

Business Ethics

ESG

Environmental, Social
and Governance

Soft law violation & liability Towards Fiduciary Duty 2.0



Sustainability Research

Strategic partnership with:

**affectio
mutandi** 
CSR, Legal, Corporate & Public Affairs

www.affectiomutandi.com

Data partner for this report:

REPRISK 
ESG Business Intelligence

Changing anatomy of liability: Civil society 2.0 & CSR regulation

The growing quantity and scope of normative standards and transparency mechanisms, which can form the basis for hard law, are proving an efficient avenue of reference for redress available to civil society and those with a grievance against a company. The proliferation of social media in corporate branding, online press and civil society campaigns presents new mechanisms of accountability and greater reputational risk.

Soft law and reputation risk targeting controversial companies

Corporates with controversial activities have increasingly found themselves in the crosshairs of “soft law” with over 175 cases so far filed via the OECD complaints process alone, comprising diverse environmental and social concerns but with human rights a central area. Reputational damage and resulting financial and operational impacts are often the greatest effect rather than monetary penalties.

Towards a new P/E ratio: price-to-ethics

Soft law documentation can provide useful indicators that integrate ESG factors into the business context. We uncover an OECD NCP supply chain report on Rana Plaza and extract from it engagement questions and indicators that can assist investors who are pushing for metrics that straddle both economic interest and sustainability concerns.

Investor collateral damage

Although CSR commitments may not be a legal obligation, the proliferation of soft law complaints and hard law litigations against corporates introduces new risks to investor assets. The credibility of corporate and investor claims relating to sustainability processes are particularly vulnerable, as they depend on trust rather than legally enforced audits. Furthermore, SRI investors are held as potential influencers of investee behaviour and may increasingly be drawn in to cases where corporates are targeted.

Limited Liability & Fiduciary Duty challenged

While investors’ legal liability remains uncertain for controversial holdings, soft law precedents insist on responsibility for minority shareholdings, and more cases are likely to come up. The focus on fiduciary duty by long-term frameworks, such as the UK Stewardship Code and Kay review, implies the need for better investor due diligence and response processes to mitigate reputational risk, liability and facilitate the remediation of violations. This report aims to provide a detailed framework for these issues.

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This report is part of a series on business ethics

June 2013

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Business Ethics

ESG
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Corruption indices: From disclosure to risk exposure



Sustainability Research

A new forward-looking indicator to assess risk exposure to corruption:
We build on the Transparency International (TI) methodology to develop a new tool for investors that rates companies on their risk exposures to corruption. Using forward-looking indicators in the context of business exposure and news flow, our rating aims at mitigating increasingly material corruption risk and enabling engagement.

Sector risks emphasized under new regulation
Extractives have the most exposure due to payment transparency regulation in the US, also being finalised by the EC. Telecoms, construction and banks, proposed though not included in EC regulation, remain exposed longer term. Closer regulatory scrutiny has not disappeared and we rate companies in these sectors, also analysing the key industry specific issues presented. Companies in Aerospace & Defence and Cap goods remain in the regulatory limelight.

"The corruption research from Kepler Cheuvreux's team builds extremely effectively on Transparency International's research methodologies and primary analysis to demonstrate the risks that investors face from corruption and how investments can be better protected by good corporate governance and putting in place adequate anti-corruption procedures." Robert Barrington, Executive Director, Transparency International UK

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Pharma Corruption Risk Index



Sustainability Research

Our TI-based methodology expanded to pharma to identify risk
European large pharma shows the widest discrepancy between good anti-corruption reporting and poor practice. The variation of final risk exposure scores between companies, remains in a comparatively poor-scoring and narrow range, and the entire sector remains exposed.

Pricing: the first casualty
Regulators take a special interest in bribery in their domestic countries when their own budget deficits are at stake. Following the US, we now see China at the start of a systematic enforcement of anti-corruption rules to control pricing.

Enter China: investors impacted by regulator flexing its muscle
Starting in 2013, China put its name firmly on the map as a regulator to take notice of. Whether through price fixing concerns, large product recalls or corruption, foreign companies are increasingly affected.

Shareholder impacts revisited
Knock-on impacts under US, UK and other geographical legislation from probes carried out in China are possible. The risk may be increased for companies like GSK and Novartis currently under a "corporate integrity agreement" contract as a result of prior settlements with US authorities for similar offences. Lobbying, in particular, is a growing long term shareholder risk due to greater government, media and civil society focus.

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Corruption indices: From disclosure to risk exposure [Document link](#)

Business ethics: Pharma corruption risk index [Document link](#)

Previous reports include:

- *Aerospace & defence: working with the transparency international index*, January 2012
- *Conflict minerals*, November 2011
- *Bribery & corruption: the trillion dollar phenomena*, April 2011

A note on our approach to sources

We neither confirm nor deny allegations reported by the media in including them in this report. ESG analysis requires us to consider all stakeholders and media sources in order to assess potential reputational risk for investors. In this report, we use a variety of journalistic sources, including local ones where we feel they reflect a relevant area of risk. Often allegations will surface long before evidence is objectively presented or any official announcements are made either by authorities or less so by companies themselves. However, they are of key interest to investors as news flow, and critical within the context of the reputational risk we examine.

Introducing Affectio Mutandi

Affectio Mutandi is the first consulting agency to specialise in reputational, social and normative strategies, working at the confluence point of multiple stakeholders, linking corporate communication, crisis management, influence, public affairs, reputation, CSR, legal issues and NGO Relations. Its expertise combines a:

- Strategic mix of CSR, public affairs, legal issues and corporate communications consulting
- Strategies of influence, dialogue with stakeholders and normative engineering
- Management of legal, social and reputational risks of ESG issues

Yann Queinnec (Director General)

Expert in CSR normative engineering and stakeholder coalition building, with a strong experience of influence, NGO advocacy and legal activism.

Pierre-Samuel Guedj (President)

Expert in reputation management, crisis communication, influence and public affairs with a specific expertise in CSR, NGO management and sustainable development.

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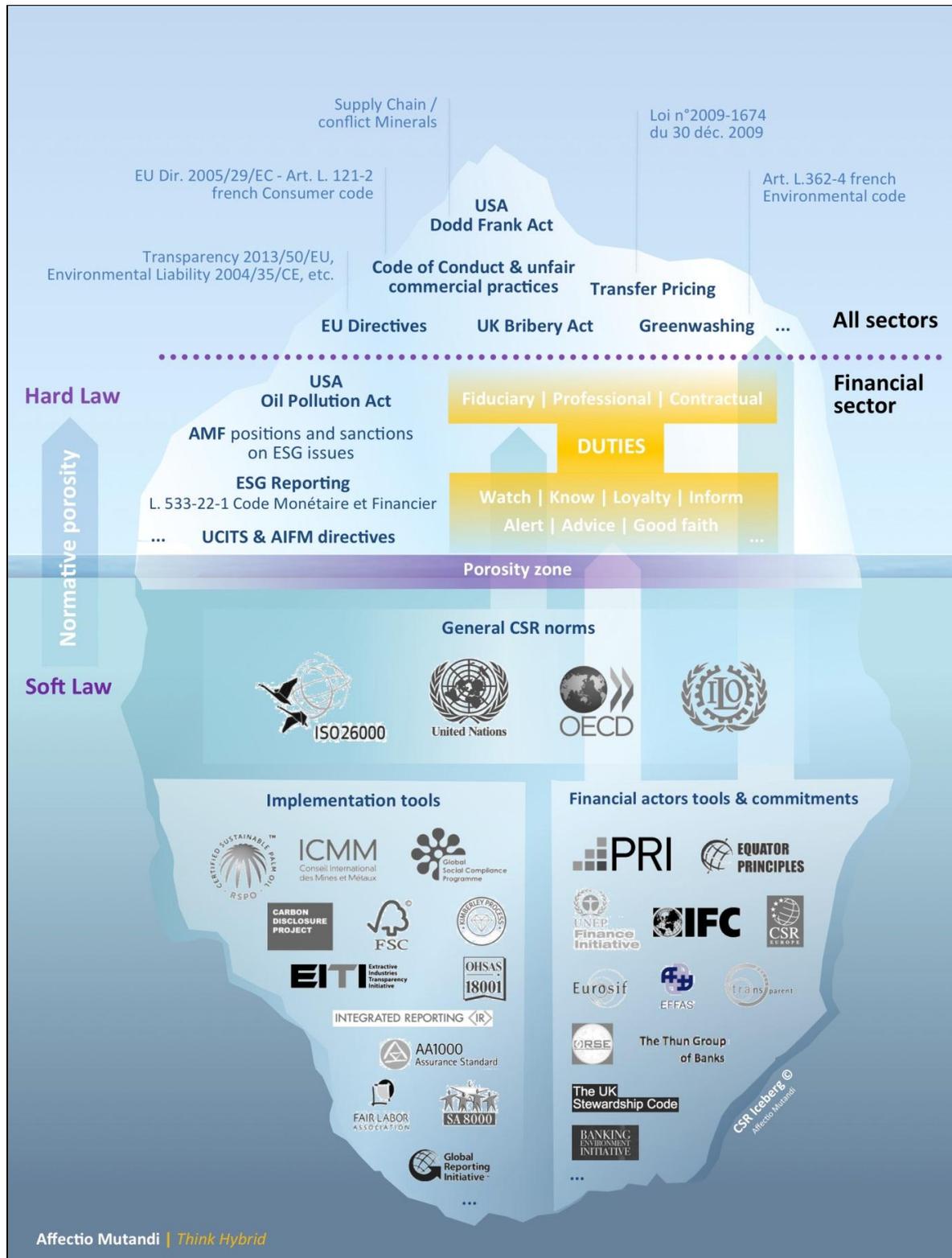
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Data partner for this study: RepRisk ESG Business Intelligence

RepRisk is a global provider of business intelligence on environmental, social and governance (ESG) risks. It runs the most comprehensive database on the ESG performance of companies, projects, sectors and countries.



Chart 1: The CSR Iceberg by Affectio Mutandi in partnership with Kepler Cheuvreux



Source: Affectio Mutandi, Kepler Cheuvreux

Executive summary

Changing the anatomy of liability: the rise of soft law may break bones

The concept of soft law relates to voluntary mechanisms that set out standards or “norms” for institutions, individuals, governments and of course companies to follow. These have been in existence for decades, but with the growing globalisation of corporate behaviour, such soft law mechanisms have increased in both quantity and scope. “Soft law” sometimes proves the only avenue of reference or potential redress available to stakeholders with a grievance against a company. Binding regulation (“hard law”) has arguably struggled to keep up with globalisation in the multiple areas covered by CSR, particularly in the domain of corporate responsibility in social and environmental matters.

Ignore at your peril: voluntary commitments can incite legal action

A number of corporates have voluntarily committed to areas of CSR. Although these commitments may appear to be outside legally mandated reporting standards, we analyse the proliferation of legal action against corporates deemed to be “greenwashing” or “fairwashing”.

CSR regulation: rewind the hard law and you will see soft law

We note the importance of soft law mechanisms which eventually become hard law. This is particularly so in areas of social regulation, where hard law can be weak, uncoordinated, unenforced or in some emerging markets non-existent. The starting point is civil society, where activism is the catalyst for improving the normative strength of voluntary standards via sector frameworks or international bodies such as the OECD or the UN. Furthermore we are seeing NGOs continue as watchdogs around CSR related themes when voluntary self-reported declarations become legally mandated requirements.

A transparency empire: favoured tool of NGOs, business and regulators

Mapping the emergence of greater sustainability efforts hinges on one major aspect: transparency. So what’s the problem? Stakeholders disagree on what should be disclosed. Corporates lobby heavily for voluntary, self-regulated standards, which in turn fall far short of NGO expectations. Governments increasingly fall between the two, but have begun to introduce CSR-related reporting regulations. In this process, disclosure of SRI and responsible investment methodologies, still at an early stage in terms of standardisation and usage, is undergoing its own challenges.

Corporates: the primary target

Corporates are the primary target for complaints via soft law mechanisms, with over 175 so far filed via the OECD complaints process through its guidelines for multinationals. In 2013, for the first time NGOs have been the main source of complaints, overtaking unions. The complaints cover the whole range of OECD Guidelines, from allegations of environmental damage, violation of labour rights, displacement of local communities, to tax avoidance and violation of privacy.

Reputation: the material of materiality for soft law and NGO campaigns

Of the multiple impacts that NGO-led soft law challenges can have on corporates and investors, reputation is the primary concern. The credibility of claims relating to sustainability or SRI processes is particularly vulnerable to these kinds of challenges.

Web 2.0 facilitates e-reputational value creation and...destruction

We note the multifaceted impacts of reputational considerations through the increasing use of social media and internet platforms, which can increase the speed of dissemination of allegations and garner support. Key developments in reputational risk management for corporates and civil society activism are centred on globalised social media presence and fluid online channels, allowing for instantaneous broadcasting of campaigns, financial support through crowd-funding, media stories and the dissemination of leaks.

Towards a new P/E: price-to-ethics

In this report we argue for specific indicators and transparency, not just related to social or environmental performance, but meaningfully integrating economic value and business model contexts so as to actually influence operations. One example is the focus in the work by the French OECD National Contact Point following the Rana Plaza disaster on how to ensure that buyers integrate specific sustainability issues. This reflects an integrated reporting approach in using a “Price/ Ethics” ratio to measure the potential attractiveness of each supplier not just on cost but also specific social risk such as health and safety performance.

The definitions of CSR have changed, will SRI follow?

A decade ago, CSR was largely defined on a case-by-case and theme-by-theme basis by companies that voluntarily allied themselves with the concept. Things have changed: the reference to external frameworks from the UN Global Compact, GRI or ISO 26000 is now increasingly expected as a minimum form of CSR credibility. SRI has perhaps not yet made such a move, with a plethora of fund definitions self-labelled as “sustainable” in some way but without any norm being made fully transparent and accepted in most cases, even where such norms do exist.

Collateral damage for investors: controversial assets an investor liability?

Although corporates have for some years faced complaints via soft law mechanisms, investors are increasingly being roped into allegations of corporate malpractice. For over a decade, controversial companies have had the potential to have an impact on those that fund them. Over the years, we have seen a number of actions relating to project financing, where issues concerning human rights, local communities and environmental impacts have been highlighted in order to pressurise investors into pulling the plug on funding. However, the types of investors being targeted now extend well beyond these parameters of project financing into the realm of asset management.

Minority shareholders: beyond the turning point

The principle of limited legal liability for minority shareholders is being challenged. We think recent cases suggest minority shareholders are now in new territory. They can, and probably will, continue to be targeted for holding shares in companies alleged to have

violated international norms. Critically, these norms increasingly fall into “soft law”, especially those mechanisms managed by supranational bodies such as the OECD or the UN, where international guidelines on business conduct have been made official but do not constitute direct legal obligations where companies can be prosecuted.

Responsible investing: an easy target on the reputational frontline?

Recent cases show that asset owners and managers whose activity has any SRI element may increasingly become targets for NGOs and the media, due to the additional visibility they give to the relevant ESG themes. We identify an increased push for openness and accountability related to statements and policies on sustainable investing. Inconsistencies or “gaps” in investment policies are being increasingly highlighted, but investors will also be able to use this momentum as an opportunity to strengthen the relevance of their methodologies and their brand. However, a future spread to mainstream financial players, for whom ESG is less important, cannot be ruled out.

Due diligence for investors

We schematise the fundamentals of investor due diligence through the steps of Know, Watch, Alert, Influence and Remediate. Each step allows for greater exertion of control over the liability increasingly presented on the SRI stage. We map the “CSR Token”, courtesy of Affectio Mutandi, our partners in this study, who centralise the use of due diligence to mitigate risk around investees’ controversial activities with an increase of the investor sphere of influence in order to contribute to greater sustainable development (and remediate when controversies do occur). This symbiotic duo is at the heart of investor responsibility.

A new principle: the duty of response above all

‘No comment’ is no longer an option for players who have made public commitments. We look at the decisions by the OECD National Contact Points that intervened in the landmark case involving investments in POSCO. Above all, one factor emerges as unavoidable: the duty of response. Wherever responsible investing or CSR commitments have been made, failure to respond is no longer acceptable. Similarly, with enhanced public visibility thanks to an eagle-eyed media and a Web 2.0 environment, legalistic responses may backfire reputationally.

Fiduciary duty: are definitions changing?

In 2005 and 2009 UNEP FI and Freshfields laid out the legal grounds for ESG to be considered a fiduciary duty in investment processes. While we have not seen hard law test cases since the publication of these landmark reports, we do consider soft law challenges from civil society, such as those under the OECD Guidelines, as having the capacity to push forward definitions of fiduciary duty regarding the use of ESG factors. In the context of, for example, the UK Stewardship Code, the Kay Review and the work of the UK Law Commission there are clear efforts to extend fiduciary concepts to clarify not just the admissibility of ESG factors as a move to longer terms focus but their necessity. In our view, the duty to uphold reputation – which is already a fiduciary element under the UK Companies Act – has scope to become an enlarged concern for Responsible Investment. This is particularly so as reputation is a necessary core of any fund with SRI claims.

The soft law dynamic

Soft Law covers declarations and agreements for institutions, individuals, governments and, of course, business. It is non-binding, but may still give rise to legal impacts. Its primary forms include guidelines set by international bodies – i.e. the OECD and United Nations, Reporting Frameworks, Codes of Conduct and voluntary declarations (i.e. for CSR). We examine its relevant characteristics and the factors that have made it of heightened interest for both companies and investors, and look at the impacts that are emerging, including on regulation.

ESG approaches by definition go beyond hard law

The incorporation of ESG factors, whether in SRI or CSR, entails an approach that includes compliance with regulation and risk management but necessarily goes further into soft law and societal obligations which are not covered by direct legal liabilities.

The proliferation of standards, as well as potentially complicating both CSR methodologies and SRI approaches, generates uncertainty over accountability and even legal liability. The same voluntary mechanisms that apply to corporates usually include financial sector companies. Increasingly mobilised stakeholders are intensifying the exposure of both corporates and investors through the use of pervasive soft law mechanisms.

The arsenal of soft law and accompanying grievance systems

Below we list no fewer than 54 normative approaches covering a large number of different aspects applicable to investors. We note that most include a substantial human rights element. While these norms and recommendations are numerous, we focus on the OECD Guidelines for multinationals, or MNEs (and the UN guiding principles on human rights, as they have a direct bearing): these have gained significant momentum, are global in scope, command official state level co-operation (if not binding power) and have grievance systems that have begun to be tested through cross-border cases involving both corporates and investors.

Both corporates and financial institutions ask how accountable they are under soft law mechanisms

Human rights are a central concern of many of the soft law mechanisms relevant to corporates and investors