Shift's Response to the UN Working Group Consultation on Investors, ESG, and Human Rights

October 2023

Shift is pleased to be responding to the Working Group on Business and Human Rights' consultation on "Investors, ESG, and Human Rights." The Working Group's forthcoming report marks an important opportunity to reflect on the state of practice of financial institutions in identifying and managing human rights impacts associated with their financing decisions, and better aligning with the international standards for responsible business conduct.

1. **No standardized approach to "S", with opportunities for more coherence:**[1]

    ESG in finance is not a standardized concept and is reflected in practice by investors in a variety of ways. Investors and financial institutions often approach the "S" in ESG in a distinctly "bottom-up" way, focusing on individual topics (diversity, modern slavery, health and safety, etc.) rather than locating these issues within a larger strategy for understanding impacts on people. ESG data providers have often responded to this demand with granular data elements that miss the opportunity to tell a more coherent and insightful story that offers insight as to how companies understand the full range of impacts on people from their activities and relationships.

    While it is certainly the case that different investors are pursuing information on a range of specific social topics, this overlooks the reality that there is a more *generalized* investor interest and need to understand how effectively companies they invest in assess and manage material risks that arise from their significant impacts and dependencies on people – whether these are workers in the workforce or value chain, communities, or consumers and end-users.

    We endorse the approach taken in the ESRS (European Sustainability Reporting Standards) S1-S4 in which material impacts on people are categorized by reference to: the company's ***Own Workforce; Workers in the Value Chain; Affected Communities;*** and ***Consumers and End-users***.[2] Applying this strategic frame to impacts on people from business activities and relationships helps avoid some of the unnecessary current confusion caused by the use of different nomenclature and indicators for similar impacts located in different parts of a company's value chain.

[1] Relevant to General Question 1
[2] Annex 1 https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13765-European-sustainability-reporting-standards-first-set_en

2. **<u>Current regulation incentivizes investors to be reactive and obscures the value of international standards:</u>**[3]

Prevailing regulation often incentivizes investors to frame their "S" analysis in overly simplistic, compliance-oriented terms in the context of human rights standards and frameworks; for example, the Sustainable Finance Disclosure Regulation (SFDR) requires financial market participants to disclose how they consider principal adverse impacts (PAI) of investment decisions on sustainability factors, including two PAI that make reference to "Violations of UN Global Compact[4] principles and Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises" and "Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines for Multinational Enterprises". In practice, many investors subscribe to commercial data services that provide alerts and analysis of corporate controversies, many sourced from news reporting around the globe. This reactive approach is contrary to the proactive investigation by investors of potential and actual harms related to their portfolio activities.

Such broad-based references to international standards of conduct begs the question of whether any company might ever be free of "violation" of these principles-based frameworks given the complexity of a typical company's value chain. Nor can that question be answered simply based on publicly reported controversies. In sum, the orientation that is encouraged by this kind of regulation is towards a naïve compliance exercise rather than recognition of effective human rights due diligence as an iterative continuous process.

3. **<u>While still the exception rather than the rule, financial institutions have developed and used effective – and in some instances, innovative - processes to address human rights issues that are aligned with the UN Guiding Principles:</u>**[5]

Despite the inevitable scale of an investor's relation to potential and actual impacts on people from portfolio company activities (given most investors' large and diverse portfolios) we do encounter asset owners, asset managers, commercial banks, and development finance institutions among others who have successfully applied the international standards for responsible business conduct, including human rights due diligence processes for their investment activities. It requires going beyond the traditional financial and operational

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[3] Relevant to General Question 1and State Duty Question 2
[4] We note the April 2023 consultation by the European Supervisory Authorities in which it is proposed that the UN Global Compact principles be replaced by reference to the UN Guiding Principles on Business and Human Rights. The issue of whether "violations" of the UNGPs offers meaningful insight remains; a more useful indicator would reflect the extent to which the UNGPs have been implemented, including whether a human rights policy has been established, confirmation of evidence that the policy has been embedded, identification of the investee's most salient human rights risks and impacts, description of how stakeholders have been engaged in both the process for identifying risks and taking action to prevent or mitigate impacts, and actions taken by the investee including metrics for progress in addressing the relevant risks and impacts.
[5] Relevant to General Question 1 and Good Practices Question 1

lenses of enterprise risk to include a lens of risk to people, and is not without its operational challenges – but it is indeed possible.

As one example, we are encouraged by investors' consideration of risks to people embedded in company business models, as a further refinement of a risk-based approach to identifying and assessing potential and actual impacts on people from business activities and relationships. They are proactively considering how business decisions around how costs and revenues are structured, how products and services are offered, and the company's value propositions all potentially affect people. This approach positions investors to find more effective ways of exerting leverage to help mitigate or prevent harms. Along with the clear benefit to moving investors away from a reactive stance when adverse impacts happen, considering business model risks aligns ESG investment professionals with traditional investment analysts who have interests in business model issues from a purely financial perspective. We are gratified to see investors building upon Shift's Business Model Red Flags tool to go beyond generalizations about propensity for risks in sectors to develop more specific understanding of the drivers of risks to people associated with businesses, which we believe positions investors to be more effective in identifying risks and exerting leverage.

4. **Qualitative data is important to assessment by investors of corporate social performance, but high-quality quantitative indicators are also possible:**[6]

Investors appreciate quantitative indicators of corporate social performance which should facilitate comparability and the ability to scale analysis over large numbers of investees. In practice, however, we observe that investors and companies alike often anchor on metrics that do not provide meaningful insight as to the investee behaviors and practices that result in better outcomes for people affected by a company's business activities.

Our 2019 research on over 1,200 questions in 8 major ESG rankings, ratings, and indices revealed that fully two-thirds focused on inputs, outputs, and activities – many of which lend themselves to quantification, but which often fail to tell the story of what is actually being achieved. Not surprisingly, our analysis of 400 corporate disclosures showed that some 70% of the disclosures were similarly focused on inputs, outputs, and activities. The remaining data on outcomes was largely limited in scope to topics subject to regulation, including diversity and health and safety.

Notwithstanding this analysis, we do find some examples of insightful quantified indicators, belying the notion held by some investors that social performance can only be characterized with qualitative insights that are difficult to scale; for example, gender gaps in

[6] Relevant to General Question 4

pay, coverage of worker populations by collective bargaining arrangements, and coverage of worker populations by at least a living wage.[7]

Shift's current work on better "S" indicators embraces the possibility of high-quality qualitative and quantitative data on social performance that offers useful insights about how companies manage their risks and impacts on people. In our forthcoming[8] analysis, we relate a variety of prevalent social indicators and metrics to certain quality criteria.[9] We consider various factors that affect the potential for indicators to offer useful insights, including:

- the clarity of the indicator's relationship to outcomes
- potential perverse consequences in behaviors and actions arising from focus on the indicator
- an assessment of the relative simplicity of the indicator or susceptibility to misuse or misinterpretation
- the potential auditability of the indicator
- the likely availability of data for the indicator
- the feasibility of disclosure
- how the indicator fits with emerging trends in disclosure standards

5. Context matters to useful insights on social performance:[10]

We note the difficulty in applying uniform indicators that characterize corporate social performance without also taking into account the context (for example, geographic footprint of a company's operations, local socio-economic realities, issues specific to an industry or sub-industry, the form of business relationships that give rise to risks or impacts, etc.) This reality limits complete comparability across a large universe of diverse investees, often because additional qualitative insight is required to interpret the indicator of social performance appropriately. This has implications for the cost and effort required for effective analysis of social performance, implying the necessity for skilled analysis of disclosed data for which current technological tools (including AI) have so far proven largely inadequate.

[7] Work by Shift and the Capitals Coalition sets forth an accounting construct and related tool that allows companies to provide meaningful insights on how progress on living wages evolves over time https://shiftproject.org/accounting-for-a-living-wage/
[8] Expected 4Q23
[9] For example, as set forth in Shift's "Signals of Seriousness" https://shiftproject.org/resource/signals-draft1/
[10] Relevant to General Question 4

6. **There is a gap between what ESG ratings and research providers currently offer and what investors need:**[11]

ESG index, data, and research providers are generally commercial enterprises that are responsive to market demands expressed by investors. While their current offerings generally fall short of the comprehensive assessment of corporate social performance and capacity required by evolving investor interests and requirements, they are likely capable of adapting their offerings. Several datasets and related analyses that typically do a better job at offering useful insights into key aspects of corporate social performance are available from non-governmental organizations (including, for example, the World Benchmarking Alliance's Social Transformation and Corporate Human Rights Benchmark, Know The Chain, etc) which suggests that high quality data of the sort that is useful to investors is possible, even if NGOs have not yet developed those datasets at scale.

We believe investors need more from ESG index, data, and research providers to be able to fulfill their own responsibilities to understand potential and actual harms to people from investee business activities and relationships. In particular, as we set forth in our work with Principles for Responsible Investment in the paper What Data Do Investors Need To Manage Human Rights Risks?, investors need more insight on companies' inherent human rights risks; how corporate boards and executives embed commitments in company culture and practice; insights on the quality of companies' human rights due diligence processes; and information about positive human rights outcomes to which a company has contributed.

While the "E" "S" and "G" in ESG have cross-cutting characteristics and dynamics, it has been regrettable that investors and their data providers have attempted in some instances to reduce a company's ESG performance to an **aggregate** rating or score.[12] This practice of blending of assessments of environmental and social performance (despite dissimilar bases for the underlying evaluations) can obscure critical information about poor human rights performance by a company performing well on an environmental score, for example, or vice versa.

Investors seeking a summary view of corporate ESG performance – for example to evaluate the quality of management, resource allocation and risk management – are more likely to derive decision-useful information from the insights on the **specific environmental and social risks and impacts that are relevant to the company**, and not from a score that obscures those insights in favor of a single letter or number.

[11] Relevant to General Question 4

[12] We note that credit rating agencies provide a single aggregated rating. This reflects their mandate to focus on the ability of a company or sovereign to pay the principal and interest due on its debt and, as such, encompasses more uniform and well-established indicators. This is in contrast to E&S risk indicators, which blend quantitative and qualitative metrics and are still evolving.

7. **Investor assessment of investee performance on managing human rights issues can be consistent with the materiality frameworks proposed by standards-setters:**[13]

There is confusion in the marketplace as to:

1. Whether ESG analysis is reflecting ESG performance only to the extent that it is financially material; or
2. Whether ESG analysis is inclusive of (or exclusive to) ESG performance that reflects a company's potential or actual impacts on people and planet regardless of financial implications.

While a narrow interpretation of fiduciary duty has motivated some investors to focus only on financially material social issues, many investors choose to understand both financial *and* impact materiality in their own right and not just as they overlap, recognizing that material impacts may become financially material over time ("dynamic materiality") or that impact materiality may be relevant to systemic risks affecting portfolio returns.[14] In addition, some investors may have sustainability preferences alongside financial objectives and seek impact materiality information to support decisions on both dimensions.

The three founding organizations of the ISSB (CDSB, IIRC and SASB), together with the Global Reporting Initiative and the Carbon Disclosure Project, articulated the critical relationship between significant impacts on people (and planet) and financial risks in their joint paper entitled 'Statement of Intent to Work Together Towards Comprehensive Corporate Reporting'. The organizations concerned recognized the 'dynamic' nature of the concept of materiality given that significant impacts on the economy, environment and people can – gradually or very quickly – become material for enterprise value creation.[15] Likewise, the European Sustainability Reporting Standards (ESRS) make the same relationship clear when they state that in conducting double materiality assessments: "[i]n general, the starting point is the assessment of impacts, although there may also be material risks and opportunities that are not related to the undertaking's impacts."[16]

ESG data and analytics providers need to be clearer in their offerings as to any limitation on dimensions of materiality, including the case where impact materiality is subordinated to financial materiality in any way. Investors should be equally clear to their clients as to how they consider financial materiality and impact materiality.

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[13] Relevant to Corporate Responsibility Question 5

[14] See for example this comment letter to the ISSB from a financial institution, which explains the motivations for considering the complete range of material impacts

[15] See also https://sasb.org/wp-content/uploads/2023/01/Statement-of-Intent-to-Work-Together-Towards-Comprehensive-Corporate-Reporting.pdf

[16] ESRS 1, Section 3.3, para 38. The caveat provided here is to recognize that system-level risks such as climate change and inequality may not always be a product of particular impacts of a given company, but may nevertheless raise material risks for that company. https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13765-European-sustainability-reporting-standards-first-set_en

8. **Lack of assurance capacity for data related to social performance generally and how companies address human rights issues specifically is a significant near-term concern:**[17]

   There is a significant disconnect between investor demand for reliable information about corporate social performance and current capacity to provide assurance of that information. Assurance underpins the reliability of information that investors value. But there are minimal levels of experience within the audit profession, generally speaking, that is relevant to audit and assurance of human rights impact and risk management, outside of mainstream issues such as health & safety and diversity, equity & inclusion. As the European Sustainability Reporting Standards come into effect, more than 40,000 companies will be providing such information. The audit profession will need to develop new knowledge, competencies and tools, both regarding how specific human rights issues manifest in different industries, and how to accommodate the expanded set of sources required to be examined when assuring information about how a company has engaged with affected stakeholders, or their estimations of the effectiveness of their risk mitigation efforts in terms of the outcomes people experience. It is likely that different criteria and techniques will need to be developed to source and weigh inputs from affected stakeholder populations, which also implies different forms of engagement with external experts and different criteria for considering whether information is credible and reliable.

9. **Understanding investee capacity and performance on human rights issues is relevant throughout the investment process:**[18]

   We note the potential for investors to integrate human rights considerations throughout the investment process in the following table, excerpted from our work with Principles for Responsible Investment in our paper What Data Do Investors Need to Manage Human Rights Risks? Some differences are noted for investors in different asset classes; for example, bond investors do not have ownership prerogatives to propose shareholder resolutions or vote.

[17] Relevant to Good Practices Question 2
[18] Relevant to Corporate Responsibility Question 4

	Investment activity	Data needs
Research	**Screening:** investors 'screen out' investees with significant negative human rights performance; and / or apply screening to identify investees for stewardship.	Range of potential data needs, including evidence of investee involvement in significant controversies, especially those with unsatisfactory resolutions, or a higher-level assessment informed by an ESG score that includes the investee's human rights track record.
	Assessment of investable universe: activities include gathering information on risk exposure to human rights, human rights performance and / or undertaking materiality analysis.	Range of potential data needs, depending on specific activities, including: sectors and regions in which the investee and its wider value chain operate; evidence of controversies along its value chain; and salient human rights issues relevant to the local context of the investee and its value chain.
Valuation	**Buy / hold / sell analysis:** investors assess an investee's financial performance through valuation models and credit assessment, as well as scenario analysis, whereby investors consider a range of future scenarios and assess financial and risk implications.	Evidence of the consequences of investees' relationships, business activities, and their approach to managing human rights-related risks.
	Sustainability analysis: investors assess an investee's sustainability performance and alignment with sustainability goals.	Evidence of investees' performance on human rights issues, including aligning with human rights standards and relevant benchmarks.
Portfolio construction	**Portfolio-level analysis:** investors apply asset allocation decisions in line with the results of the research and valuation stages at portfolio level, including running different ESG scenarios.	An aggregation of analysis of investees' human rights risks and impacts to inform sector / industry analysis and risk management strategies.
Stewardship	**Engagement:** creating dialogue with investees to develop further understanding of their human rights risks, related management processes, and progress towards addressing risks to people.	Insights into investees' human rights risk management processes including their alignment with international standards. This step builds off the results from research and valuation.
	Voting: investors vote on shareholder resolutions to communicate their views to company management about their human rights conduct.	An understanding of corporate governance practices related to human rights risk management, including board and senior management incentives and how they are held accountable.
Reporting	Fulfilling regulatory and client reporting requirements.	A need for comparability and scalability of relevant data.

10. **Investors have a variety of opportunities to build and/or exert leverage in response to potential or actual harms to people from investee activities or relationships.**[19]

The international standards are clear in defining appropriate investor actions according to whether they themselves have caused, contributed, or are directly linked to an adverse human rights impact resulting from an investee/client's business activities or relationships. We observe that investors often presume that their relationships to harms are through linkage, and discount the possibility of their contribution to those harms either through their actions or omission of action. In the instances where investors are directly linked to harms, we also observe some tendency for investors to stop at the point of identifying the risk or impact, and not fulfill their responsibility for developing and applying leverage to help mitigate or prevent the harm.

Investors have many ways of exerting their leverage to address the potential and actual human rights impacts related to their portfolio companies. Investors may act unilaterally or by joining with others to magnify their influence. Although the focus of investor leverage is most commonly on the investee, policy interventions may also be a form of leverage available to investors, in cases where the lack of appropriate regulation or enforcement creates or enables the adverse impact.

Equity investors may have legal prerogatives related to ownership (proposing shareholder resolutions, votes at Annual General Meetings, etc) in addition to engagement tactics that are generally available to all investors. Lenders and private asset investors (limited partners) will tend to have more leverage before a transaction is executed; for example, as we explored in Shift's Financial Institutions Circle and subsequently summarized in our paper Using Leverage With Clients To Drive Better Outcomes For People, lenders can reposition client engagement from an intrusion to a valued resource; focus on higher quality asks of clients that matter to outcomes to people; build leverage into the decision-making processes for approving transactions; ensure internal accountability for development of leverage strategies and evaluation of their effectiveness; find opportunities to build internal capacity for leverage; and engage with sector and policy initiatives to level the playing field.

11. **Investor disclosure of their own policies and processes related to addressing human rights issues tend to be topically focused and often fall short of illuminating any systematic approach:**[20]

The UN Guiding Principles Reporting Framework is applicable to investors who wish to provide holistic disclosure about their policies and practices associated with human rights issues. Investors have successfully used the UNGP Reporting Framework in this way; for example, see this report from AP2.

[19] Relevant to Corporate responsibility Question 4
[20] Relevant to Corporate Responsibility Question 7

12. **Other entities in the investor ecosystem can be effective at focusing attention on corporate social performance:**[21]

    Although we do not believe stock exchanges are in a position to *ensure* respect for rights by investors or investees, they are well situated to improve the quality of information about investees' policies and practices related to human rights issues. For example, NASDAQ's Board Diversity Rule requires operating companies listed on NASDAQ to provide annual disclosure of diversity statistics. The JSE Sustainability Disclosure Guidance outlines human rights disclosures for companies listed on the Johannesburg Stock Exchange.

    Index providers can incentivize attention from both investors and investees on facets of corporate social performance by their decisions on what to score companies on and how to weight the scores. While the expectation is that index providers are being responsive to investor interests and priorities, there is also opportunity for these providers to exert leadership and center attention on underappreciated elements of social performance. For example, we observed welcome growth in attention to the issue of living wages when Dow Jones Sustainability Indices included relevant questions in the underlying Corporate Sustainability Assessment.

13. **Investors have a role to play in enabling or providing remedy:**[22]

    The remedy frameworks set forth in International Standards (UN Guiding Principles on Business and Human Rights, and the OECD Guidelines for Multinational Enterprises) link the responsibility to provide or contribute to remedy to those organizations that have caused or contributed to a harm. That said, even where an investor is only 'directly linked' to a harm through its relationship with a client or investee, it may play a key role in using its leverage to support the provision of remedy.

    While effective grievance mechanisms play an important role in the remedy landscape, investors are generally not at the 'operational level' where harms are arising in relation to investees/clients and are not therefore the typical primary channels for stakeholder complaints and allegations. Most affected stakeholders likely will have no way to identify all of the financial institutions who are linked to the harm. We believe it is useful for investors to think beyond grievance mechanisms and consider their role in a "remedy ecosystem", as we set forth in our note Rethinking Remedy and Responsibility in the Financial Sector. By enlarging the focus beyond which parties can provide remedy to include consideration of which parties have roles to play in enabling remedy, investors can take a more strategic approach to deploying leverage. This brings the advantages of a focus on preparedness for remedy, including more deliberate building of leverage at earlier stages of a relationship with the investee.

[21] Relevant to Corporate Responsibility Question 11
[22] Relevant to Access To Remedy (Non-state) Question 1