

# 1514. Human rights due diligence as part of 'Social' in ESG

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**Environmental, Social & Governance (ESG) due diligence has become an important part of investment decisions, corporate finance and business strategies in a very short time. The influence of ESG in the business processes of many companies is becoming increasingly clear. Developments in national and international legislation will only increase this. This article describes developments in the field of human rights due diligence as part of the 'Social' domain in ESG. Attention will be paid to the growing relevance of this subject for the supply chain of companies. The reason why financial institutions should also pay attention to human rights due diligence is discussed as well.**

### The Social Factor ESG

The 'S' factor in ESG covers a multitude of factors, including human rights, modern slavery, corporate security, diversity, employee relations, supply chain sustainability, consumer relations and data protection.

In the context of due diligence and compliance within companies, Social in particular refers to policies regarding industrial accidents, anti-discrimination, privacy, third party risk, whistleblowing, corporate social responsibility, consumer relations and product safety. It is important to recognise that, from a European law perspective, 'Social' is explicitly part of the concept of 'sustainability'. To associate this concept only with the 'E' of Environmental or Ecological, is too limited. According to the European Commission, ecological and social considerations are often intertwined, because especially climate change can increase existing inequalities<sup>(1)</sup>. According to the preamble of the Regulation on sustainability disclosure in the financial services sector ('SFDR', Regulation (EU) No 2019/2088, OJEU L317), which is expected to come into force in March 2021, respect for human rights is explicitly part of the concept of 'sustainability factors', alongside social and employment issues, among others.

### Human rights as part of 'Social' in ESG due diligence

The scope of human rights covered by the 'S' of ESG is quite broad. For example, it includes the 30 human rights listed in the 1948 Universal Declaration of Human Rights (such as the right to life, freedom and security, the right to equality before the law, the prohibition of torture and slavery, the prohibition of forced labour, the prohibition of discrimination, etc.). In addition, human rights include what is laid down in the Convention on Civil and Political Rights (1966) and in the International Covenant on Economic, Social and Cultural Rights (1966). Finally, nine UN treaties are also relevant, which, for example, deal with the rights of the child, the prohibition of discrimination against women or the rights of migrant workers<sup>(2)</sup>.

With regard to respect for human rights in the context of business operations, the UN Guiding Principles on Business and Human Rights (UNGPs; 2011)<sup>(3)</sup> are the main source. They relate to the recognized human rights as just indicated. The first ten principles address states regarding their duty to protect human rights. The next fourteen principles address the responsibility of corporations to respect human rights. In summary, this last category of principles boils down to the following themes:

- (1) For example, the European Commission states in the 'Action Plan: Financing Sustainable Growth' of 8 March 2018, COM (2018)97: 'Sustainable financing' generally refers to the process of taking proper account of environmental and social considerations in investment decision-making, leading to increased investment in longer-term oriented and sustainable activities. 'Social considerations' refers to issues of inequality, inclusiveness, employment relations, investment in human capital and communities.
- (2) According to the UN Human Rights Office of the High Commissioner (OHCHR) there are nine core treaties in this area. For the list, see: <https://www.ohchr.org/EN/ProfessionalInterest/Pages/CoreInstruments.aspx>
- (3) [https://www.ohchr.org/documents/publications/guidingprinciplesbusinessshr\\_en.pdf](https://www.ohchr.org/documents/publications/guidingprinciplesbusinessshr_en.pdf). The Guiding Principles are structured in three parts: Part I deals with the obligation of the state to protect human rights, Part II deals with the responsibility of corporations to protect human rights, and Part III deals with access to remedial measures, aimed at both states and corporations. The three parts are each subdivided into 'Foundational' and 'Operational' principles.

- the principles apply to all companies, regardless of their size, sector, operational context or (ownership) structure;
- companies should prevent, mitigate and address any adverse human rights impacts, not only where those impacts are caused by their own operations, but also those of their business partners;
- due diligence processes and effective redress procedures should be in place;
- human rights risks should be measured through impact assessments;
- companies are transparent about negative consequences, the measures taken and their effectiveness.

In addition to the UNGPs, sector-specific guidelines, the International Labour Organization (ILO) Child Labour Guidance Tool for Business (2015), the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (2017), the OECD Guidelines for Multinational Enterprises ('MNE'; 2011) and the OECD Due Diligence Guidance for Responsible Business (2018) also play a significant role. Of particular relevance to financial institutions is the 2019 OECD report 'Due Diligence for Responsible Corporate Lending and Securities Underwriting'. It provides guidance on how to implement the OECD MNE Guidelines with respect to the banking activities mentioned in the title of the report. It is important to realize that 'due diligence' in this context is broader than what banks typically understand by it. Indeed, the MNE Guidelines consider due diligence to be an ongoing process of systematically and proactively identifying risks and potential negative consequences for corporate social responsibility. It also includes the monitoring of business relationships and related activities. It thus goes beyond just an initial investigation of a potential business relationship or transaction, aimed at preventing reputational, financial or legal damage to the bank itself - it rather is about preventing damage to the environment, communities or employees caused by the activities of the bank's client<sup>(4)</sup>.

### From 'soft law' to 'hard law' on human rights due diligence

The Business Human Rights ('BHR') guidelines just mentioned can only be adopted and applied by companies on a voluntary basis. For this reason they are referred to as 'soft law'. Business Human Rights have, however, gained increasing significance in recent years. The first cause is to be found in an increasing number of civil lawsuits against companies about their human rights violations. NGOs are increasingly suing (also in the Netherlands) internationally operating companies for wrongful acts<sup>(5)</sup>. A second cause can be found in an increase in the acceptance of the principles and guidelines by companies that want to do business in a socially responsible way. Thirdly, there is an increase in national legislation, which takes on the character of obligations to apply BHR due diligence, whereby non-compliance can be punished. This type of legislation is referred to as 'hard law'.

On 6 July 2020, the Global Human Rights Sanctions Regulations 2020 came into force in the UK, following on from the UK Modern Slavery Act (2015). Australia and the US state of California have similar laws against modern slavery. The new UK law follows in the footsteps of US and Canadian sanctions legislation. This Anglo-Saxon legislation shows a global trend of increased focus on regulating the supply chain, addressing corruption, modern slavery and other human rights violations.

France has had a legal compliance requirement regarding human rights due diligence since 2017<sup>(6)</sup>. In Switzerland, with a referendum in late 2020 following a 2019 proposal by the Verein Konzernverantwortungsinitiative, legislative initiatives have been taken on supply chain due diligence and human rights. In Germany, part of the government wants to require companies based in that country with more than 500 employees to comply with social and sustainability standards throughout the supply chain. This is a rather far-reaching requirement that met with resistance from the German Minister of Economic Affairs, causing the debate on the bill to be postponed.<sup>(7)</sup> In Norway, legislation on transparency and due diligence in the supply chain<sup>(8)</sup> is also in preparation.

<sup>(4)</sup> Page 14 of the report and Annex A, "Terminology," p. 67.

<sup>(5)</sup> See for a recent example: <https://www.trouw.nl/buitenland/mensenrechtenorganisatie-both-ends-eist-inzage-documenten-boskalis~bb7056f1/>. Incidentally, the claim to disclose documents was dismissed by the preliminary relief judge in Rotterdam on 18 September 2020 on formal grounds.

<sup>(6)</sup> LOI n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre (1).

<sup>(7)</sup> <https://www.hrw.org/news/2020/08/27/german-economics-ministry-blocks-effective-supply-chains-law>.

<sup>(8)</sup> <https://www.regjeringen.no/en/dokumenter/supply-chain-transparency/id2680057/>

## The Dutch Child Labour (Duty of Care) Act

The Netherlands has also made its presence felt in the field of 'hard law' regarding BHR due diligence. On November 13, 2019, the Dutch Child Labour (Duty of Care) Act ("WZK") was published in the *Staatsblad* (Official Gazette, 2019, 401). This Act is likely to enter into force in mid-2022, but will then look back at the period from November 13, 2019, if long-term contracts have been concluded from that date. The law requires anyone (including foreign companies) supplying or providing goods and services to end-users in the Netherlands to certify that 'due care' has been taken to ensure that these goods and services have not been produced using child labour. Lower legislation will have to further specify the law, but in Section 5 WZK there is already a link to the Child Labour Guidance Tool for Business of the ILO. The company which declares that it exercises due diligence in respect of child labour, declares that it implements an ongoing policy to identify child labour in its production chain<sup>(9)</sup>. This is not full chain transparency, but a less far-reaching due diligence that applies to the entire chain<sup>(10)</sup>. The company does not have to guarantee that child labour does not occur, but declares what it is doing within its capabilities to identify, prevent and/or eliminate child labour<sup>(11)</sup>. Enforcement of the WZK takes place with an administrative fine and in case of recidivism the conduct becomes an economic offence so that criminal prosecution comes into the picture.

### A look ahead: Mandatory Human Rights Due Diligence regulation from Brussels

In the context of increasing 'hard law' regulation, with regard to Social in ESG, the role of the EU cannot go unmentioned. First, on January 1, 2021, the Regulation on Responsible Trade in Minerals from High Risk or Conflict Areas will come into force<sup>(12)</sup>. This regulation requires EU importers of tin, tantalum and tungsten, the corresponding ores and gold from certain conflict zones to apply due diligence to their supply chain. This should ensure that the trade in these minerals and ores does not finance armed groups in those areas.

Second, at the end of April 2020, European Justice Commissioner Didier Reynders announced that legislation for mandatory human rights due diligence would be proposed in 2021. A January 2020 academic study on due diligence requirements through the supply chain<sup>(13)</sup> had shown that voluntariness had not led to the necessary changes in companies' behaviour. That led the Euro commissioner to propose mandatory legislation.

The legislative plan announced by Brussels was positively received from several quarters. MEPs from the Responsible Business Conduct Working Group welcomed this legislative initiative<sup>(14)</sup>. A little later, the Briefing Paper, "Human Rights Due Diligence Legislation - Options for the EU," prepared for the European Parliament's Subcommittee on Human Rights, was published<sup>(15)</sup>. This study highlights that existing and proposed national legislation is not always in line with the UNGPs. For example, the Dutch regulation in the WZK only applies to child labour and the due diligence obligation regarding the supply chain can be interpreted restrictively. Other regulations have restrictions regarding the nature of the violation or apply to companies of a certain size<sup>(16)</sup>. The recommendations of this study include an applicability of mandatory due diligence legislation to all human rights, to all companies, and to the entire supply chain.

A group of 25 international companies and institutions expressed support for the envisaged legislative program in a joint statement on September 2, 2020<sup>(17)</sup>. The signatories recognize the need for new binding rules and advocate a "level playing field" by creating more legal clarity. From the corner of human rights organizations also came a statement of support<sup>(18)</sup> from a dozen organizations in September 2020.

<sup>(9)</sup> Letter from Member of Parliament Kuiken dated October 12, 2018 to the President of the Senate of the States General; See *Kamerstukken I 2018/19, 34 506, M*.

<sup>(10)</sup> *Kamerstukken II 2016/17, 34 506, nr. 8 (Nota naar aanleiding van verslag)*.

<sup>(11)</sup> Letter from Member of Parliament Kuiken dated October 12, 2018 to the President of the Senate of the States General; See *Kamerstukken I 2018/19, 34 506, M*.

<sup>(12)</sup> Regulation (EU) 2017/821 of the European Parliament and of the Council of 17 May 2017, often referred to in the literature in English as the "Conflict Minerals Regulation", in Dutch the 'Conflictmineralen verordening'.

<sup>(13)</sup> Available at <https://op.europa.eu/nl/publication-detail/-/publication/8ba0a8fd-4c83-11ea-b8b7-01aa75ed71a1/language-en>.

<sup>(14)</sup> Their open letter can be found at: <https://responsiblebusinessconduct.eu/wp/wp-content/uploads/2020/06/RBC-WG-Letter-to-Reynders-final.pdf>.

<sup>(15)</sup> See [https://www.europarl.europa.eu/meetdocs/2014\\_2019/plmrep/COMMITTEES/DROI/DV/2020/06-22/DGEXPObriefingHumanRightsDueDiligence\\_EN.pdf](https://www.europarl.europa.eu/meetdocs/2014_2019/plmrep/COMMITTEES/DROI/DV/2020/06-22/DGEXPObriefingHumanRightsDueDiligence_EN.pdf).

<sup>(16)</sup> For example, the UK Modern Slavery Act has a turnover threshold as an application requirement, the French law applies to companies with at least 5,000 employees and the European rules for reporting non-financial information apply to companies of a certain financial size.

<sup>(17)</sup> Two Dutch companies, Unilever and ABN AMRO, were part of this group, see <https://www.business-humanrights.org/en/latest-news/support-for-eu-framework-on-mandatory-human-rights-and-environmental-due-diligence/>

<sup>(18)</sup> <https://actionaid.nl/wp-content/uploads/2020/09/IOR6029592020ENGLISH.pdf>

## Human rights due diligence and the financial sector

In 2016, a dozen Dutch banks signed the International Corporate Social Responsibility covenant for the banking sector<sup>(19)</sup>. The Dutch association of Banks (NVB), civil society organizations, trade unions and the government agreed to support the banks in respecting human rights according to the OECD MNE Guidelines and the UNGPs. The covenant remained in force for three years. Today, most banks have incorporated respect for human rights into their ESG policies and due diligence processes. This is done in a variety of ways: through an Environmental and Social Risk management (ESR) Framework<sup>(20)</sup>, through analysis programs whose results are described in human rights reports<sup>(21)</sup>, in a Sustainability Policy Framework whereby clients of the bank and their chain partners can be facilitated to implement concrete actions<sup>(22)</sup> on human rights, through a detailed human rights policy with as an important component a 'chain policy' that clients are expected to have towards their suppliers, customers and other related parties<sup>(23)</sup>, and so on.

What they all have in common is that they apply - on a voluntary basis - the OECD Guidelines already mentioned and the UNGPs. If a manufacturer of sportswear wants to take out a loan from a bank, he will currently not have a good chance of getting that loan if child labour occurs in his supply chain. A manufacturer of smartphones or other new technology will suffer the same if the essential raw material tantalum turns out to have been mined with forced labour in an area of Africa controlled by armed militias. These are now factors that banks want to examine as part of human rights due diligence. This - as noted earlier - has a broader scope than a bank's due diligence, which is focused on preventing risks to and liability of the bank itself. In 2021, the coming into force of the European Conflict Minerals Regulation will create a legal obligation for Union importers of (among others) tantalum, to report and comply with due diligence in the supply chain in accordance with the OECD Guidelines. The WZK will have to be complied with by the sportswear manufacturer in the sense that with respect to possible child labour they will exercise due diligence according to ILO standards. This will include: implementing policies that prevent child labour, conducting risk assessments, as well as reporting and communicating on how child labour has been addressed.

For banks, this will mean that what they already apply as 'soft law' will soon be 'hard law'. But mandatory transparency from all their clients on respect for human rights, independent of the sector, will make it easier for banks to determine their risk profile.

Legislative developments will therefore have consequences for (future) risk management in the financial sector. Every financial institution must ensure sound and controlled management<sup>(24)</sup>. Pursuant to Section 10 *Besluit prudentiële regels Wft* (Prudential Rules Act Decree), a financial institution must carry out a systematic analysis of integrity risks. The trust sector and pension funds have a similar requirement.<sup>(25)</sup>

Since 2014, DNB (Dutch National Bank) has emphatically drawn attention to the quality of systematic integrity risk analyses (SIRAs) as a basis for good risk management. According to DNB, an important part of the risk management cycle is that financial institutions make conscious choices about integrity risks on an ongoing basis. In DNB's view, this concerns non-integrity behaviour by the institution itself or by third parties (including customers), which can be attributed to the institution or in which it plays a criminal role.

<sup>(19)</sup> These are ABN AMRO, BNG Bank, De Volksbank, FMO, ING, NIBC Bank, NWB Bank, Rabobank, Triodos Bank and Van Lanschot Kempen.

<sup>(20)</sup> ING applies Client and Transaction ESR Assessments to see if they meet ING's requirements. If necessary, the bank enters into dialogue with clients to improve the environmental and social impact where possible and even excludes certain sectors and countries. See the link 'Sustainability Policy' on the ING website.

<sup>(21)</sup> ABN AMRO, which assesses all clients in high-risk sectors against its human rights policy when granting loans, and only does business if they are willing to comply with certain conditions. When investments are made through ABN AMRO, the bank also monitors any improvements in specific portfolios and provides clients with the information they need to make the right decisions.

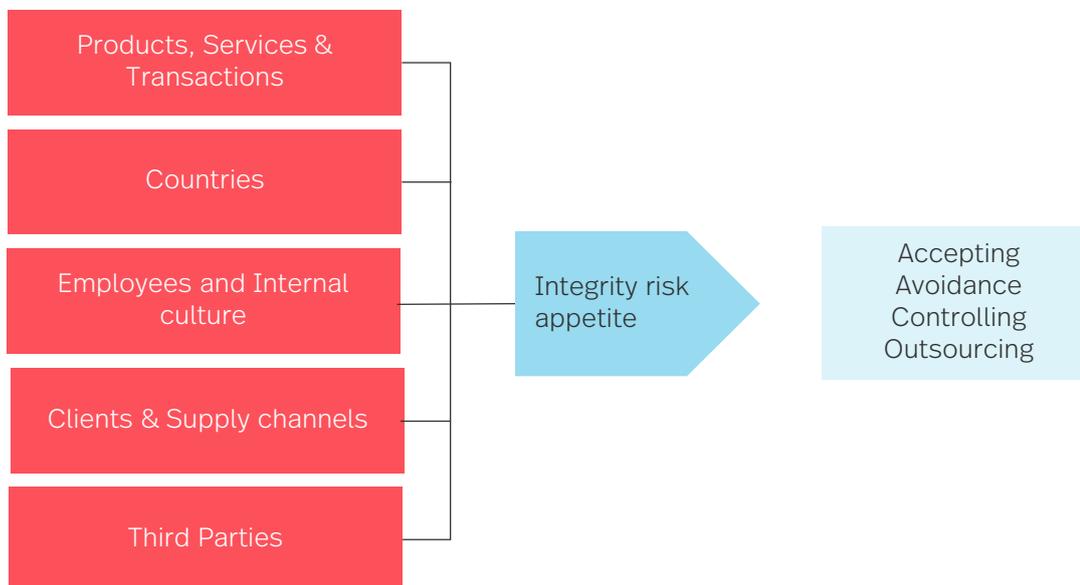
<sup>(22)</sup> RABOBANK does this and uses a sustainability matrix to annually measure the ecological and social impact of all their clients, after which discussions about human rights issues may take place.

<sup>(23)</sup> De Volksbank has 16 selection criteria for companies, which are not approved if they develop activities that could negatively affect human rights.

<sup>(24)</sup> This is provided for in Sections 3:10 and 3:17 '*Wet financieel toezicht*' (Financial Supervision Act), Section 10 '*Wet toezicht trustkantoren*' (Trust Offices Supervision Act) and Section 19 '*Besluit financieel toetsingskader pensioenfondsen*' (Decree on the Financial Assessment Framework for Pension Funds).

<sup>(25)</sup> For trust offices, this is regulated in Section 4 '*Regeling integere bedrijfsvoering Wtt 2014*' (Regulation on Sound Business Conduct Wtt 2014) and for pension funds it is Section 14 '*Besluit uitvoering Pensioenwet*' (Pensions Act Implementation Decree).

According to DNB, the institution can best make choices about integrity risks after formulating a clear integrity risk appetite.<sup>(26)</sup> Schematically that looks as follows.<sup>(27)</sup>



The factors 'clients & supply channels' and 'third parties' that are relevant for the risk appetite analysis by financial institutions have common ground with human rights due diligence and supply chain management as parts of the domain Social in ESG. If future mandatory human rights due diligence will also apply to financial institutions, the significance of the SIRA will only increase. The violation of supply chain integrity in relation to human rights by clients of the bank will then be added to the list of non-infringing behaviours. The bank will be obliged to act on this towards the client.

Also for asset managers, as of (expectedly) March 2021, the relevance of human rights due diligence and the Social factor will increase. In the foregoing, the Regulation on the Provision of Sustainability Information in the Financial Services Sector has already been touched upon. The Regulation imposes on (among others) asset managers certain forms of disclosure regarding sustainability risks. Such a risk is defined<sup>(28)</sup> as "an environmental, social or governance event or condition that, if it were to occur, would cause an actual or potential material adverse effect on the value of the investment. Another future obligation relates to transparency regarding the main adverse effects on sustainability factors. These are, as already discussed, environmental, social and employment issues, respect for human rights, and combating corruption and bribery.

The domain of Social, and more specifically the respect of human rights by companies, has thus become an important part of sustainable finance. Because of the all-encompassing nature of the transition to sustainability, in practice there will be a need for guidelines and 'track books'. One example is the initiative of the Association for Financial Markets in Europe, which published<sup>(29)</sup> a document in September 2020 entitled 'Governance, conduct and compliance in the transition to sustainable finance.' Based on these four topics, fifteen principles provide guidance on how to make the transition in a systematic way:

<sup>(26)</sup> See the 'Good Practice Integrity Risk Appetite' (2017) and '*De integriteitsrisicoanalyse. Meer waar dat moet, minder waar dat kan*' (2015) (The integrity risk analysis. More where necessary, less where possible) (2015), which DNB has published on its website.

<sup>(27)</sup> This schedule can be found in DNB's 'Good Practice Integrity Risk Appetite' on page 5.

<sup>(28)</sup> Article 2 of the Regulation provides a large number of definitions. Sustainability risk' is defined under 22 and 'sustainability factors' under 24.

<sup>(29)</sup> This Whitepaper can be found here [www.afme.eu](http://www.afme.eu).

- Objectives and governance
- Risk management
- Compliance and monitoring
- Determining effectiveness.

### Challenges to compliance

We do not yet know exactly what the European legislation on Mandatory Human Rights Due Diligence will look like. However, the question is justified as to how companies and financial institutions will have to organise their human rights due diligence and related compliance. The answer to the question seems to be found in taking as an example already existing anti-corruption compliance programs. <sup>(30)</sup>

Indeed, practice shows that corruption in a country can perpetuate the lack of respect for human rights: corruption and human rights violations often go hand in hand.<sup>(31)</sup> A coordinated approach to compliance in both areas can lead to a much broader focus of a company than simply focusing on strict legal compliance: it can result in a company with a changed culture, namely that of ethical and sustainable business. In the context of ESG, this can be a plus for investors and increase the value of the company. The International Business Council of the World Economic Forum seems to have recognized this. This council released a report<sup>(32)</sup> in September 2020 that includes ESG metrics and reporting procedures that are in line with the United Nations' Sustainable Development Goals. Certain anti-corruption risk factors are explicitly included in the framework of measurable ESG transparency and disclosure.

Synergy between human rights and anti-corruption can be found in the standard components of an effective anti-corruption compliance system. For example, it could look like this:

- An initial risk analysis with dual scope.
- Integrating human rights and anti-corruption into the corporate culture.
- Getting compliance functions Anti-corruption (mostly Compliance) and Human Rights (mostly Corporate Responsibility or the Human Resources Department) to work together.
- Coordinating due diligence processes with respect to suppliers and business partners (supply chain management and third party risk assessments with a dual scope).
- Combined training to staff and management.
- Internal whistleblower policy.
- Evaluation and measurability of effectiveness using data (for example, data collected on anti-corruption compliance could be used to evaluate human rights risks).
- External reporting to stakeholders.

It seems crucial to me that when the European legislator tries to codify the UNGPs as 'hard law', he will also have to take into account the complexity of supply chain management. There should be room for flexibility in determining due diligence processes, depending on the specific circumstances under which a company operates. The OECD MNE Guidelines, for example, provide such flexibility. The principle of proportionality will also have to be taken into account: small and medium-sized enterprises should be subject to different requirements than multinationals, if the goal of the European legislator is indeed to make all companies subject to the Mandatory Human Rights Due Diligence rules. The importance of adequate risk analysis to achieve effective risk-based human rights compliance of the supply chain seems obvious to me. For financial institutions, measurable and transparent human rights due diligence on companies provides clear input into the ongoing integrity risk analysis process.

<sup>(30)</sup> See in the same sense, inter alia: 'Leveraging anti-bribery compliance programs to address human rights in a post-covid-19 world', TRACE Whitepaper, April 2020, <https://info.traceinternational.org/leveraging-anti-bribery-compliance-programs-to-address-human-rights-in-a-post-covid-19-world> [www.TRACEinternational.org](http://www.TRACEinternational.org); and 'Connecting the anti-corruption and human rights agendas: A guide for business and employers' organisations', van Business at OECD (BIAC) en IOE. Available at <http://biac.org/wp-content/uploads/2020/09/2020-08-31-Business-at-OECD-IOE-AC-HR-guide.pdf>

<sup>(31)</sup> Integrity and anti-corruption are inextricably linked. See also, among others, the conference volume Ethics and Sustainability, accompanying ICC's International Integrity & Anti-corruption Conference 2019 in The Hague, December 2019.

### Recommendations for Practice

- Human rights due diligence at companies is becoming increasingly important due to developments in (international) legislation. Business and the financial sector should be aware of this.
- A comprehensive legislative operation on mandatory human rights due diligence is coming from Brussels in 2021, so companies from all sectors should prepare for it.
- Existing anti-corruption compliance can serve as a stepping stone for effective human rights compliance.
- For financial institutions and asset managers, human rights due diligence as part of the 'S' factor of ESG is becoming a regular element of their risk management, integrity risk analyses and own due diligence processes.

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