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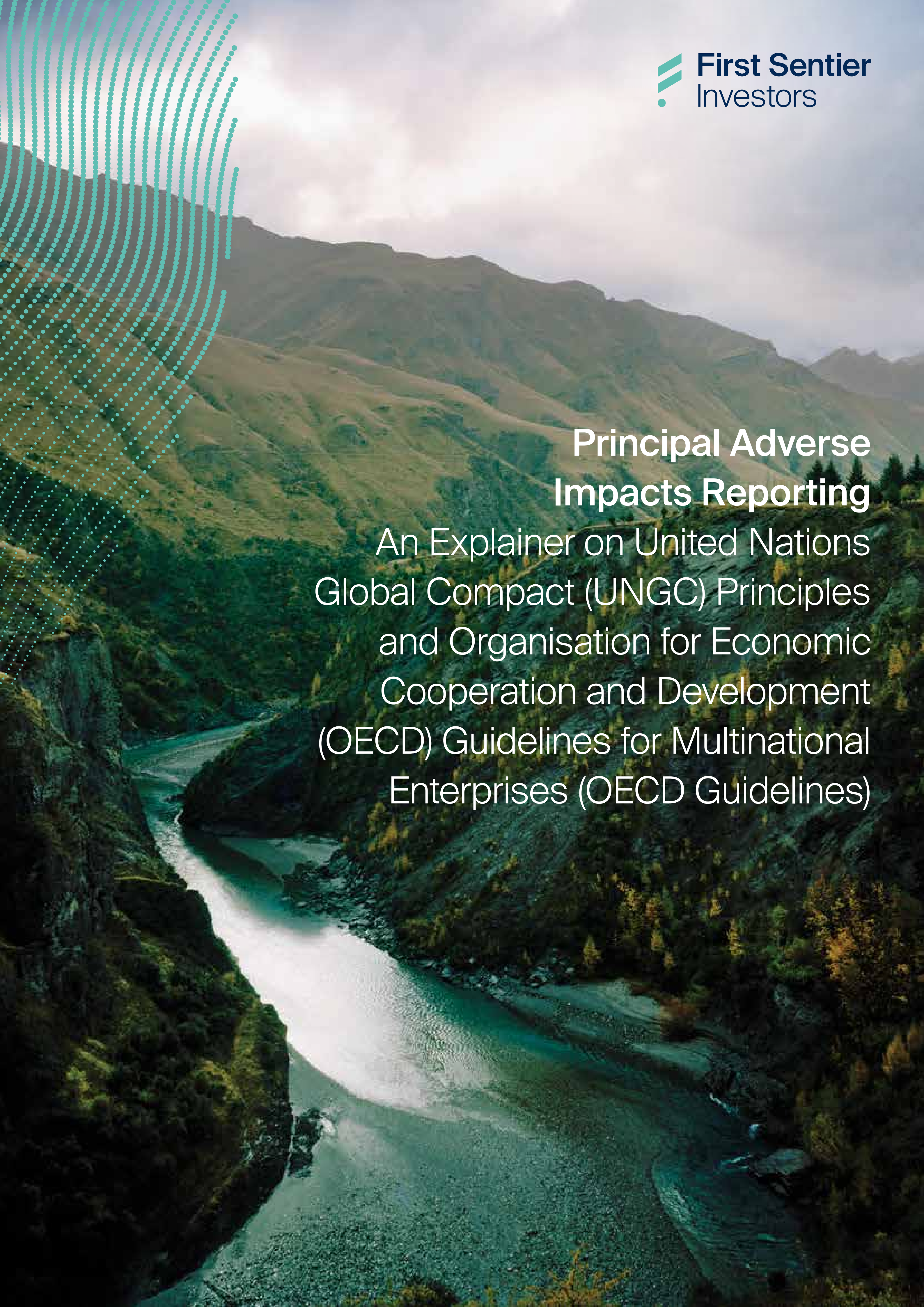


# Principal Adverse Impacts Reporting

## An Explainer on United Nations Global Compact (UNGC) Principles and Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises (OECD Guidelines)

## The Sustainable Finance Disclosure Regulation (SFDR) for the European Union mandates the disclosure of the "Principal Adverse Impacts (PAIs) that investment decisions have on sustainability factors[1]". These can broadly be thought of as the negative impacts caused by a firm or an asset, on people and planet.

Asset managers are among the "financial market participants" that need to report on mandatory and voluntary PAIs, in order to identify and assess risks and minimise harm associated with their portfolios.

This article focuses on two of the PAIs related to the United Nations Global Compact (UNGC) Principles and Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises on Responsible Business Conduct (the Guidelines). **PAI 10** measures violations of UNGC Principles and OECD Guidelines. **PAI 11** flags companies lacking process and compliance mechanisms to monitor compliance with UNGC Principles and OECD Guidelines.

These indicators measure how companies cause, contribute to, or are linked to, violations of international norms and standards, as well as what policies and procedures are in place to monitor compliance with these norms and standards, and address such violations. It includes details about the indicators, some of the data challenges related to them, and how investors may use the information they provide.

1 European Securities and Markets Authority https://eur-lex.europa.eu/eli/reg_del/2022/1288/oj

## What are the UNGC Principles?

The UN Global Compact is a voluntary initiative that calls for companies to meet minimum fundamental responsibilities in the areas of human rights, labour, the environment and anti-corruption.

These responsibilities are defined in ten principles, referred to as the UNGC Principles. Complying with these principles can be thought of as the bare minimum for corporate responsibility.

The ten principles of the UNGC are derived from:

- The Universal Declaration of Human Rights;
- The International Labour Organization's Declaration on Fundamental Principles and Rights at Work;
- The Rio Declaration on Environment and Development; and
- The United Nations Convention against Corruption.

## The Ten Principles of the UN Global Compact

| | |
|---|---|
| **Human Rights** | |
| Principle 1 | Businesses should support and respect the protection of internationally proclaimed human rights. |
| Principle 2 | Businesses should make sure that they are not complicit in human rights abuses. |
| **Labour** | |
| Principle 3 | Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining. |
| Principle 4 | Businesses should uphold the elimination of all forms of forced and compulsory labour. |
| Principle 5 | Businesses should uphold the effective abolition of child labour. |
| Principle 6 | Businesses should uphold the elimination of discrimination in respect of employment and occupation. |
| **Environment** | |
| Principle 7 | Businesses should support a precautionary approach to environmental challenges. |
| Principle 8 | Businesses should undertake initiatives to promote greater environmental responsibility. |
| Principle 9 | Businesses should encourage the development and diffusion of environmentally friendly technologies. |
| **Anti-Corruption** | |
| Principle 10 | Businesses should work against corruption in all its forms, including extortion and bribery. |

## What are the OECD Guidelines?

The OECD Guidelines for Multinational Enterprises on Responsible Business Conduct ('OECD Guidelines') are recommendations jointly addressed by governments to multinational enterprises ('MNEs'). They aim to enhance the business contribution to sustainable development and address adverse impacts associated with business activities on people, planet, and society.

Whilst the OECD Guidelines are also voluntary, they are supported by National Contact Points ('NCPs'). NCPs are agencies established by governments to assist enterprises and their stakeholders to respond appropriately to further the observance of the Guidelines.

Compared to the higher-level UNGC Principles (outlined in the table above), the OECD Guidelines are more prescriptive. They cover multiple areas of business responsibility, including: human rights; labour rights; environment; bribery; consumer interests; information disclosure; science and technology; competition; and taxation.

### What do these PAI indicators measure?

There are two indicators related to the UNGC Principles and the OECD Guidelines, one which measures preparedness to monitor compliance with, and address any violations of, these norms and standards; and another which assesses performance (violations or non-compliance).

The preparedness indicator (PAI 11) flags companies that lack the right processes and systems to ensure they meet established expectations for responsible business conduct. In order to be compliant with this indicator, a company must have all the relevant policies with regard to: the environment, collective bargaining, human rights, freedom of association, scope of social suppliers, bribery and corruption, and discrimination. Additionally, a company must include the following dimensions in its grievance/complaints handling mechanisms (formal processes whereby stakeholders negatively impacted by business activities can make complaints and seek remediation): employee-related matters, human rights issues, ethical matters, environmental matters.

The performance indicator (PAI 10) identifies companies that fail to meet established expectations for responsible business conduct, according to the UNGC Principles and the OECD Guidelines. Company assessments are based on a number of different dimensions, including impact, company responsibility and management, applying standards derived from international guidelines. A holistic assessment should be made based on all dimensions to determine a company's status.

It is helpful to assess these two metrics together, as they give a picture of completeness and whether there is a gap between what a company says it is doing and what it is doing in practice. Both metrics can be used to identify investee companies that may need further assessment regarding performance against standards of conduct.

### Why are these indicators important?

Companies that fail to comply with the UNGC Principles or the OECD Guidelines may face various risks, including:

- Reputational risks: Companies that are involved in human rights abuses or environmental scandals can suffer damage to their brand, which can lead to loss of sales, customers, and investors.
- Financial risks: Companies that violate human rights or environmental laws may be subject to fines, penalties, and other financial liabilities.
- Operational risks: Companies that fail to manage their social and environmental risks may experience disruptions to their operations, such as strikes, boycotts, and regulatory investigations, which may result in earnings volatility.

These risks can have a significant impact on a company's financial performance and long-term success. Investors who invest in companies that fail to comply with the UNGC Principles or OECD Guidelines may therefore be exposing themselves to unnecessary risks.

Some examples of incidents that have led to a non-compliant or 'watchlist' status, as assessed by Sustainalytics, along with their associated impacts to the company, include Volkswagen's emissions testing scandal, BP's Deepwater Horizon oil spill, and Boohoo Group's labour exploitation controversy during Covid-19.

- Volkswagen's stock price fell over 30% in the days after news broke that it had cheated nitrous oxide emissions testing to meet US standards in 2015[2], and by mid-2020, the company had paid over $30bn in settlements and other costs[3]. US Volkswagen sales also fell sharply in the months following the scandal, partly because it was unable to sell the non-compliant diesel vehicles[4], and partly due to consumer mistrust.

- BP's stock price fell over 50% within two months after the Deepwater Horizon oil rig exploded and sank in the Gulf of Mexico in 2010, causing the largest oil spill in marine drilling history[5]. On top of the stock price impact, BP was forced to pay over $60bn in penalties and remediation[6].

- Fashion retailer Boohoo Group experienced a 50% share price decrease in just 9 days following a scandal where labour abuses were found in its supply chain in June 2020[7]. The company's suppliers in Leicester (UK) were found to be paying below minimum wage, stayed open during Covid-19 lockdowns and in violation of health & safety standards, putting workers at risk[8]. RightsDD analysis has shown that a major factor in the share price impact was its lack of a robust Human Rights Due Diligence process[9].

In addition, monitoring processes and grievance mechanisms can help to safeguard the long-term financial interests of investors. By proactively addressing potential violations, companies can mitigate the risks of costly legal disputes, regulatory sanctions, and reputational damages.

While there are financial, reputational and operational risks involved with investing in companies in violation of global norms and standards, there is also significant risk to people and planet, as a result of such failures of corporate responsibility.

Non-compliance with the UNGC Principles and OECD Guidelines may indicate significant negative impacts on sustainability outcomes, such as:

- Forced labour: companies may directly trick, coerce or force vulnerable people into exploitative situations that they cannot refuse or escape. Companies failing to respect the rights to freedom of association and collective bargaining may also be creating conditions that are conducive to forced labour as this makes it easier for workers to be exploited, including longer work hours, lower wages or unsafe working conditions.

- Child labour: if a company is flagged as failing to uphold the effective abolition of child labour, it is likely they are creating conditions for children to be exploited in the workforce. For example, these companies may intentionally exploit children in their workforces, lack adequate systems in place to verify the age of workers, or they may be sourcing products from suppliers who use child labour without doing adequate due diligence to identify and address the issue.

- Environmental degradation: companies may be flagged as non-compliant due to their impact on the environment. These companies are likely to be involved in business practices that have a severe and irreversible impact on the environment, such as the disposal of mining tailings in rivers/seas or unnecessary habitat destruction.

- Corruption: companies that are involved in bribery, extortion, or fraud can be flagged as violating the principle of anti-corruption. Corruption can lead to erosion of trust in businesses and government officials can divert resources away from essential services.

If a company has proper governance and adequate monitoring systems in place, this indicates a level of commitment to its social and environmental responsibilities.

Measures like grievance mechanisms can demonstrate that a company is equipped to handle these incidents, especially if they align with the United Nations Guiding Principles on Business and Human Rights (UNGPs) effectiveness criteria to properly handle complaints; by providing a platform for stakeholders

2 https://finance.yahoo.com/quote/VOW.DE/history?ltr=1
3 https://www.reuters.com/article/us-volkswagen-results-diesel-idUSKBN2141JB/
4 https://www.bloomberg.com/news/articles/2015-12-01/vw-brand-u-s-sales-tumble-25-in-november-amid-diesel-scandal?leadSource=uverify%20wall
5 https://finance.yahoo.com/quote/BP/history?p=BP+&period1=1263513600&period2=1292371200&guccounter=1
6 https://www.reuters.com/article/idUSKBN1F5005/
7 https://finance.yahoo.com/quote/BOO.L/history?p=BOO.L
8 https://labourbehindthelabel.org/report-boohoo-covid-19-the-people-behind-the-profit/
9 https://www.rightsdd.com/posts/impact-of-labour-abuse-on-boohoos-share-price

to voice their concerns, companies can demonstrate their commitment to transparency, accountability, and fair treatment. Effective grievance mechanisms provide a structured and accessible channel for stakeholders, including employees and communities, to raise concerns about potential violations of human rights, labour standards or environmental protection. These mechanisms play a crucial role in addressing potential issues early on, preventing them from escalating into larger-scale reputational damage, legal liabilities, and financial setbacks for companies.

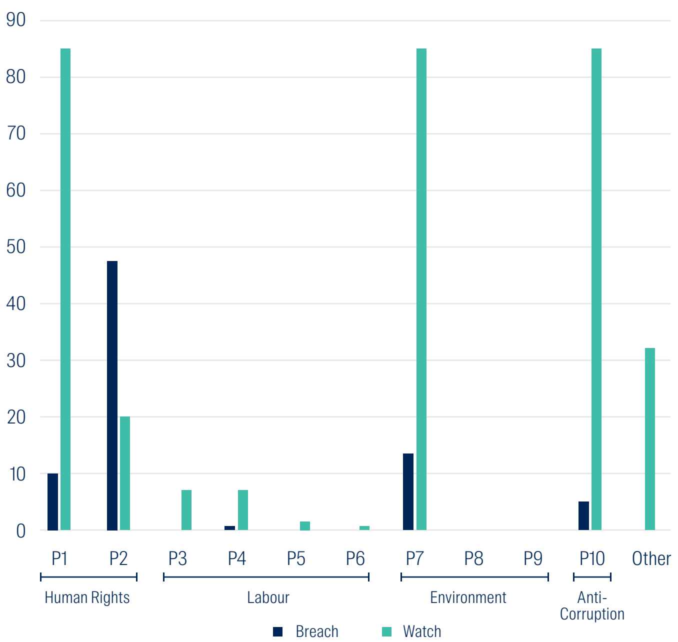
## Issues and Challenges

Unfortunately, there is often a gap between the policies and processes that a company has in place to address a risk, and their performance, which is why it is so important to consider these two indicators together.

However, complying with the UNGC Principles and the OECD Guidelines should be thought of as the bare minimum for corporate responsibility. Violations of these global standards will therefore tend to only highlight the worst cases of poor corporate behaviour. A company might be contributing to, or linked with, adverse impacts in areas such as human rights or environmental degradation, but this will not always be flagged. That does not mean that no risk exists to investors in that company.

To account for this, a number of research providers also provide information on 'watchlist' companies – those in danger of violating globally recognised norms and standards, but yet to formally be considered in violation.

**PAI 10: No. of 'Breach' and 'Watchlisted' companies per UNGC Principle**

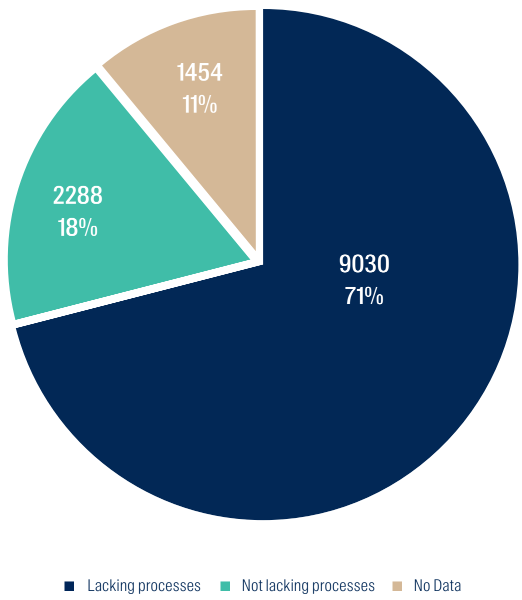



Source: Sustainalytics data as at 31 Dec 2023

Investors can use this as a starting point for engagement with companies on the watchlist to ensure that matters do not escalate to a stage where the investment may carry an unmanageable level of risk. In doing so, investors should be aware of the limitations of such third-party information, including incomplete data coverage.

Investors should use these PAIs as part of a more holistic assessment of company performance against globally recognised standards of business conduct.

**PAI 11: No. of companies lacking processes & compliance mechanisms to monitor UNGC Principles / OECD Guidelines compliance**




Source: Sustainalytics data as at 31 Dec 2023, research universe of 12,772 companies

## Data availability

The current availability of publicly disclosed corporate data on compliance with the UNGC Principles or OECD Guidelines, or associated monitoring procedures and grievance mechanisms, is limited. While some companies report on their UNGC compliance in their annual sustainability reports, there is no standardised format for reporting, and the level of detail varies widely. Additionally, there is no central repository for such data, making it difficult to compare companies' performance.

However, there are initiatives underway to improve the disclosure of UNGC compliance data. For example, the Global Reporting Initiative (GRI) has developed a set of UNGC-specific disclosures, and the UNGC itself is working to develop a more comprehensive and standardised reporting framework. UNGC participant companies are required to report annually via a 'Communication on Progress' report, which can be found on company profile pages on the UNGC website[10].

10 https://unglobalcompact.org/what-is-gc/participants

At this stage, investors may decide to rely on external providers for assessments of company compliance and processes in the first instance. Whilst there are a number of external providers that have rigorous assessment processes, assessments do have a subjective element, which means that they vary between providers. In addition, these providers may not have full research coverage of each PAI in their universe, as can be seen in the assessment of PAI 11 (above).

The charts above show a summary representation of the Sustainalytics data on PAI 10 and 11, taken from a total of 12,772 researched companies as at 31 December 2023. The 10 UNGC Principles are labelled P1-10 in the PAI 10 chart.

There are an additional 32 companies listed as 'Watch' against PAI 10 under the Sustainalytics SFDR dataset that are not linked to specific UNGC Principles. These companies are closely monitored due to highly controversial events that may be deemed to lead to violations of the Principles in the future.

## Thresholds

Investors may use this data in multiple ways, including:

- Engagement with companies that do not have adequate monitoring processes and/or grievance mechanisms in place. This is the most proactive option for engagement.
- Engagement with watchlist and/or non-compliant companies.
- Divestment from non-compliant companies.
- Setting maximum thresholds for the portion of the portfolio either in breach or at risk of breaching the UNGC Principles and/or OECD Guidelines for risk management purposes. However, it can be difficult to set a percentage across asset classes, regions and investment universes.

It is important that, over time, investee companies improve their practices, and that non-compliance trends down across the portfolio over time. While well-intentioned companies have incidents, companies repeatedly found to be in violation across multiple issues and time periods can be considered at higher risk of further breaches, which may result in further investment risk.

It can be helpful to compare companies in violation with these standards, and those that lack effective monitoring processes and grievance mechanisms, against their industry benchmark, especially to understand which companies are the best and worst performers.

## Engagement

For companies that lack policies to monitor compliance with the UNGC Principles or OECD Guidelines or that lack grievance/complaints handling mechanisms to address violations of the principles or guidelines, potential questions to ask include:

- What governance structures are in place to monitor compliance? Who has ultimate oversight?
- Is your grievance mechanism in line with UNGP's effectiveness criteria? Does it extend to your operations and supply chain?
- How frequently has your grievance mechanism been used in the past year?

For companies found to be non-compliant with the UNGC Principles and/or the OECD Guidelines, or at risk of non-compliance, potential questions to ask include:

- Which stakeholders are impacted, i.e. employees, communities, workers in the supply chain or other?
- What governance structures are in place to address the issue? Who has ultimate oversight?
- What grievance mechanisms are in place to ensure effective management of worker and other stakeholder complaints?
- What has the company done to provide or enable remedy to the situation?
- What policies and procedures are in place to ensure the risk of repeat occurrences can be minimised?

## Conclusion

Whilst these indicators have good coverage, as they are based on the assessment of an external provider, there is a degree of subjectivity regarding how companies perform against them. Violations of these global norms and standards tend to only highlight the worst cases of poor corporate behaviour. Therefore, it is recommended that these indicators are assessed together as well as individually, to give a picture of preparedness and performance of companies. They can be useful for engagement both proactively to ensure a company has the right processes and systems in place, and reactively after an incident has occurred.

## Appendix 1

Alignment between UNGC Principles and OECD Guidelines for Multinational Enterprises

| UN Global Compact Principles | | OECD Guidelines for Multinational Enterprises Chapters |
|---|---|---|
| Human Rights | P1 - Businesses should support and respect the protection of internationally proclaimed human rights.<br><br>P2 - Businesses should make sure that they are not complicit in human rights abuses. | Chapter IV - Human Rights<br>Chapter VIII - Consumer Interests |
| Labour Rights | P3 - Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining.<br><br>P4 - Businesses should uphold the elimination of all forms of forced and compulsory labour.<br><br>P5 - Businesses should uphold the effective abolition of child labour.<br><br>P6 - Businesses should uphold the elimination of discrimination in respect of employment and occupation. | Chapter V - Employment and Industrial Relations |
| Environment | P7 - Businesses should support a precautionary approach to environmental challenges.<br><br>P8 - Businesses should undertake initiatives to promote greater environmental responsibility.<br><br>P9 - Businesses should encourage the development and diffusion of environmentally friendly technologies. | Chapter VI - Environment<br>Chapter IX - Science and Technology |
| Business Ethics | P10 - Businesses should work against corruption in all its forms, including extortion and bribery | Chapter VII – Combating Bribery, Bribe Solicitation and Extortion<br>Chapter X – Competition<br>Chapter XI –Taxation |

Source: Sustainalytics, 2023: 'Global Standards Screening – Methodology Version 2'

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