, investors may engage with these stakeholders to help shape their response to the risk (see also Sections 2.2 and 2.3).

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17 OECD Guidelines for Multinational Enterprises (2011), Chapter II, Commentary, paragraph 21.

18 OECD Guidelines for Multinational Enterprises (2011), Chapter II paragraph 14.

19 OECD Guidelines for Multinational Enterprises (2011), Chapter II, Commentary, paragraph 25.

1.5 Remediation under the OECD Guidelines

Under the OECD Guidelines where enterprises are causing or contributing to adverse impacts they are expected to address those impacts. While the focus of the due diligence process is on avoiding adverse impacts, enterprises also need systems and approaches that can provide for, or cooperate in, **providing remedies**, such as, where relevant – fixing the problem, making sure it does not re-occur and providing compensation or rehabilitation for those people or the environment who have suffered harm.

"Some situations require cooperation with judicial or State-based non-judicial mechanisms. In others, operational-level grievance mechanisms for those potentially impacted by enterprises' activities can be an effective means of providing for such processes when they meet the core criteria of: legitimacy, accessibility, predictability, equitability, compatibility with the OECD Guidelines and transparency, and are based on dialogue and engagement with a view to seeking agreed solutions."[20] (See also Section 2.5.)

Remediation and investors

Remediation is an expectation in situations where an enterprise causes or contributes to adverse impacts. In some instances investors may be contributing to impacts caused by their investee companies and may be responsible for remediation. These situations could arise where investors wield significant managerial control over a company, for example, in certain General Partnerships. However, in the context of adverse impacts arising from investee companies, investors will in most instances not cause or contribute to, but only be directly linked to the adverse impact. As a result investors would not be expected to provide remedy, but they should seek to encourage the investee company to do so as a component of their responsibility to seek to prevent and mitigate, based on prioritisation (see also Sections 1.3 and 2.5).

[20] OECD Guidelines for Multinational Enterprises, Chapter IV, Commentary, paragraph 46.

2. IMPLEMENTATION OF THE OECD GUIDELINES IN THE CONTEXT OF INSTITUTIONAL INVESTMENT

2.1 Embedding responsible business conduct in investor policies and management systems

Although embedding RBC into an investment institution's policies and management systems is not a formal component of due diligence under the OECD Guidelines, it helps to ensure that due diligence activities, as envisaged in the OECD Guidelines, are effective and credible. The box below describes actions that investors can take to embed RBC in investor policy and management systems. Investment institutions often have a corporate entity which has a duty to secure reasonable returns for its shareholders and an investment entity which manages assets and has a legal duty to act in the interest of the owners of those assets. To avoid conflicts of interest, these two entities generally have separate policies and governance structures. Therefore, these investor actions include separate recommendations for corporate and investment entities where relevant.

Investor actions

- → Adopting investor policy(ies) on RBC (the RBC Policy) which:
  - Commit the investor to observe international RBC standards (e.g. the OECD Guidelines, the UN Principles for Responsible Investment);
  - For asset managers, articulate expectations of its workers (i.e. staff) and business relationships with regard to RBC. These may include an expectation that investee companies should operate in accordance with international RBC frameworks, such as the OECD Guidelines;
  - For asset owners, includes procedures for incorporating due diligence considerations into their relationships with external investment managers;
  - describes the investment institution's approach to due diligence;
  - describes the investment institution's approach to stakeholder engagement;
  - is informed by relevant internal and external expertise;
  - For corporate policies of investment institutions, is approved at the most senior level of the investment institution;
  - is publicly available and communicated.
- → Assigning accountability for RBC performance to fund managers and establishing a system of internal reporting on RBC to fund managers.
- → Adopting systems to manage RBC risks for the investment institution.
- → Integrating RBC matters within investment decision-making. For example by articulating procedures for research on RBC risk when required in the context of investment decision making. When such research is required, it may vary across different asset classes and investment strategies.
- → Developing internal controls within the investment institution, including: setting RBC targets and reviewing performance against these targets; appropriate information systems; and operating procedures. For example:
  - putting procedures in place to track effectiveness of the investment team's due diligence processes and responses to real and potential adverse impacts;
  - building a knowledge base (e.g. for record-keeping on RBC information, activities and decision-making). This may include:

- a register of RBC risks identified in the investment portfolio (including RBC risks or incidents reported through grievance mechanisms);
- assessments of investee companies' RBC performance;
- records of engagement with investee companies and/or stakeholders.

→ Providing adequate support and resources across all relevant departments and locations for due diligence within the investment institution (e.g. analysis, , research, and legal departments).

Building in feedback loops between corporate and investment management departments for continuous improvement, building on findings from other mechanisms (e.g. through social dialogue with workers, internal disputes resolution mechanisms, whistleblower mechanisms, operational-level grievance mechanisms).

Key considerations for investors

Building on existing frameworks

One of the investor's core roles is to analyse and measure financial risk, so investors already have strong frameworks in place for financial risk management. In addition, many investors already have an established framework for incorporating environmental and social issues into the different stages of their investment process and the different dimensions of their operating model, for example through integrating ESG factors into portfolio analysis, automating ESG signals in trading and risk platforms, etc.

The OECD Guidelines' expectation that investors undertake RBC risk-based due diligence can be implemented through existing risk management frameworks,[21] provided they are also targeted towards RBC risk and not just towards risks to the investor itself, or its investee companies. As discussed in further detail below, there is often a strong alignment between financial materiality and RBC risk and thus integration of RBC risk management into existing financial risk analysis and management can be advantageous. Box 5 provides several approaches of how ESG risk analysis has been built into core investment analysis in a global investment institution. While ESG criteria are often used for the purpose of identifying financial risk, these processes could be built upon to take into account RBC risks.

[21] OECD Guidelines for Multinational Enterprises, General Policies, paragraph 10.

Box 5. ESG integration

Some institutional investors explicitly consider ESG criteria when considering strategies of certain funds. Some investors have specific ESG funds (for example, see Box 11 on ESG Indices), while other investment strategies look to integrate ESG criteria across their investment portfolio. Investment strategies may be challenged to ensure ESG criteria are part of the decision making process. Fund managers may interact with staff leading responsible investment initiatives to ensure that ESG factors are integrated into investment analysis and decision making. The following integration techniques are described by PRI:[1]

- Fundamental strategies (also known as traditional strategies): Investors can adjust forecasted financials (such as revenue, operating cost, asset book value and capital expenditure) or company valuation models (including the dividend discount model, the discounted cash flow model and adjusted present value model) for the expected impact of ESG factors.
- Quantitative strategies (also known as systematic strategies): Quant managers can construct models that integrate ESG factors alongside factors such as value, size, momentum, growth, and volatility.
- Smart beta strategies (also known as strategic beta, alternative beta and factor investing): ESG factors and scores can be used as a weight in portfolio construction to create excess risk-adjusted returns, reduce downside risk and/or enhance portfolios' ESG risk profile.
- Passive (also known as indexing) and enhanced passive strategies (also known as enhanced index): The overall ESG risk profile, or exposure to a particular ESG factor, of passive investments can be reduced by adjusting index constituent weights or by tracking an index that already does so.

[1] PRI (2016) A Practical Guide to ESG Integration for Equity Investing, www.unpri.org/page/pri-launches-esg-integration-guide-for-equity-investors

Recognising alignments between financial materiality and RBC risks

Under fiduciary duty or equivalent legal obligations (such as the prudent person rule), investors must act in the financial interests of their clients or beneficiaries. The OECD Guidelines recognise that in many cases, their recommendations go beyond national law but should not conflict with it.

What is considered material to determining these financial interests is a dynamic concept. The materiality of RBC issues, with respect to investment, evolve over time, driven by changes in legislation and policy, changes in risk and understanding of risk, changes in the social, environmental and economic impacts of specific businesses or industries and changes in societal (and beneficiary) expectations and norms. The analysis of RBC issues as an integral part of the investment process enables investors to make a full assessment of the risks and opportunities associated with particular investments.

Where RBC risks are severe, they may often be financially material, and likewise, strong RBC practices have been proven to be correlated with stronger financial performance (Box 6). Early management of RBC risk is also likely to avoid risks developing into more financially material impacts. This is increasingly being recognised by investors and regulators.

Box 6. Improved financial performance of companies following RBC strategies

Various studies, as well as anecdotal events, over the years have demonstrated the business case for RBC.

Most recently, a meta study conducted by Deutsche Asset Management and the University of Hamburg, found that roughly 90% of studies (2200 individual studies) find a non-negative correlation between ESG and corporate financial performance (CFP). More importantly, the large majority of studies report positive findings. The positive ESG impact on CFP appears stable over time.[1]

Likewise, a Harvard Business School study which tracked the performance of companies over 18 years, found that "high sustainability" companies, those with strong ESG systems and practices in place, outperformed "low sustainability" companies, as measured by stock performance and in real accounting terms.[2]

In another meta study of 127 studies, published between 1972 and 2002, measuring the relationship between companies' socially responsible conduct and business performance, almost half of the studies pointed to a positive relationship between corporate social performance and financial performance. Only seven studies found a negative relationship; 28 studies reported non-significant relationships, while 20 reported a mixed set of findings.[3]

Notes

1 Gunnar Friede, Timo Buschi and Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance & Investment, Volume 5, 2015 - Issue 4.

2 Eccles G.R., Ioannou I. Serafeim G. (November, 2011) "The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance," Harvard Business School.

3 Joshua D. Margolis and James P. Walsh. Misery Loves Companies: Rethinking Social Initiatives by Business Administrative Science Quarterly Vol. 48, No. 2 (June, 2003), pp.268-305.

Over the past decade, changes in investment practice and public policy have created positive duties on investors to integrate RBC or ESG issues where they are financially material, subject to compliance with both internal and external policies, laws, and regulations.[22] Some governments (e.g. Canada and South Africa), have clarified and made explicit that investors should take social and environmental issues into account in these circumstances. In the United States, guidance from the Department of Labor clarified that for plans under the Employee Retirement Income Security Act (ERISA), where ESG issues are material to the economic value of an investment, those issues form part of the fiduciary's analysis.[23]A recent study by UNEP Finance Initiative, UN Global Compact and the PRI, *UNEP Inquiry into the Design of a Sustainable Finance System*, analysed fiduciary duty in Australia, Brazil, Canada, Germany, Japan, South Africa and the United Kingdom and concluded that

22 See UN Global Compact, UNEP Finance Initiative, Principles for Responsible Investment, UNEP Inquiry into the Design of a Sustainable Financial System (2015), 'Fiduciary Duty in the 21st Century' www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf

23 The US Department of Labor, Interpretive Bulletin (IB 2015-01) on Economically Targeted Investments (ETIs) and Investment Strategies that Consider Environmental, Social and Governance (ESG) Factors (2015). See UNEP, UN Global Compact, PRI (2015) Fiduciary Duty in the 21st Century, p.9 www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf

"failing to consider long-term investment value drivers, which include environmental, social and governance issues, in investment practice is a failure of fiduciary duty."[24]

Investors are also paying increasing attention to long-term investment and recognising the long-term financial implications of environmental and social issues. This recognition is reflected in the development of stewardship codes and initiatives to encourage investors to monitor and engage with companies.

Developing policies to manage RBC risks and internalising the objective of avoiding and addressing RBC risk into core operations generally should not impede but on the contrary inform and contribute to an investor's ability to represent the interests and expectations of its beneficiaries.[25]

Some investment managers may believe that they should only take account of RBC issues when their clients expressly request or instruct them to do so.[26] Systematically including RBC issues in policies and mandates between asset owners and investment managers can be helpful in demonstrating that RBC risk management through due diligence responds to the interests and expectations of relevant beneficiaries.

Using policy to signal prioritisation

Developing an RBC policy may be a useful way for investors to communicate and explain their priorities with regard to RBC risk management. Investors often hold investments in a wide range of different companies. For larger investors, investment portfolios may be a reflection of the market as a whole. As a result, investors may be directly linked to a comprehensive range of adverse impacts through their investment portfolios. It may be more challenging for investors to identify the most severe risks among their portfolios. Investor policies may be used as a tool for communicating any specific RBC priorities with regard to management of adverse impacts, and explaining how these priorities were reached. For example, investors may flag in their policies that climate change risk is a priority for them, given the significant scale, scope and irremediable character of climate change impacts, as well as signals from regulators and their clients that this should be a priority issue.

In developing rationales for prioritisation, investors are encouraged to consult with relevant stakeholders, such as their beneficiaries or clients in the case of asset managers, as well as worker organisations and civil society organisations familiar with RBC issues.[27] This will aid them in setting priorities informed by the severity of RBC risks that reflect relevant stakeholder perspectives.

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24 UNEP, UN Global Compact, PRI (2015) Fiduciary Duty in the 21st Century, p.9 www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf

25 The OECD is currently examining institutional investors' duties towards their beneficiaries and what these mean for integration of ESG factors in their investment decisions, as well as the impact of ESG factors on expected investment performance. For more information, see OECD (2016), Investment Governance and the Integration of ESG Factors, www.oecd.org/cgfi/resources/Analytical_Report_on_Investment_Governance_and_the_Integration_of_ESG_Factors.pdf

26 Id.

27 The G20/OECD Principles for Corporate Governance explicitly recognise employees and their representative organisation as stakeholders. See Chapter IV of G20/OECD Principles for Corporate Governance (2015).

2.2 Implementing due diligence: Identifying actual and potential adverse impacts Identifying actual and potential adverse impacts

The purpose of this step in the due diligence process is to assist investors to identify and then assess potential and actual adverse impacts across their investment portfolio. First, investors try to understand the scope of issues they may be directly linked to through identification, and secondly they prioritise and respond to them as appropriate. The box below shows examples of actions that can be taken by investors to identify and assess adverse impacts that they may be linked to via companies within their investment portfolios.

Investor actions	→ Integrate RBC risk identification for investments into existing processes (e.g. qualitative and quantitative risk evaluation prior to investment, and to inform investment decision-making and active ownership (as appropriate to the asset class)) → Actively screen investment portfolios to identify potential RBC risk areas based on what is considered high-risk: geography, sectors, products, stages of the supply chain (before and after investment across asset classes as appropriate to the strategy).

Key considerations for investors

Applying a risk-based approach for identifying real and potential impacts

Many investors have a large investment portfolio which can make continuous identification of RBC risks amongst their investee companies highly resource intensive. Applying a risk-based approach means that investors with large portfolios may identify general areas where the risk of adverse impacts is most significant and, based on this assessment, prioritise investee companies for further assessment where appropriate. In other words, investors may screen their portfolios to identify general areas where RBC risk is most significant and use this information as a basis for more detailed investigation, either individually or collaboratively.

Investors should apply more detailed investigations as part of their due diligence for investee companies that are actually, or likely to be, associated with more severe RBC risks. Follow up and additional fact-finding may be done through the investor's own desk-based research, using specialised research services, collaborative databases and engagement techniques (Box 7 and Box 8), as well as direct engagement with the prioritised investee companies to obtain additional information on their approach to RBC issues (e.g. by requesting the investee to provide certain information, questionnaires, site visits etc.). Investors can work collaboratively to approach companies in these situations or to collect more information about them. For example, mechanisms such as the PRI Collaboration Platform can be used (Box 7).

Recognising the challenges in obtaining detailed information for in-depth investigations on some passive investments prior to investment, investors should include passive investments in their general risk screening to identify areas where RBC risk is most significant and to inform potential action (Section 2.3).

A risk-based approach may take account of factors such as:

- RBC risks related to the sector concerned/nature of activities (e.g. labour and working conditions in apparel factories) of investee companies.

- RBC risks related to the home country of investee companies and the country or countries of their operations, including:
  - socio-economic factors of the context in which investee companies operate (e.g. post-conflict zones, countries with large migrant or refugee populations);
  - governance context in which investee companies operates (e.g. corruption issues or weak rule of law.
- RBC risks related to the investee companies themselves (e.g. poor track record in the context of RBC issues, such as a history of conflict with its workers, poor environmental performance etc.)
- Priority issues identified in the investor's RBC policy (as relevant).

Box 7. UN-supported PRI Collaboration Platform

The Collaboration Platform offers a range of global engagement initiatives that involve investors engaging with listed companies, policy makers and other actors in the investment chain.

Posts to the Collaboration Platform include:

- invitations to sign joint letters to companies;
- proposals for in-depth research and investor guidance;
- opportunities to join investor-company engagements on particular ESG themes;
- calls to foster dialogue with policy makers;
- requests for support on upcoming shareholder resolutions.

PRI Collaboration Platform www.unpri.org/about/pri-teams/esg-engagements/collaboration-platform

Responding to information deficits through combined approaches

Gaps in information on RBC risk pose a challenge for investors. Of the estimated 80,000 multinational companies in the world, only around 5,000-10,000 are estimated to publish environmental and social performance reports.[28] Moreover, the effectiveness and value to investors of existing regulations on non-financial reporting and regulators' monitoring and enforcement of these reporting rules, have been questioned.[29] As company disclosure on RBC issues is, in many cases, still poor, it may be difficult for investors to gain a full understanding of RBC risks facing a company in their portfolio and whether they are being adequately addressed.

[28] Sustainable Stock Exchanges Initiative (2014). Report on Progress. www.sseinitiative.org/wp- content/ uploads/2012/03/SSE-2014-ROP.pdf

[29] Shorter, G. (2013). SEC Climate Change Disclosure Guidance: An Overview and Congressional Concerns. www.fas.org/sgp/crs/misc/R42544.pdf

ESG research services are growing in scope and sophistication and can provide investors with a starting point for RBC information. ESG research services cover company performance on a range of ESG issues, as well as incidents and controversies that arise in relation to international environmental and social standards. However, ESG research services may not cover an investor's entire portfolio nor all potential RBC risks.

Investors may not be able to identify and be aware of all RBC risks present in their portfolio at all times, however, they can use existing information and a combination of approaches to identify real and potential impacts in the face of information deficits. They should also be continuously updating information on RBC issues as these issues are not static.

Research services can be used to screen an investor's portfolio and identify RBC risks with respect to the companies that the service covers. Companies in the portfolio, that are not, or inadequately covered by ESG research services can be approached from a risk-based approach as described above. In addition to active risk-based screening, grievance mechanisms and other reporting platforms can be used to alert investors to red flag companies in their portfolio. Box 8 describes how an institutional investor may use a combination of sources to identify RBC risk.

Box 8. Sources of RBC risk information for institutional investors

An institutional investor may actively identify RBC risks within a portfolio through due diligence prior to investment and the on-going monitoring of RBC risks. Sources of RBC information may include: external RBC market research providers; internal financial analysts or responsible investment specialists; specifically commissioned studies; public information or shared information from peer networks; or collaborative initiatives. Some institutional investors have internal databases of RBC data at a company and industry group level which can be used by analysts along with financial valuation data.

Assessing credibility of information

The credibility or objectivity of RBC information may be difficult to assess. To ensure credibility of identified RBC risks, investors should rely on existing reputable information and resources, such as market research services, specialised indices, reports from credible international organisations, civil society and media. To assess the credibility of claims submitted through a grievance mechanism, investors can develop submission criteria and a policy on how the credibility of complaints is evaluated, taking care to ensure that evaluation criteria are publically communicated and not unnecessarily onerous (see Section 2.5 for more information on grievance mechanisms).

Where potential severe adverse impacts are identified, investors may consult additional sources to verify or triangulate claims, e.g. reports from national authorities, international organisations, NGOs, media coverage, industry literature, statements from National Contact Points (NCPs), as described in Box 9.

Box 9. Statements of National Contact Points

National Contact Points (NCPs) provide a forum where parties can submit claims of alleged non-observance of the recommendations of the OECD Guidelines (known as specific instances) and engage in mediated dialogue on these issues. NCPs publish statements describing the outcomes of these proceedings which can serve as an important source of RBC risk information. For example, statements published at the conclusion of NCP procedures can indicate whether the issue in question was resolved or not. Some NCPs include determinations on whether a company observed the OECD Guidelines or not. Furthermore, many NCP's include recommendations in their final statements and sometimes follow up their recommendations to track progress which can be useful for investors to reference in their engagement with investee companies. The OECD Database of specific instances (https://mneguidelines.oecd.org/database/) includes summaries of all specific instances brought to the NCP mechanism and links to statements of NCPs.

Ultimately, identification is conducted to help inform the investor's actual or potential RBC risk exposure. Thus, information or claims about RBC risk or impacts does not have to be completely verified in order to trigger further investigation and closer engagement under an RBC risk-based due diligence approach.

Where an investor decides to engage in closer assessment, consultation with stakeholders might be helpful in assessing harm and developing appropriate responses. Who the stakeholders are will depend on the adverse impact in question. For example, global union federations and their affiliated individual trade unions will often represent impacted workers, and can also provide a source of information or expertise on a range of labour or human rights matters.

Taking proactive approaches to enhance quality and availability of RBC information

As a method of responding to information deficits, investors can consider engaging in individual and collaborative efforts to progressively seek to obtain more information from investee companies, and push for more disclosure on RBC risk. This can be done through participating in existing industry initiatives to enhance the availability of this type of information – for example, the Carbon Disclosure Project (CDP) which is backed by over 800 investors and provides information on companies' greenhouse gas emissions and climate-related risks. It can also involve development of, or involvement in, initiatives addressing specific issues such as RBC risks related to smaller companies in high-RBC risk sectors or countries.

Entities that facilitate investment, such as index providers and exchanges, can also play a role in collecting additional information related to RBC risks, particularly since many of these entities may already be subject to RBC expectations, such as the OECD Guidelines (Box 10).

Box 10. Stock exchanges and due diligence under the OECD Guidelines for Multinational Enterprises

Stock exchanges play a number of roles within the economy, including raising capital for the private sector, creating investment opportunities, corporate governance and are now increasingly helping to develop more sustainable capital markets. Historically, most exchanges were not-for-profit organisations owned by their members; now, the majority of exchanges are demutualised and a growing number are publicly listed companies themselves. Given these changes, as well as the intensive competition among exchanges, the traditional role of self-regulation among stock exchanges continues to evolve, with some exchanges now having shared or even transferred regulatory responsibilities to securities regulators. To be listed on an exchange, companies must comply with listing rules; oversight for these rules varies by country. A 'business relationship' exists between exchanges and companies under the OECD Guidelines, and therefore a due diligence expectation arises.

The Sustainable Stock Exchanges Initiative (SSE) - a collaboration between the Principles for Responsible Investment, UNCTAD, the UNEP Finance Initiative and the UN Global Compact – is a peer-to-peer learning platform for exploring how exchanges, in collaboration with investors, regulators, and companies, can enhance corporate transparency – and ultimately performance – on ESG issues and encourage sustainable investment.

The SSE reports that stock exchanges are increasingly taking actions that contribute to creating more sustainable capital markets. The SSE now has 60 Partner Exchanges, listing over 30,000 companies and representing a market capitalisation of over USD 55 trillion. Eight of the 50 countries examined have implemented a stewardship code that addresses ESG factors; six of these eight are voluntary and two were adopted under a "comply-or-explain" basis. Thirteen countries have government policies in place requiring asset owners to disclose how ESG factors are considered in the investment process.

Approaches to identifying and assessing real and potential adverse impacts by asset class

Table 1 sets out some high-level approaches for investment managers across different asset classes, before and after investment, to identify adverse impacts related to investee companies. Where an asset owner or asset manager appoints an external investment manager, they should ascertain that the investment manager has appropriate policies and procedures in place to identify actual and potential adverse impacts. They should also monitor the investment manager's implementation of these policies and procedures on an ongoing basis.

Table 1. Identifying actual and potential adverse impacts: Practices by asset class and investment strategy

	Listed equity		Fixed income		Private equity, real estate, infrastructure	
	Active	**Passive**	**Corporate**	**Government**	**Fund**	**Direct**
Before investment	Conduct research to identify RBC risk, prioritising by severity.	Consider discussing RBC information needs and RBC risk expectations with index provider.	Conduct research to identify RBC risk.		**LP*:** include RBC risk in due diligence on fund manager before making commitment to the fund. **GP**:** conduct research on individual companies before investment to identify RBC risk.	Conduct research to identify RBC risk.
After investment	Using a risk-based approach, screen the whole public markets portfolio (listed equities and bonds, active and passive) at regular intervals to identify RBC issues that have emerged. Identify and further assess high RBC risk companies within the portfolio through further engagement.	Using a risk-based approach, screen the markets portfolio included in the index or investment product (listed equities and bonds, active and passive) at regular intervals to identify general RBC issues that have emerged, and prioritise for follow up.	Using a risk-based approach, screen the markets portfolio included in the index or investment product (listed equities and bonds, active and passive) at regular intervals to identify general RBC issues that have emerged and prioritise for follow up.		**LP:** include RBC risk in ongoing monitoring of GP **GP:** include RBC risk in ongoing monitoring of portfolio companies.	Include RBC risk in ongoing monitoring of the investment.

*LP: Limited Partner – the asset owner or ultimate investor in a private equity, real estate or infrastructure fund
**GP: General Partner – the entity that manages the fund, and which selects companies or assets for investment and monitors the investments on an ongoing basis. (See Annex 3 for additional explanation on the roles of these different actors).

2.3 Implementing due diligence: Seeking to prevent and mitigate adverse impacts

Once investors have identified actual and potential adverse impacts across their portfolios, they can turn the information gathered into action to prevent and mitigate potential impacts based on their prioritisation. This is a crucial step in enabling an investor to meet the expectations under the OECD Guidelines. The box below provides potential actions that can be taken by investors to prevent and mitigate real and potential adverse impacts.

Investor actions

Appropriate approaches to prevention may include:

- Clear RBC requirements in investment mandates and clear RBC conditions precedent to investments (e.g. exclusionary policies as a prohibition on investment under any circumstances (from certain companies or sectors, e.g. for controversial weapons), due diligence requirements with respect to investee companies).
- Where investors wield some managerial control over a company (e.g. General Partners in private equity, real estate, infrastructure), where possible and in compliance with regulatory obligations, insistence on investee company due diligence and commitments to observe RBC standards through contractual language or language in other forms of written agreements that allow investors to exercise legal leverage in case of investee company breach of covenants or RBC policies.
- Screening potential investments to screen out companies with high RBC risk or those which fall under exclusionary policies.
- As a complement to other approaches and to the extent feasible under regulatory obligations, investment in ESG indices (Box 11), in order to direct capital away from companies with poor RBC practices.
- As a complement to other approaches and as a way of addressing systemic challenges, participation in industry or multi-stakeholder initiatives with RBC objectives (e.g. PRI Collaboration Platform, UNEP Finance Initiative, investor networks on climate change, Corporate Sustainability Reporting Coalition).[1]
- Use of long term investment strategies which recognise the long-term financial implications of environmental and social issues, such as those elaborated under the G20-OECD High-level Principles of Long-term Investment Financing by Institutional Investors.
- Active engagement with investee companies to improve their management of RBC issues.

Appropriate responses, once actual or potential adverse impacts have been identified, may include:

- Continuation of the relationship with an investee company throughout the course of RBC risk mitigation efforts. For example through “engagement” with companies to exert leverage to mitigate adverse impacts including:
  - Contacting the investee company by letter, email and/or telephone
  - Face-to-face meetings with the company at operational, senior management and/or board level to express views on RBC matters
  - Attendance and speaking at Annual General Meetings to express views on RBC matters
  - Using voting rights to express views on RBC matters
  - Collaboration with other investors to exert leverage on RBC matters

- Engagement with regulators and policymakers on RBC issues
- Joining geographic or issue-specific initiatives that seek to prevent and mitigate adverse impacts in the areas identified (e.g. country, commodity or sector roundtables, multi-stakeholder initiatives and on-the-ground programmes)

→ For active strategies, reduction of the investment position in the light of RBC risk(s) identified, where appropriate, and clearly communicating the reason for the reduction in the investment to the company. Increase intensity of engagement actions if the company does not respond positively in the first instance.

→ For active strategies, temporary divestment while pursuing ongoing RBC risk mitigation as appropriate and where possible.

→ For active strategies, divestment either after failed attempts at mitigation or where the investor deems mitigation not feasible, or due to the severity of the adverse impact.

→ For passive strategies, where possible and in compliance with regulatory obligations, redesign of investment strategy to avoid investments with highly severe impacts (e.g. exiting a passive index and investing in an adjusted or tailored index which excludes severe risks identified by the investor).

[1] PRI Collaboration Platform. www.unpri.org/about/pri-teams/esg-engagements/collaboration-platform

Box 11. ESG indices

ESG indices are indices weighted wholly or partly on the basis of ESG factors. In these cases, the ESG research that underpins the index construction is undertaken by the index provider (or a specialist supplier of ESG information contracted by the index provider). General ESG and sustainability indices represent only a small fraction of the total volume of passively invested assets. However, growing awareness of the financial implications of climate change has led to increasing interest in indices weighted according to companies' carbon intensity. For example, MSCI, one of the leading index providers, now provides carbon footprint information for its leading conventional indices (i.e. not just those in specialist low-carbon indices). Information is provided at the index level, not for individual companies.

Key considerations for investors

Stewardship activities and prevention and mitigation

Broadly, the concept of stewardship in the context of institutional investment refers to enhanced engagement and ongoing monitoring by investors over their investee companies. The concept of investor stewardship arose in the wake of the 2008 financial crisis and, in the case of the United Kingdom, was first formalised with the development of the UK Stewardship Code in 2012. Under this code investors commit to:

- publicly disclose their policy on how they will discharge their stewardship responsibilities;
- have a robust policy on managing conflicts of interest in relation to stewardship which:
  - should be publicly disclosed.
  - monitor their investee companies.
  - establish clear guidelines on when and how they will escalate their stewardship activities.

- be willing to act collectively with other investors where appropriate;
- have a clear policy on voting and disclosure of voting activity;
- report periodically on their stewardship and voting activities.[30]

Some stewardship activities closely mirror activities recommended under due diligence, particularly in the context of prevention and mitigation, although the objectives may vary slightly.[31] (See Box 12 for an explanation of investment stewardship.)

Box 12. Engagement as Part of Investment Stewardship

Engagement is often core to investor stewardship programs as it helps to assess a company's approach to RBC risks, as well as promote prevention and mitigation strategies in line with RBC standards.

Stewardship, to a large extent, involves engaging with and supporting company management to do better and resolve issues. Large institutional investors may engage with hundreds to thousands of investee companies annually on RBC issues. This may involve meeting with company management, such as executives and board directors, and with other shareholders where appropriate, attending shareholder meetings and voting on shareholder proposals.

Understanding relationship to impacts

Where actual or potential adverse impacts are identified, investors should seek to understand their relationship to them. The relationship of an investor to an adverse impact (i.e. whether it is *caused or contributed* to by the investor or whether it is *directly linked* by a business relationship) is an important consideration as it will determine whether there is also a responsibility to address it or in other words, to provide some form of remedy. Figure 1 provides an overview of the variation of responses expected based on the relationship to impact under the OECD Guidelines.

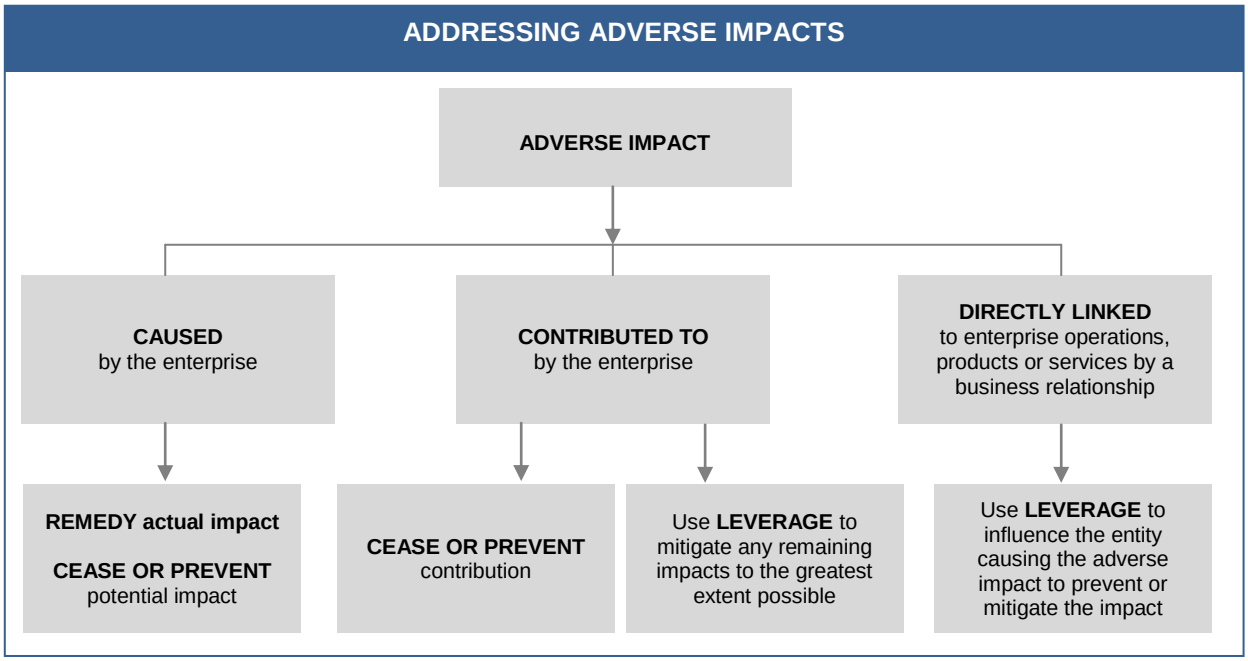
Under the OECD Guidelines an enterprise 'causes' an adverse impact if there is direct connection between the actions or failure to act of an enterprise and the adverse impact. "'[C]ontributing to' an adverse impact should be interpreted as a substantial contribution, meaning an activity that causes, facilitates or incentivises another entity to cause an adverse impact and does not include minor or trivial contributions."[32] Finally, an enterprise's operations, products or services can also be 'directly linked' to an adverse impact through a business relationship.

30 Financial Reporting Council (2012) UK Stewardship Code www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code- September-2012.aspx

31 Stewardship activities generally aim to increase long-term risk-adjusted returns to shareholders rather than prevent and mitigate adverse impacts as defined under the Guidelines.

32 OECD Guidelines for Multinational Enterprises (2011), Chapter II, Commentary on General Policies, paragraph 14.

Figure 1. Addressing adverse impacts under the OECD Guidelines for Multinational Enterprises



Generally, a minority shareholder relationship, particularly in listed equities, is unlikely to lead to a substantial contribution to an adverse impact under the OECD Guidelines. Thus, in the vast majority of cases, institutional investors holding a minority shareholding will not be in a position to "contribute" to an adverse impact at an investee company. Such a case might arise, however, if investors take a larger share in a company and become actively involved in trying to direct or influence management in a manner that results in adverse impacts.

Given that minority shareholdings represent the largest proportion of assets under management by institutional investors, this paper focuses on issues related to those cases where an investor is directly linked to harm through its investments. A minority shareholding may be considered a business relationship under the OECD Guidelines. Investors, even those with minority shareholdings, may be directly linked to adverse impacts caused or contributed to by investee companies as a result of their ownership or management of shares in the company. In other words, the existence of RBC risks (potential impacts) or actual RBC impacts in an investor's own investment portfolio means, in the vast majority of cases, there is direct linkage (see also Footnote 10).

No shifting of responsibility to investor from companies to prevent or mitigate impacts

The OECD Guidelines underscore that the expectation that enterprises seek to prevent or mitigate adverse impacts directly linked to their operations, products or services by a business relationship is "not intended to shift responsibility from the entity causing an adverse impact to the enterprise with which it has a business relationship." [33]

It remains the responsibility of the investee companies to prevent or mitigate adverse impacts they cause or contribute to. Investors are expected to build and exert their leverage to the extent

[33] OECD Guidelines for Multinational Enterprises, Chapter II, paragraph 12.

possible to influence their underlying companies to take action to prevent and mitigate adverse impacts where risks arise.[34] Furthermore, *how* investors seek to prevent and mitigate an adverse impact will vary according to the type of asset class and strategy in question, position in an investment portfolio and regulatory context. As such, in the context of business relationships, due diligence is a process through which investors seek to prevent or mitigate adverse impacts. Enterprises, or in this case, investors, are not generally responsible for the actions of the entity with which they have a business relationship, but rather for their own conduct, including their efforts to influence or encourage that entity (see also *Leverage limitations*.)

The responsibility to address adverse impacts cannot be shifted from the investee to the investor. Investors who lack (or have exhausted) leverage over an investee that is causing impacts may choose to maintain the relationship or divest. Both divestment from, and continued investment in, an investee company may be appropriate outcomes following risk-based prioritisations as laid out in this document. If the investor chooses to remain in the relationship, it should continue to account for its ongoing risk mitigation efforts[35] and be aware of the reputational, financial or legal risks of the continuing connection. (See also *Considering divestment and exclusion*.)

This approach reflects principles of corporate governance which recognise that the primary responsibility for directing the affairs of a company lies legally with its board and management, while investors have a responsibility to make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest (Box 4).

Prioritisation of actions

As pointed out in Section 1.2, in the context of investment the nature and extent of due diligence may depend on the nature of an investment entity, the size and nature of its investment portfolio and relationship to specific investments (e.g. the ownership share in the company, tenure of investment, access to relevant information and the likelihood that meaningful influence may be exercised). Where enterprises have large numbers of suppliers, or in this case investee companies, they are encouraged under the OECD Guidelines to *prioritise* efforts based on risk assessments.[36] Prioritisation dictates how actions may be sequenced and how company due diligence resources are targeted and recognises that not all adverse impacts can be identified and responded to at once. Investors should seek to prioritise the most severe impacts for due diligence while continuing to monitor RBC risks, evaluate prioritisation decisions and build on their actions to the extent possible and necessary over time, to cover a broader range of investee companies and actions.

As discussed in Section 2.1, the universe of potential adverse impacts among investee companies is vast so investors may also develop and articulate their own policy regarding prioritisation. This policy should be adequately explained, including any rationale for assessing severity of RBC risk, aligned with the recommendations of the OECD Guidelines and communicated externally (for example, in its annual public report or on its website).

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34 In jurisdictions where formal "influence" is disallowed investors should seek to honour the recommendation to seek to prevent and mitigate to the extent that it does not put them in violation of domestic law. See the introduction section of this paper for more information.

35 See OECD Guidelines for Multinational Enterprises (2011), Chapter II, General Policies, paragraph 10 and Commentary on General Policies, paragraph 22.

36 OECD Guidelines for Multinational Enterprises, Chapter II paragraph 12, Commentary on General Principles, paragraph 16

In addition to consideration of severity of impact, the following criteria may be relevant to deciding how to prevent or mitigate actual or potential adverse impacts:

- How crucial the investee company is for the investor, which will likely be informed by the materiality of the issue for the company concerned and, by extension, the materiality of the issue for the investor.

- Resource implications of various approaches to prevention and mitigation.

- Whether engagement efforts are already underway by other investors with the same company and related to the same issues, so as not to duplicate efforts.

- Strength of information concerning adverse impacts, the implication being that credible attempts should be made to verify whether information about possible severe risks is genuine.

- Practical limitations on the ability of investors to effect change in the behaviour of their investee companies (see also *Leverage limitations*).

Leverage limitations

Where an RBC risk is identified, an investor's ability to exercise influence over the company concerned – to use its so-called leverage to mitigate the RBC risk – may be affected by a number of factors. For example:

- Even the largest institutional investors may be only small minority shareholders in many companies.

- For publically traded companies, corporate ownership structures and corporate governance rules and practices in some countries may impede minority shareholders, particularly foreign shareholders, from exercising influence. For example, companies may give shareholders limited information and, access to management. Only in exceptional circumstances do shareholders as a whole have the formal power to direct the board of a company to take a specific action.[37]

- The ability to exercise influence may be limited by the characteristic of an asset class. For example, investors in corporate or government bonds may have very limited opportunities to influence the company or government that issued the bond. Bond investors may insert covenants (conditions) into loan agreements when bonds are issued that restrict the company's ability to make certain kinds of investment. Bondholders have rights in the event of default or bankruptcy. However, their ability to exercise ongoing influence over a company's day-to-day actions is limited. The individual bondholder's influence over a government is even more limited.

- Passive investment managers may require client consent to exclude companies from an index.

[37] G20/OECD Principles of Corporate Governance, Chapter II, The rights and equitable treatment of shareholders and key ownership functions.

- In many instances, divestment may not be possible, due to the nature of the investment product or strategy. Nor will it be appropriate in all cases; without engaged investors, there is often no other voice persuading the company to change its practices.

- The accessibility of a company may be limited depending on whether the investor has a local office or staff with relevant language skills.

- The company may not demonstrate any will to prevent or mitigate adverse impacts.

The OECD Guidelines recognise that "there are practical limitations on the ability of [investors] to effect change in the behaviour of [an entity with which it has a business relationship]."[38] The degree of leverage an investor has over the company causing the adverse impact is useful in considering *what* it can do to persuade that entity to take action, but is not relevant to considering *whether* the investor should carry out due diligence and effectively exercise any leverage it may have[39] For example:

- In private equity, infrastructure and real estate funds, General Partners (GPs) are generally able to exercise more influence than minority shareholders in listed companies. GPs that hold a majority shareholding in a portfolio company or asset control the company. In either situation, LPs that are investors in the fund concerned may be able to work with the GP to influence portfolio companies.

- Minority shareholders can have leverage over a company independently; however, there are instances where further leverage can be gained by collaborating with other shareholders – for instance, through the PRI Collaboration platform.

- Investors, individually and collectively, can engage with regulators, policymakers and civil society organisations to promote implementation of RBC standards such as the OECD Guidelines.

38 See OECD Guidelines for Multinational Enterprises (2011), Chapter II, Commentary, paragraph 21.

39 Id, see also Commentary, paragraph 20 and OECD (2014) Due diligence in the financial sector: adverse impacts directly linked to financial sector operations, products or services by a business relationship, https://mneguidelines.oecd.org/rbc-financial-sector.htm

Box 13. Minority investor's engagement and NCP specific instances

Several NCP cases have resulted in successful resolution due to engagement by investors. For example, in 2015 a case was brought to the Dutch NCP involving Mylan, a pharmaceutical company, for human rights impacts associated with a sale of their product used for lethal injections in US prisons. In its final statement for the specific instance, the NCP noted that "dialogue as well as disengagement by some [investors] appear to have contributed to improvements in Mylan's conduct."[1]

One of the most high profile NCP cases brought to the UK NCP was resolved when Soco, an oil exploration company, committed to ceasing exploration in Virunga National Park, a World Heritage Site in the Democratic Republic of the Congo. Much of this successful outcome can be attributed to intensive engagement by Soco's investors in parallel to the mediation process at the UK NCP.[2]

Notes

1 NCP of the Netherlands, (April 2016) Final Statement Bart Stapert, attorney, vs Mylan) www.oecdguidelines.nl/documents/publication/2016/4/11/bart-stapert-attorney-vs-mylan.

2 NCP of the UK (July 2014) Final Statement following agreement reached in complaint from WWF International against SOCO International plc, www.gov.uk/government/publications/uk-ncp-final-statement-wwf-international-and-soco-international-plc-agreement-reached.

Considering divestment and exclusion

Under the OECD Guidelines, an appropriate response once adverse impacts have been identified may include divestment after failed attempts at mitigation, where the investor deems mitigation unfeasible, where the investor policy dictates exclusion, or simply because of the severity of the adverse impact. [40] This may be the case if an investor has limited leverage or has been otherwise unsuccessful in preventing or mitigating adverse impacts after an extended period of escalating engagement.

Some factors to consider when deciding if divestment is an appropriate response are: the investor's leverage over the company; how crucial the relationship is to the investor; the severity of the impact; and whether terminating the relationship with the company would result in adverse impacts. This decision will also depend on the nature of the asset class and strategy[41] and whether divestment is prudent as understood in the context of a relevant jurisdiction's laws on fiduciary duty or prudent investment.[42]

40 OECD Guidelines for Multinational Enterprises, Chapter II, Paragraph 22.

41 Divesting from a specific company may not be possible if that investment is held through a passive index. However, investors can consider exiting an index and investing in an adjusted or tailored index which excludes severe risks identified by the investor.

42 The debate about whether or not ESG investing is compatible with fiduciary duty hinges to a large extent on the interpretations of the duty of care and especially prudent investment practice. Institutional investors may feel that divestment conflicts with their obligation to invest prudently, as it involves straying from established market benchmarks. However, regulatory frameworks allow scope for institutional investors to integrate ESG factors into their investment governance. OECD (2016), Investment Governance and the Integration of ESG Factors Progress report, www.oecd.org/cgfi/resources/Analytical_Report_on_Investment_Governance_and_the_Integration_of_ESG_Factors.pdf

Investors should also judge what constitutes 'extended engagement' in their particular circumstances, taking into account factors such as their scale and resource levels, the size of the investment and the severity of the adverse impact. Generally the more severe the adverse impact, the more quickly the investor will need to see change before it takes a decision on whether it should end the relationship.

Under the OECD Guidelines, divestment should in most cases be a last resort or reserved only for the most severe adverse impacts.[43] However, in some cases, exclusion may be a first response to adverse impacts. For example, some investment institutions have exclusion policies for highly damaging industries or products or those with potential systemic negative impacts (Box 14).

Box 14. Exclusions and divestment

Many investors have exclusion or divestment policies tied to specific impacts or standards. For example, some investors have exclusions with regard to companies that are involved in the production of cluster weapons, anti-personnel (land) mines, and chemical and biological weapons or coal production. Investors may also review the performance of companies in their portfolios against certain standards such as the OECD Guidelines or UN Global Compact principles. If companies which breach these standards are unresponsive to engagement and do not improve their conduct, divestment may be considered.

In some situations, investors may conclude that companies causing or contributing to adverse impacts, or at risk of doing so, will remain in their portfolio. In some circumstances divestment will be particularly difficult or even impossible (e.g. in pooled passive portfolios, and other situations in which an investment manager's clients do not agree that divestment is appropriate). In other cases, where a company continues to exert leverage, it may be inappropriate to divest as it may deprive the company of an engaged investor. Finally, in some instances, the company may represent a crucial business relationship, or investment. Under the UN Guiding Principles, a relationship could be deemed as crucial if it provides a product or service that is essential to the enterprise's business, and for which no reasonable alternative source exists. In the context of investment, this is likely to be less relevant to specific investee companies but may be relevant for categories of companies of a given size or sector which are necessary to adequately diversify a portfolio (e.g. high market-cap energy companies).

Figure 2 illustrates a decision-making logic with regard to when to end a business relationship with an enterprise which is causing or contributing to adverse impacts. Following such a logic should be preceded by an analysis of whether ending a business relationship (or divestment) would run counter to any legal or regulatory requirements of the investors (Footnote 44).

[43] Appropriate responses with regard to the business relationship may include […]as a last resort, disengagement with the supplier either after failed attempts at mitigation, or where the enterprise deems mitigation not feasible, or because of the severity of the adverse impact. OECD Guidelines for Multinational Enterprises (2011), Commentary to General Policies, paragraph 22.

Figure 2. Deciding when to end a business relationship

	Have leverage	Lack leverage
Crucial business relationships	1 • Mitigate the risk that the abuse continues/recurs • If unsuccessful, go to step 2	2 • Seek to increase leverage • If unsuccessful, seek to mitigate risk that the abuse continues/recurs • If unsuccessful, consider ending the relationship**, or demonstrate efforts made to mitigate abuse, recognising possible consequences of remaining
Non-crucial business relationships	3 • Try to mitigate the risk that the abuse continues/recurs • If unsuccessful, take steps to end the relationship*	4 • Assess reasonable options for increasing leverage to mitigate the risk that the abuse continues/recurs • If impossible or unsuccessful, consider ending the relationship*

* Decisions on ending the relationship should take into account credible assessments of any potential adverse human rights impact of doing so.

** If the relationship is deemed crucial, the severity of the impact should also be considered when assessing the appropriate course of action.

In cases where investors decide to continue to invest in a company that is causing or contributing to adverse impacts they should report the situation internally as part of the investor's responsibility to account for its due diligence activities under the OECD Guidelines (Section 2.4). They should also continue to monitor the investment, for example, through maintaining a knowledge database, and revisit their decision where circumstances change or as part of the investor's long term strategy to systemically respond to all of the recommendations of the OECD Guidelines.

In some instances, continuing to invest in a company which has been identified as causing or contributing to adverse impacts may pose reputational risks or potential financial risks to investors.[44] In these instances it may be in the investors interest to publically explain their decision to stay invested, how this decision aligns with their RBC policy and priorities, what actions are being taken to attempt to apply leverage to mitigate the impacts, and how the investment will continue to be monitored in the future.

Approaches to preventing and mitigating real and potential adverse impacts by asset class

Tables 2 and 3 set out emerging good practices for preventing and mitigating adverse impacts for asset owners and managers and by asset class. In each case, where an asset owner appoints an external investment manager, they should ensure that the investment manager has appropriate policies and procedures in place to prevent and mitigate adverse impacts. They should also monitor the investment manager's implementation of these policies and procedures on an ongoing basis.

44 United Nations Guiding Principles, Guiding Principle 19, Commentary. "For as long as the adverse impact continues and the enterprise remains in the relationship, it should be able to demonstrate its own ongoing efforts to mitigate the impact and be prepared to accept any consequences—reputational, financial or legal—of continuing the connection."

Table 2. Seek to prevent and mitigate adverse impacts: Recommended practices by asset owners and investment managers

		Prior to forming business relationship	Post forming a business relationship
Seek to Prevent/ mitigate	**Asset owner**	Active and passive investment: ensure investment manager's policies and systems seek to prevent/mitigate RBC risks. Appropriate requirements can be included in contracts with investment managers.	Active investment and passive investment: monitor investment manager to gain assurance that action has been taken to seek to prevent/mitigate RBC risks.
	Investment manager	Ensure that policies and systems are in place to seek to prevent/mitigate RBC risks in investee companies.	**For active strategies**: Conduct RBC risk-based engagement with companies to seek to prevent/mitigate RBC risk. **For passive strategies**: If feasible, redesign investment vehicle, participate in initiatives with RBC aims.

Table 3. Seek to prevent and mitigate adverse impacts: Practices by asset class and investment strategy post investment

	Listed equity		Fixed income		Private equity, real estate, infrastructure	
	Active	**Passive**	**Corporate**	**Government**	**Funds**	**Direct**
Engagement with investee company	Engagement, individual and/or collaborative, with escalation if appropriate, over an extended period if necessary.	Engagement, individual and/or collaborative with investee company.	Engagement, individual and/or collaborative, taking account of lack of formal rights to influence.	Engagement, individual and/or collaborative, taking account of lack of formal rights to influence and limited potential for individual investor to influence governments.	Engagement by General Partners.	Engagement.
Divestment	Consider divestment if engagement unsuccessful.	Consider if divestment from index is practicable in cases of severe impact, and reinvest in specially tailored indices that avoid identified RBC risks.	Consider divestment if practicable in cases of severe impact.			
Business relationship	If engagement is unsuccessful and divestment is not possible, or not considered appropriate, account for reasoning behind staying invested at the relevant level of detail.					
Influencing public policy	Proactive engagement in individual and/or collaborative activities to influence public policy on RBC matters – e.g. company disclosure, international codes and standards.					

2.4 Implementing due diligence: Accounting through tracking and communicating on results

An investor should account for how it has addressed adverse impacts throughout its operations and with its business relationships through (a) tracking and (b) communicating on results. Tracking is part of the "know" of "knowing and showing" how the investor is managing impacts. Communication is part of the "show" of "knowing and showing" how the investor is managing impacts. The box below suggests actions which may comprise accounting for due diligence.

Investor actions

Tracking to be accountable internally for due diligence processes and reporting to fund managers. This may include:

- → tracking the investor's own performance against the investor RBC Policy or other commitments on RBC such as under the PRI.
- → risk identification methodology and general findings of adverse impacts across portfolios.
- → monitoring investee companies' efforts to prevent and mitigate identified adverse impacts.

Communicating publically and with stakeholders. Public reporting may include information on the following:

- → investor RBC Policy, including due diligence approaches;
- → how investor RBC Policy and diligence approaches are implemented across different asset classes;
- → engagement activities undertaken by the investor;
- → companies with which the investor has engaged;
- → results of engagement with specific companies;
- → decisions regarding divestment;
- → voting records of investor in investee company shareholder meetings and guidelines for voting in investee companies;
- → investor's future RBC plans and targets.

Key considerations for investors

Balancing transparency and confidentiality

The OECD Guidelines recommend that enterprises "account for how they address their actual and potential adverse impacts."[45] This can be done through reporting and communicating on the investor's commitments and corresponding due diligence processes. However, this should be done with due regard for commercial confidentiality and other competitive or security concerns.

For example, domestic law may sometimes prevent certain disclosures, or outline areas of protected commercial information. Contracts between investment managers and their clients may also prevent certain information from being disclosed (e.g. the identity of clients). Furthermore, the

[45] OECD Guidelines for Multinational Enterprises (2011), General Policies, paragraph 10.

disclosure of certain information about an investor's holdings may induce other investors to act in a way that undermines the value of those investments. This will be a particular concern for very large investors.

Nonetheless, investors should strive to account for their due diligence processes to the extent possible while respecting confidentiality concerns. This may involve:

- limiting access to sensitive information to those approved by the information provider.
- anonymising the source of information.
- providing a valid explanation or justification, where possible, for why the information has not been shared
- using third parties or innovative technologies that allow disclosure of key information while protecting commercially sensitive data, for example, to disclose certain information in aggregate or without identifying specific investor-investee relationships.

Balancing transparency and effective engagement

Investors may take into account how and when reporting will result in improved outcomes. For example, an investor may judge that certain disclosure may damage the effectiveness of their action (e.g. where disclosure about engagement can put the effectiveness of engagement at risk).

Expectations of non-financial disclosure in law and among beneficiaries

Reporting may also have to respond to priorities of the audience being reported to as well as regulatory reporting obligations. For example, mandatory RBC reporting is becoming increasingly common (e.g. Article 173 of the French Law for Energy Transition and Green Growth and requirements in various countries which oblige investors to disclose relevant policies and activities on a 'comply or explain' basis, such as under the UK Stewardship Code). In addition to reporting regulations, investors may also have to shape their reporting based on expectations of their clients, beneficiaries/members (in the case of a pension fund) or based on their own policies, for example, requirements under the Principles for Responsible Investment Reporting Framework for UN PRI signatories.

Risk mitigation through transparency

Proactive public reporting on due diligence processes, the rationale behind how prioritisation decisions are made and why, in certain instances, investors may choose to maintain their investment in companies causing or contributing to adverse impacts can be useful in communicating how the investor is seeking to implement the recommendations of the OECD Guidelines and why in certain instances they may not have been able to fully do so. Transparency and clear communication on these issues can help signal that investors are working to apply the recommendations of the OECD Guidelines in good faith and to the best of their abilities and can help to avoid criticism by stakeholder groups or involvement in specific instances brought to the NCP mechanism (see also Box 15 and below).

Specific approaches for accounting for how impacts are addressed

High level approaches for accounting for due diligence specific to asset owners and investment managers are provided in Table 4. These approaches are not specific to certain asset classes or investment strategies.

Table 4. Accounting for due diligence: Practices by asset owners and investment managers

Account	**Asset owner**	Provide disclosures on policies, procedures and activities undertaken to identify and prevent/mitigate RBC risks to beneficiaries and publically as necessary. Establish procedures to verify that due diligence processes have been implemented, and that RBC risks and adverse impacts have been identified and responded to appropriately.
	Investment manager	Provide disclosures on policies, procedures and activities undertaken to identify and prevent/mitigate RBC risks to client as agreed to and publically as necessary. Establish procedures to verify that due diligence processes have been implemented by investment institution, and that RBC risks and adverse impacts have been identified and responded to appropriately.

2.5 Processes to support remediation

A core purpose of conducting due diligence is to *avoid* actual adverse impacts. But where adverse impacts do occur and an enterprise has caused or contributed to them, remediation is expected. Although remediation is not a formal component of due diligence under the OECD Guidelines, it represents a supporting element necessary to enable and complement due diligence.

As noted above, in instances where an investor 'causes' or 'contributes' to an adverse impact covered by the OECD Guidelines, the investor is expected to address the impact through remediation and account for how it is addressed.[46] For example, if an investment institution discriminates against one of its employees, it would be expected to remediate (e.g. provide compensation, apologise, restore them to their position). In some instances, investors may be contributing to impacts caused by their investee companies and may be responsible for remediation. These situations could arise where investors wield significant managerial control over a company, for example, in certain General Partnerships. However, in the context of adverse impacts arising from investee companies, investors will, in most instances, only be directly linked to the adverse impact. As a result, investors would not be expected to remediate, although may apply efforts to persuade the investee company to do so as a component of their responsibility to seek to prevent and mitigate.

Additionally, although investors will in most cases not be expected to provide remediation for impacts of their investee companies, this should not preclude them from participating in dialogue or mediation processes regarding the adverse impacts in question. For example, participation in such mediation processes can help investors identify how they can strengthen their management systems or due diligence processes with respect to RBC. The box below describes what actions should be taken to ensure there are processes in place to enable remediation where the investor has deemed they caused or contributed to such impacts (see *Understanding relationship to impacts* in Section 2.3).

Investor actions	**Where relevant, processes to enable remediation should be established, this may include:** → co-operation with judicial or state-based non-judicial mechanisms. → establishment of operational-level grievance mechanisms.

[46] OECD Guidelines for Multinational Enterprises, Chapter II, paragraph. 14

Key considerations for investors

Establishment of a grievance mechanism

The human rights chapter of provides that enterprises should "provide for or co-operate through legitimate processes in the remediation of adverse human rights impacts where they identify that they have caused or contributed to these impacts",[47] which can involve both judicial, state-based non-judicial, and operational level grievance mechanisms. Establishment of a grievance mechanism can serve as early-warning system for RBC risks and can also serve as a platform for remediation in instances where an investor is indeed causing or contributing to an adverse impact or not adequately carrying out due diligence. Grievance mechanisms should reflect the criteria provided under the human rights chapter of the OECD Guidelines which is aligned with Principle 31 of the UN Guiding Principles, and provides that grievance mechanisms should meet the core criteria of: legitimacy, accessibility, predictability, equitability, transparency, compatibility with the OECD Guidelines, be based on dialogue and engagement with a view to seeking agreed solutions.[48]

Engagement with National Contact Points

National Contact Points (NCPs) provide a forum for discussion to contribute to the resolution of issues that arise relating to implementation of the OECD Guidelines in "specific instances".[49] NCPs facilitate access to consensual and non-adversarial means of dispute resolution, such as mediation or conciliation, aimed primarily at reaching a mutual agreement between the parties rather than a legal judgment. The OECD Guidelines describe the NCPs and a framework for their operations, but leave much discretion to the member states in how they choose to set up their NCPs. At present, there is significant heterogeneity in the organisation and functioning of the NCPs.[50]

NCPs cannot impose sanctions, directly provide compensation nor compel parties to participate in a conciliation or mediation process. However the NCP system can generate important results. NCPs have to issue final statements upon concluding cases, which can include recommendations. Some NCPs also make determinations of whether a company's behaviour was in conformity with the OECD Guidelines. NCPs may follow-up with the parties on their response to these recommendations.[51] Furthermore, some governments consider NCP statements with regard to economic decisions, e.g. in the context of public procurement decisions or when providing public support to companies in the form of economic diplomacy or export credits.[52]

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47 OECD Guidelines for Multinational Enterprises (2011), Chapter IV Human Rights, paragraph 6.

48 OECD Guidelines for Multinational Enterprises (2011), Chapter IV Human Rights, commentary, paragraph 46.

49 OECD Guidelines for Multinational Enterprises, 2011. Procedural Guidance, Section C.

50 See generally OECD (2016) Implementing the OECD Guidelines for Multinational Enterprises: The National Contact Points from 2000 to 2015, available at: http://mneguidelines.oecd.org/OECD-report-15-years-National-Contact-Points.pdf.

51 OECD Guidelines for Multinational Enterprises (2011), Commentary on Procedural Guidance, paragraph 36.

52 For example, 25 countries which adhere to the Guidelines report that NCP statements are taken into account in reviews of applications to their Export Credit Agency. Under Canada's 2014 Corporate Responsibility Strategy, companies are encouraged to participate in the NCP mechanism and "[a]s a penalty for companies that do not embody CSR best practices and refuse to participate in […]NCP dispute resolution processes, Government of Canada support in foreign markets will be withdrawn".

Box 15. NCP specific instances processes: What to expect

NCPs offer a forum for discussion to assist the business community, worker organisations, other non-governmental organisations, and other interested parties deal with issues raised with respect to observance of the OECD Guidelines in an efficient and timely manner and in accordance with applicable law.

Generally, issues will be dealt with by the NCP of the country in which the issues have arisen. Under the OECD Guidelines when issues arise from an enterprise's activity that takes place in several adhering countries or from the activity of a group of enterprises based in different adhering countries, the NCPs involved should consult with a view to agreeing on which NCP will take the lead in assisting the parties. The NCP should consult with the other NCPs, which should provide appropriate assistance when requested by the lead NCP.

Each specific instance proceeding begins with an initial assessment of the submission. As part of this assessment the NCP may reach out to the enterprise(s) involved for their input or feedback on the issues raised. Here investors involved in a specific instance proceeding would have their first opportunity to understand and respond to issues raised in the submission.

While some NCPs publish initial assessment statements naming the parties and describing the facts and circumstances of a specific instance, other NCPs do not. If a submission is accepted for further examination following the initial assessment, the NCP will offer to provide mediation to the parties through a confidential process aimed at reaching an agreement between the parties. Through this process, parties are given the chance to exchange and explain their views. This may involve one or several meetings between the parties, mediated by the NCP. Some NCPs use a professional mediator.

The specific instance process concludes with a final statement or report by the NCP.

Where the NCP decides that the issues raised do not merit further consideration, the statement includes, at a minimum, a description of the issues raised and the reasons for the NCP's decision.

When the parties have reached an agreement, the statement at a minimum describes the issues raised, the procedures the NCP initiated in assisting the parties and when agreement was reached. The statement only includes information on the content of the agreement insofar as the parties involved agree thereto.

When no agreement is reached or when a party is unwilling to participate in the procedures, the statement at a minimum describes the issues raised, the reasons why the NCP decided that the issues raised merit further examination and the procedures the NCP initiated in assisting the parties. Where appropriate, the statement may also include the reasons that agreement could not be reached.

The NCP may make recommendations on the implementation of the OECD Guidelines as appropriate, which should be included in final statements and may engage in follow-up with the parties on their response to these recommendations.

Many NCPs allow parties to specific instances to review and provide feedback to final statements before they are published.

The number of specific instances brought to the NCP mechanism involving investors is growing fast. From 2000-2010, specific instances involving financial service providers accounted for just 8% of all cases brought. From 2011, this number increased to 17% and the financial sector was the most prevalent sector with respect to specific instances filed in 2014-2015.[53]

Investors should cooperate in NCP proceedings. Engagement can be beneficial to investors as the process is meant to be constructive. It is aimed at promoting agreement between the parties to improve business conduct. Engagement with the NCP process can be an opportunity to explain investors' efforts to carry out due diligence and to discuss potential challenges with regard to managing RBC risk.

Not engaging in NCP specific instance procedures deprives the investor of the opportunity to discuss these issues in a non-adversarial environment. As discussed above, NCP statements can also serve as a useful source of information to investors regarding investee companies that have been involved in specific instance proceedings (Box 9). Information on engaging with the NCP process is provided in Box 15.

Specific instances involving investors may have challenging cross-border dimensions. Where specific instances concern issues arising in several different countries the NCPs in the involved countries are expected to consult and coordinate in specific instances (Box 15).

Specific approaches for processes to enable remediation

Good practices for enabling remediation are not specific to asset owners and managers nor specific asset classes or investment strategies. Table 5 shows general approaches to enable remediation for both asset owners and managers across investment strategies and asset classes.

Table 5. Processes to support remediation: Practices by asset owners and investment managers

Remediation	**Asset owner**	Both asset owners and investment managers can establish facilities to enable stakeholders to bring actual or potential adverse impacts involving their investments to their attention. Investors are encouraged to collaborate with parties that raise concerns regarding investor relationship to adverse impacts through operational- level or external grievance mechanisms.
	Investment manager	

[53] OECD (2016), Annual Report of the OECD Guidelines for Multinational Enterprises 2015.

CONCLUSION

Under the OECD Guidelines, investors are expected to carry out due diligence to identify, prevent or mitigate adverse impacts and account for how adverse impacts are addressed. The due diligence process recommended by the OECD Guidelines can help investors evaluate risks of adverse impacts on matters covered by the OECD Guidelines and respond to them. Due diligence may also help avoid financial and reputational risks and respond to expectations of clients and beneficiaries. Institutional investors possess unique characteristics which can influence their due diligence approaches. For one, investors may hold investments in a large range of companies, across industries and geographies. As such they may be linked to adverse impacts in the context of their business relationships. Investors are also highly regulated and must first and foremost respond to legal obligations in the jurisdictions in which they operate. Lastly, the ability to influence investee companies may also be limited due to the nature of the investor's investment strategies and other factors.

The characteristics of investors and their respective portfolios will impact *how* an investor goes about carrying out due diligence under the OECD Guidelines, but not whether they are expected to carry out due diligence. Investors play an important role in promoting RBC amongst the companies they invest in. Indeed this is an expectation of enterprises under the recommendations of the OECD Guidelines. Investors have already achieved important results with regard to promoting RBC amongst investee companies. By appropriately carrying out due diligence, investors will not only enhance their risk management processes but help promote RBC globally.

ANNEX 1. TERMINOLOGY

The OECD Guidelines include terminology which is also commonly used in the context of institutional investment. However the meaning and application of this shared terminology is different in the context of the OECD Guidelines than in the context of institutional investment. Most particularly, the term 'due diligence', a central expectation under the OECD Guidelines, is a common 'term of art' in both the investment and other sectors, but the meaning differs from that in the OECD Guidelines. To facilitate understanding, this list shows the different meanings of relevant terms in the context of the OECD Guidelines and institutional investment.

	Risk
Terms used under the OECD Guidelines for Multinational Enterprises	✪ **"*Risk*" within the meaning of the OECD Guidelines refers to the existence of real or potential 'adverse impacts' on all matters covered by the OECD Guidelines (e.g. disclosure, human rights, employment and industrial relations, environment, combatting bribery, bribe solicitation and extortion and consumer interests).** It does not refer to financial risk, but rather to risks of adverse impacts when the recommendations of the OECD Guidelines are not respected (e.g. health and safety of workers or the public, negative impacts on livelihoods, etc.).
Terms commonly used by institutional investors	✪ **"*Risk*" for investors refers to the likelihood of negative impacts on investee companies and investors themselves. These impacts are usually financial, and relate to the value of investments. Risk may also relate to the risk of an investor's non-compliance with regulations; however such risks are generally also linked to negative financial impacts to investors.** The most common uses of the term '*risk*' include the possibility that an individual investment will not generate the returns expected and the volatility of the financial performance of an individual investment or a portfolio as a whole compared with the performance of benchmark against which performance is measured. '*Risk*' may also refer to the likelihood of an absolute loss of capital – i.e. not just a loss relative to a benchmark. Other forms of risk include: – *Market risk* (also known as systemic risk): the possibility of losses as a result of factors affecting the market as a whole – *Credit risk*: the risk that the issuer of a bond will not be able to make expected interest payments – *Counterparty risk*: the risk that the other party to a contract will not fulfil its obligations (e.g. in a derivative contract) – *Currency risk*: the risk of loss as a result of fluctuations in exchange rates.
Differences in terminology and application for this paper	The principal difference between these two understandings of risk is the **nature of the impacts** that they reference. Under the OECD Guidelines, it means broadly, risks external to the investee company -- risks of adverse impacts (e.g. risk of adverse human rights, labour and environmental impacts). In the context of institutional investment, it refers to the risk of internal financial impacts to the investee company or the investor. ➲ **For the purposes of clarity, this paper refers to risk commonly understood by institutional investors as "*financial risk*." This paper refers to "risk" as understood under the OECD Guidelines as responsible business conduct risk or "*RBC risk*." RBC risks can also have financial implications (negative or positive) for the company concerned and thus sometimes RBC risks are also financial risks.**

	Due Diligence
Terms used under the OECD Guidelines for Multinational Enterprises	✪ **"*Due diligence"* is the process through which enterprises 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.*** Due diligence is an ongoing, both proactive and reactive, and process-oriented activity; it is to be carried out throughout the entire life-cycle of operations, products and service because circumstances change and so will adverse impacts. This means that due diligence should not be limited to an initial investigation of a potential business relationship or transaction, but should also be applied proactively through establishment of systematic measures to identify RBC risk and prevent or mitigate potential adverse impacts, as well as through on-going monitoring of business relationships and related operations. Due diligence is a key aspect of responsible business conduct as it is a process for enterprises to "know and show" what they are doing about their adverse impacts. ** In this context RBC risk and adverse impacts are related to harms to society and the environment —"adverse impacts" as described above.*
Terms commonly used by institutional investors	✪ **"*Due diligence*" for investors is generally understood as a process that is conducted before an investment is made to identify potential risks and liabilities.** The term is used predominantly in relation to unlisted (private market) investments – e.g. private equity (PE) or real estate funds. For the collection of information prior to an investment decision in relation to listed (public market) investments – such as shares traded on a stock exchange – the term 'research' is more normally used (though the term "*due diligence*" is sometimes used in this context). The term "*pre-investment screening*" may sometimes be used to refer to an early stage of identifying potential companies or securities for investment, before more detailed research is conducted. Due diligence in all these situations may cover RBC issues. Due diligence also refers to the assessment of financial soundness, the integrity of internal systems, and compliance with relevant regulations during the process by which an asset owner appoints an external investment manager to manage some of its assets. Due diligence is also conducted by investors on other parties with which they do business – for example, the providers of investment indices; or counterparties for over-the-counter (privately negotiated) transactions. After an investment has been made, an investor conducts "*monitoring*" of its investments. In some cases, this involves monitoring individual companies. An asset owner – such as a pension fund or insurance company – that has outsourced the management of its investments to one or more asset managers monitors the performance of the manager(s). The term '*due diligence*' is not used in this context.
Differences in terminology and application for this paper	• The principal differences between the meaning of due diligence in the context of the OECD Guidelines and institutional investment are: under the OECD Guidelines, due diligence is a continuous process; whereas, in an investment practice, it is carried out prior to making certain investments or the appointment of an asset manager. • Under the OECD Guidelines, it is not only the process of identifying issues but also actively managing and accounting for them; whereas in investment practice, it describes processes used to simply identify issues, often in anticipation of a transaction • Under the OECD Guidelines, due diligence aims to avoid and respond to RBC risk; whereas in investment practice it aims to identify financial risk, as defined above). ➲ **This paper only discusses due diligence as understood under the OECD Guidelines and all reference made to due diligence should be understood within the meaning of the OECD Guidelines.**

	Leverage
Terms used under the OECD Guidelines for Multinational Enterprises	✪ **"*Leverage"* is an advantage that gives power to influence. In the context of the OECD Guidelines it refers to the ability of an enterprise to effect change in the practices of another party that is causing or contributing to adverse impacts.** Where a business enterprise is found to be directly linked to an adverse impact through a business relationship there is an expectation under the OECD Guidelines that it use its leverage to influence the entity causing the adverse impact to prevent or mitigate that impact, acting alone or in co-operation with other entities, as appropriate.
Terms commonly used by institutional investors	✪ **"*Leverage"* for investors is (i) the use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment and (ii) debt used to finance a firm's assets. A firm with significantly more debt than equity is considered to be highly leveraged.** The word "*leverage*" is also used in the more colloquial sense of "influence".
Differences in terminology and application for this paper	The colloquial understanding of leverage in the context of institutional investment has the same meaning as in the context of the OECD Guidelines, that being a sense of influence. However, in the context of the OECD Guidelines, leverage is intended to effect change in the wrongful practices of a party causing or contributing to adverse impacts whereas in the context of investment leverage is intended to influence potential return on an investment. Additionally in the context of investment "*leveraged*" can be used to describe the state of financing of a firm rather than the act of influencing. ➲ **In the context of this paper, leverage should be understood within the meaning under the OECD Guidelines.**

	Responsible Business Conduct
Terms used under the OECD Guidelines for Multinational Enterprises	✪ **Under the OECD Guidelines "*responsible business conduct*" means that business should a) make a positive contribution to economic, environmental and social progress with a view to achieving sustainable development and b) should avoid and address adverse impacts through their own activities and seek to prevent or mitigate adverse impacts directly linked to their operations, products or services by a business relationship.**
Terms commonly used by institutional investors	✪ **"*Environmental, Social and Governance*" (ESG) criteria is a set of criteria for a company's operations that socially conscious investors use to screen investments.** Environmental criteria looks at how a company performs as a steward of the natural environment. Social criteria examines how a company manages relationships with its employees, suppliers, customers and the communities where it operates and often includes human rights and labour rights. Governance deals with a company's corporate governance – its leadership, executive pay, audits and internal controls, and shareholder rights. Investors who want to purchase securities that have been screened for ESG criteria can do so through socially responsible funds or by using ESG service providers.
Differences in terminology and application for this paper	The scope of RBC and ESG criteria are related. Both relate to social and environmental considerations, however RBC is broader and specific to the standards and recommendations set out in the OECD Guidelines for Multinational Enterprises. ESG criteria may be used primarily to identify financial risks rather than RBC risks (see above).

ANNEX 2. COMMON INVESTMENT VALUE CHAINS

These figures are provided to demonstrate common investment value chains for readers that may not be familiar with them. The value chains depicted have been simplified for clarity.

Figure A2.1. Asset owner manages some assets in-house

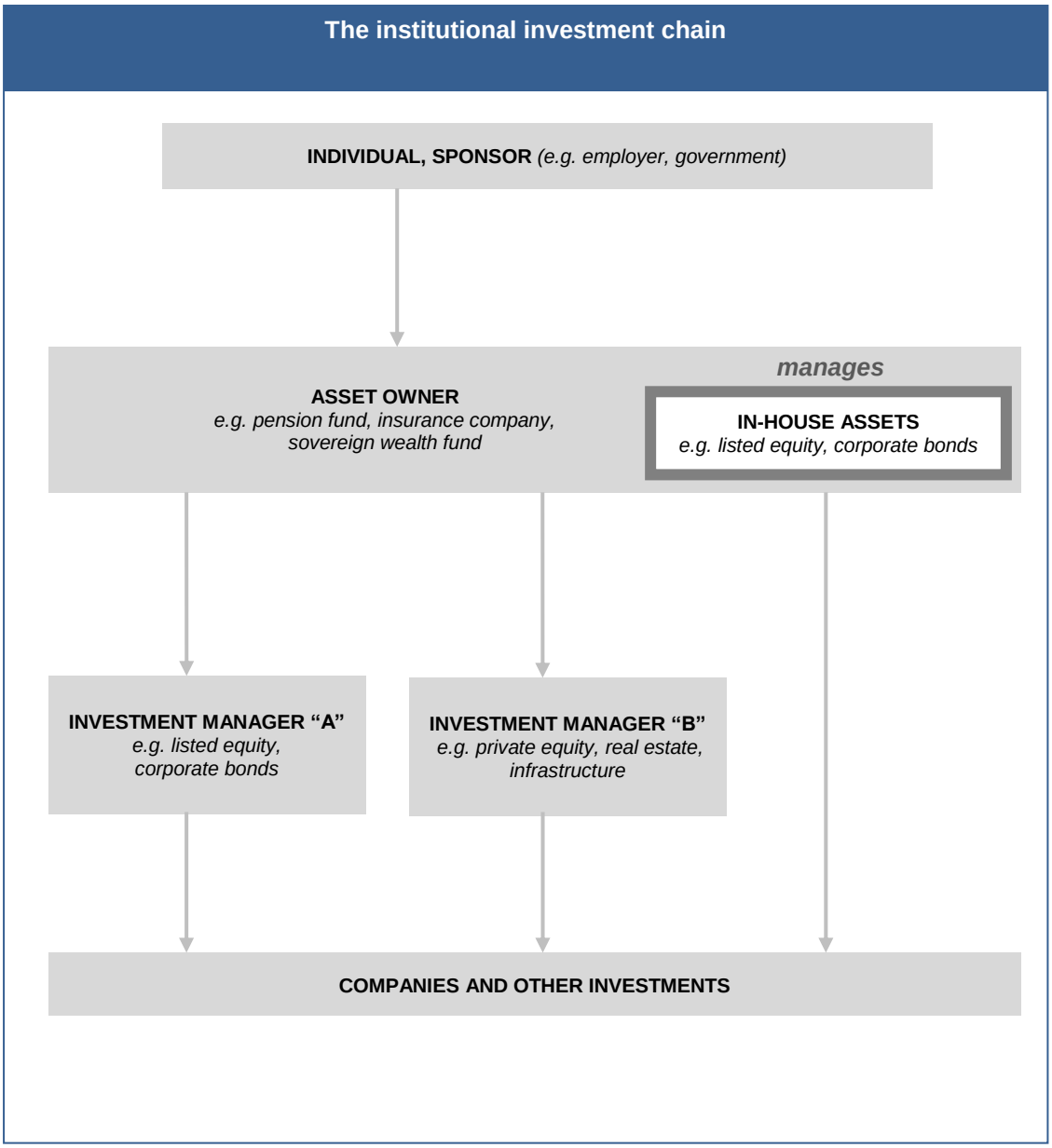


Figure A2.2. Asset owner outsources whole portfolio to a single manager

Figure A2.3. Asset owner outsources whole portfolio to multiple managers

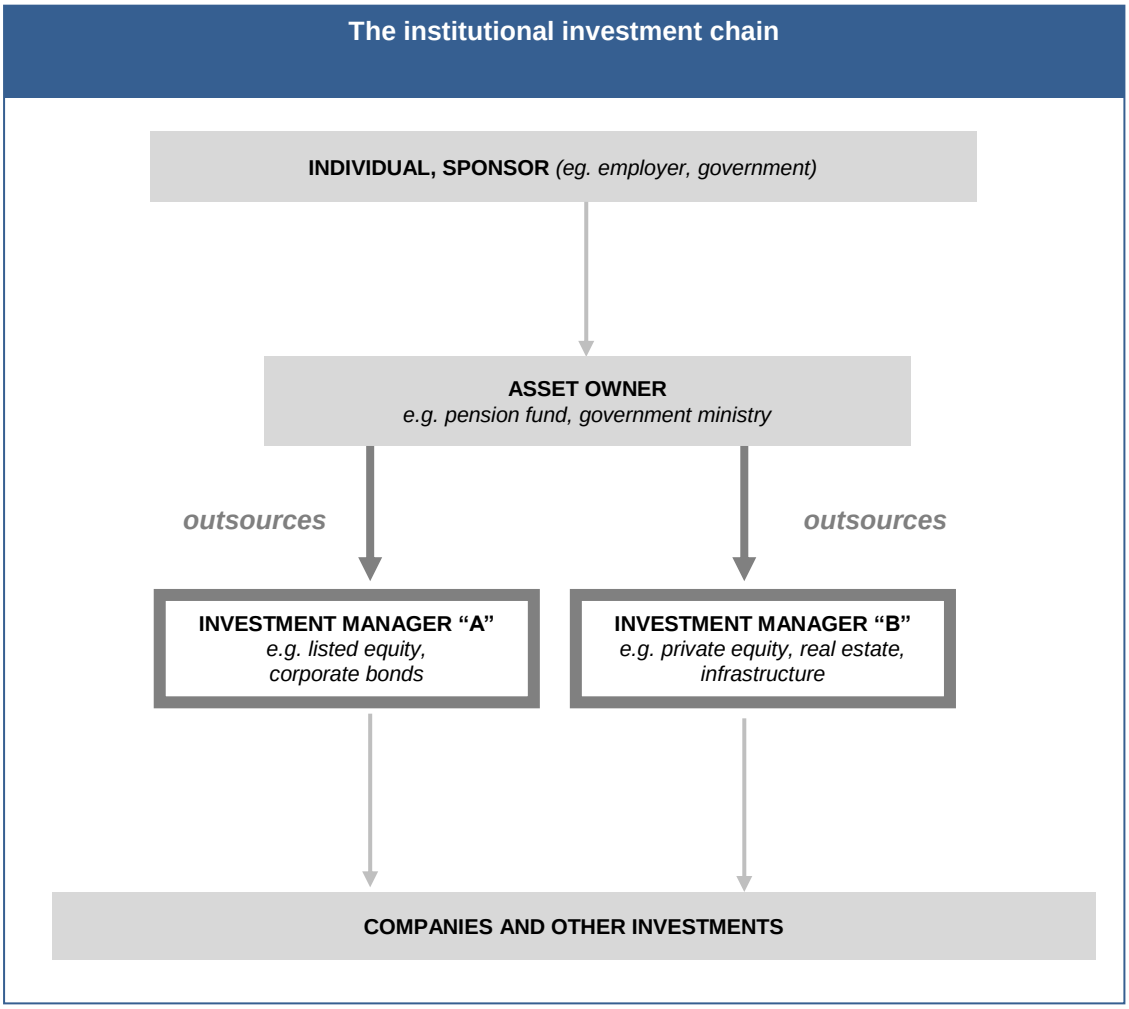
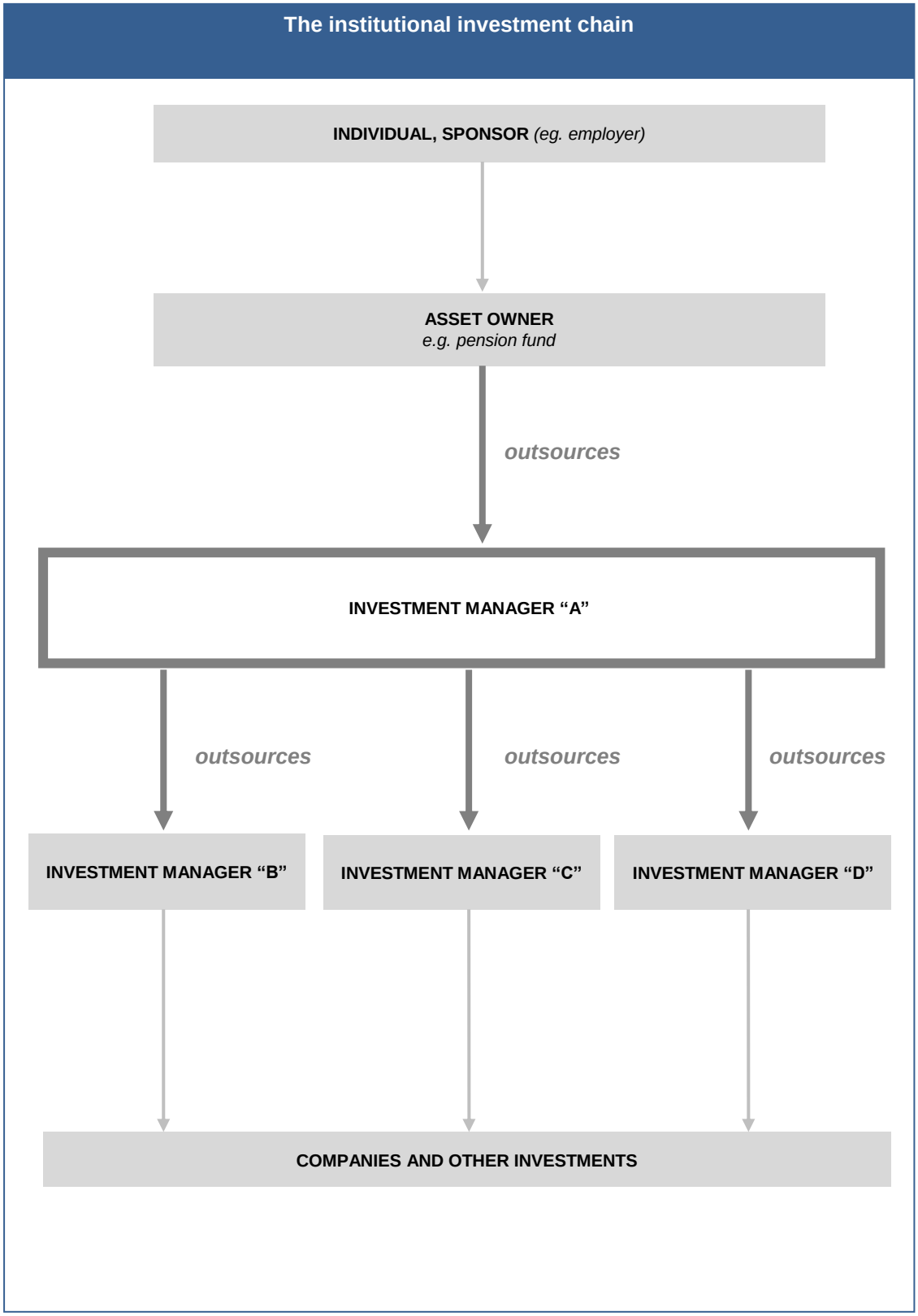


Figure A2.4. Asset owner outsources using fund-of-funds structures



ANNEX 3. ASSET CLASSES AND INVESTMENT STRATEGIES

This list provides descriptions of asset classes and strategies and their pre- and post-investment characteristics. Descriptions have been simplified for clarity.

LISTED EQUITY – FUNDAMENTAL ACTIVE INVESTMENT	
The investor buys shares in companies traded on a stock exchange. A large investor may have shares in several hundred companies in different actively managed portfolios.	
✪ Pre-investment characteristics Investment decisions are based on research on the company and its prospects, notably the outlook for its earnings, share price and (sometimes) dividend payments. Research is based on financial analysis, usually using information from specialist data providers or sell-side analysts (brokers); analysis of the company's strategy, products, markets, research and development plans, management team and competitors; and the general market environment – e.g. interest rates, the outlook for growth, consumer trends, etc. This process usually includes dialogue with management to inform the investor's understanding of the company. RBC issues that are particularly salient may be covered within the research process (e.g. high environmental liabilities or the company's track record in managing stakeholder issues that are crucial for its business – for example, a natural resource company's ability to manage local environmental and community issues in order to execute projects effectively). Investors with a strong focus on RBC investigate the company's RBC policies and performance in greater detail at this pre-investment stage.	**✪ Post-investment characteristics** The investor monitors the company and its performance in order to determine whether to continue to hold the shares, to sell, or to increase the investment. This usually involves dialogue with management. Investors with a strong focus on RBC may hold meetings with the company focused exclusively on RBC issues, in addition to covering particularly significant issues in other meetings. Buying and selling decisions by active investors influence the company's share price. This affects executive remuneration that is linked to the share price and the company's ability to expand by acquisition financed by shares. Trading decisions – or the anticipation of such decisions – may thereby exercise influence over company management. The investor has the right to vote at company annual general meetings on matters such as executive remuneration, the approval of the accounts, mergers and acquisitions, and shareholder resolutions on environmental and social issues. This combination of market influence and formal rights in principle gives the active investor the potential to influence company behaviour.

LISTED EQUITY – PASSIVE INVESTMENT

The investor buys shares in all companies in an investment index. An index consists of a number of companies selected to represent the composition and financial performance of the stock market as a whole. One of the most widely used global indices, the MSCI All World Index, has 2 477 constituents (www.msci.com/resources/factsheets/index_fact_sheet/msci-acwi.pdf. The largest passive investors hold shares in many more companies than this – up to ca. 10,000 in the case of the very largest.

✪ Pre-investment characteristics

The investor selects an index according to the particular market whose performance it wishes to replicate. The investor checks that the index construction methodology is appropriate for its needs (e.g. how the weightings of individual companies are determined) and conducts due diligence on the index provider (e.g. on its compliance with regulations).

The investor buys shares in proportion to their weighting in the index. Investment decisions are based purely on these weightings, not on specific research on individual companies. No contact between the investor and the company takes place before the investment is made.

Passive investments have become substantially more popular in recent years because of their low cost and efficiency as a way of achieving most investors' core objective of at least matching the performance of the market as a whole.

Specialist ESG or sustainability indices – e.g. reflecting companies' carbon intensity – are now available. Low-carbon indices are gaining increasing attention from asset owners as awareness of the implications of climate change grows. However, more general ESG indices are not widely used by mainstream investors.

✪ Post-investment characteristics

The investor may monitor companies and conduct dialogue with management in priority cases. The investor has the normal rights of a minority shareholder. The investor buys and sells shares only to reflect changes in a company's weighting in the index. If a company is removed from the index because its market capitalisation falls too low, the investor sells its stake completely.

CORPORATE BONDS – FUNDAMENTAL ACTIVE MANAGEMENT

The investor buys bonds issued by companies. A large investor may have bonds issued by several hundred companies in different actively managed portfolios.

✪ Pre-investment characteristics

Investment decisions are based on research on the company and its prospects, notably the outlook for its earnings and the likelihood that it will default on its debt. Research covers similar areas to those explored for actively managed listed equity, and may sometimes include dialogue with management.

✪ Post-investment characteristics

The investor monitors the company and its performance in order to determine whether to continue to hold the bonds, to sell, or to increase the investment. This may involve dialogue with management. The investor does not have voting rights at annual general meetings. The bondholder's ability to influence the company is limited. Trading decisions do not influence the company's share price.

CORPORATE BONDS – PASSIVE INVESTMENT

The investor buys all bonds in an investment index. An index consists of a number of bonds selected to represent the composition and financial performance of the bond market as a whole.

✪ Pre-investment characteristics	✪ Post-investment characteristics
The investor buys bonds in proportion to their weighting in the index. Investment decisions are based purely on these weightings, not on specific research on individual companies. No contact between the investor and the company takes place before the investment is made.	The investor is unlikely to monitor the company. The investor cannot sell individual bonds in the index. The investor does not have voting rights at annual general meetings. The investor's ability to influence the company is limited.

PRIVATE EQUITY – FUNDS

Private equity funds are managed by specialist investment managers (known as General Partners – GPs). GPs raise capital from asset owners – known as Limited Partners (LPs) to establish funds. The GP buys shares in unlisted companies.

✪ Pre-investment characteristics	✪ Post-investment characteristics
Investment decisions are made by the GP and are based on research on the company and its prospects, notably the outlook for its earnings and the value of the investor's stake. Research covers similar areas to those explored for actively managed listed equity, and always includes dialogue with management.	The GP monitors the company and its performance in order to determine when to sell the company. This always involves dialogue with management. An individual private equity firm may be the majority shareholder and have at least one seat on the board. The majority shareholder controls the company. The other largest investors also have seats on the board. LPs do not have direct contact with companies in the portfolio. In some cases they may not know which companies are in the fund. They have limited ability to influence the fund after the terms of the contract have been set. The largest LPs in a fund sit on a Limited Partner Advisory Committee (LPAC). LPACs 'are formed for the purpose of advising the GP on specific issues during the lifetime of a fund, including conflicts of interest and material changes to the governing documents of the fund where LPs' consents or approvals are required. GPs may also selectively consult with their LPAC in order to obtain LP opinions on operational or investment-related matters'. LPs monitor the GP and have regular meetings with them. LPs cannot instruct GPs to take particular actions (e.g. engagement with portfolio companies on RBC issues). However, they can encourage a GP to take appropriate action, and ask questions about what has been done in specific situations.

PRIVATE EQUITY – DIRECT INVESTMENT

Large asset owners may make direct private equity investments: they invest directly in an unlisted company, not through a fund.

✪ Pre-investment characteristics	✪ Post-investment characteristics
The investor conducts thorough research on the company. Research covers similar areas to those explored for actively managed listed equity, and always includes dialogue with management.	The investor may be the majority shareholder and usually has at least one seat on the board of the company. As the majority shareholder it controls the company.

INFRASTRUCTURE – FUNDS

Infrastructure funds are managed by specialist investment managers (known as General Partners – GPs). GPs raise capital to establish funds from asset owners – known as Limited Partners (LPs). The GP buys shares in unlisted companies that own and operate infrastructure assets such as ports, airports, toll roads, hospitals, schools and wind and solar farms. Each company may own and operate one or more infrastructure assets.

✪ Pre-investment characteristics

Investment decisions are made by the GP and are based on research on the company/asset and its prospects, notably the outlook for its earnings from user fees and the value of the investor's stake. Research always includes dialogue with management.

✪ Post-investment characteristics

The GP monitors the company/asset and its performance in order to determine whether/when to sell. This always involves dialogue with management. An individual infrastructure investment firm may be the majority shareholder and have at least one seat on the board. The other largest investors also have seats on the board. Investors with board seats directly control the company.

LPs do not have direct contact with companies/assets in the portfolio. They have limited ability to influence the fund after the terms of the contract have been set.

INFRASTRUCTURE – DIRECT INVESTMENT

Large asset owners may make direct private equity investments: they invest directly in an unlisted company, not through a fund.

✪ Pre-investment characteristics

The investor conducts thorough research on the company.

✪ Post-investment characteristics

The investor may be the majority shareholder and usually has at least one seat on the board of the company. It can therefore exercise considerable influence over the company.

REAL ESTATE – FUND

Real estate (property) funds are managed by specialist investment managers (known as General Partners – GPs). GPs raise capital to establish funds from asset owners – known as Limited Partners (LPs). The GP buys shares in unlisted companies that develop and manage real estate – e.g. offices, retail, logistics, residential. Each company may own and operate one or more property assets.

✪ Pre-investment characteristics

Investment decisions by the fund manager are based on research on the company/asset and its prospects, notably the revenues to be generated from rent and the potential increase in capital value.

✪ Post-investment characteristics

The investor monitors the company/asset and its performance in order to determine whether operational improvements are required and whether/when to sell. This always involves dialogue with management directly responsible for the asset. An individual real estate investment firm may be the majority shareholder of the operating company and have at least one seat on the board. The other largest investors also have seats on the board. LPs do not have direct contact with companies or assets in the portfolio. They have limited ability to influence the fund after the terms of the contract have been set.

REAL ESTATE – DIRECT INVESTMENTS

Large asset owners may make direct real estate investments: they invest directly in individual properties, not through a fund.

✪ Pre-investment characteristics	✪ Post-investment characteristics
The investor conducts thorough research on the company.	If the investor is the majority owner, it can exercise considerable influence over the management of the property.

GOVERNMENT BONDS – FUNDAMENTAL ACTIVE MANAGEMENT

The investor buys bonds issued by governments.

✪ Pre-investment characteristics	✪ Post-investment characteristics
Investment decisions are based on research on the country and its prospects, notably the outlook for its economy and the likelihood that it will default on its debt. Research may sometimes include dialogue with the country's government or central bank.	The investor monitors the country and its performance in order to determine whether to continue to hold the bonds, to sell, or to increase the investment. This may involve dialogue with the government or central bank. The individual investor's ability to influence the country is very limited.

GOVERNMENT BONDS – PASSIVE INVESTMENT

The investor buys all bonds in an investment index. An index consists of a number of bonds selected to represent the composition and financial performance of the government bond market as a whole.

✪ Pre-investment characteristics	✪ Post-investment characteristics
The investor buys bonds in proportion to their weighting in the index. Investment decisions are based purely on these weightings, not on specific research on individual countries. No contact between the investor and the government or central bank takes place before the investment is made.	The investor is unlikely to monitor the country. The investor cannot sell individual bonds in the index. The individual investor's ability to influence the country is very limited.

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