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Due diligence in the financial sector: adverse impacts directly linked to financial sector operations, products or services by a business relationship

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DUE DILIGENCE IN THE FINANCIAL SECTOR: ADVERSE IMPACTS DIRECTLY LINKED TO FINANCIAL SECTOR OPERATIONS, PRODUCTS OR SERVICES BY A BUSINESS RELATIONSHIP

Introduction

The present document is a Note from the Secretariat on due diligence in the financial sector, and specifically the concept of 'adverse impacts directly linked to operations, products or services by a business relationship' as used in the OECD Guidelines for Multinational Enterprises (the Guidelines).[1]

Since 2011, the Guidelines and the UN Guiding Principles on Business and Human Rights (UNGPs) introduced new expectations vis-à-vis corporate conduct. Under the Guidelines, multinational enterprises (MNEs) are encouraged to carry out risk-based due diligence[2] to:

1. Avoid causing or contributing to adverse impacts through their own activities; and

2. Seek to prevent or mitigate adverse impacts where they have not contributed to that impact, when the impact is nevertheless directly linked to their operations, products or services by a business relationship.[3]

The Guidelines are recommendations addressed by governments to MNEs. They provide principles and standards of good practice consistent with applicable laws and internationally recognised standards. Countries adhering to the Guidelines make a binding commitment to implement them and matters covered by the Guidelines may also be the subject of national law and international commitments. However in the absence of implementing law or other commitments observance of the Guidelines is non-binding for corporations and not legally enforceable.[4] This understanding is reflected throughout the text of the Guidelines in the use of appropriate terms and the conscious avoidance of terms that might have unintended legal connotations, such as "obligation", "violation" "breach", "compliance" and "duty".

MNE's include enterprises in all sectors of the economy and ownership may be private, State or mixed.[5] This broad conceptualization has implications for scope and application of the Guidelines. For example, the Guidelines state that a precise definition of MNEs is not required for their purposes, since they are aimed at the widest possible observance.[6] Accordingly, the Guidelines are applicable by

1 OECD Guidelines for Multinational Enterprises, Chapter II, paragraph A12.

2 OECD Guidelines for Multinational Enterprises, Chapter II, paragraph A11 and A12

3 OECD Guidelines for Multinational Enterprises, Chapter II, paragraph A11 and A12

4 However matters covered by the Guidelines may also be the subject of national law and international commitments. OECD Guidelines for Multinational Enterprises, Chapter I, paragraph 1

5 OECD Guidelines for Multinational Enterprises, Chapter I, paragraph 4

6 OECD Guidelines for Multinational Enterprises Chapter I, paragraph 4 and 6

enterprises in the financial sector.[7] This includes the entire range of financial institutions and actors, e.g. commercial banks, retail banks, investment banks, rating agencies, financial service providers, institutional investors, etc. Financial institutions, like any other MNEs, should thus avoid causing or contributing to adverse impacts, and seek to prevent or mitigate those impacts when their operations, products and services can be directly linked to them by a business relationship.

On the basis of research conducted by the Sustainable Finance Advisory, it was concluded that "Of the FI study participants, some refer to the OECD Guidelines in their E&S policies, but few use them in the implementation of E&S due diligence as they are seen as too generic. Many FIs cite a lack of clarity on terminology, for example, "business relationships" and "business partners", "direct" links to adverse impacts […]''.[8]. It should be noted that this does not mean that FIs do not have E&S due diligence policies/processes in place.

This document is submitted for the purposes of the pro-active agenda project on the financial sector: it will support the work of developing practical guidance for the financial sector in applying these and related provisions. It also serves to inform the discussions with the OECD Investment Committee on the four priority issues regarding the application of the Guidelines to the financial sector[9] (of which the meaning of "adverse impacts directly linked to their business operations, products or services by a business relationship" in the financial sector is one such priority issue).

Adverse impacts: "cause", "contribute" or "directly linked"

Under the Guidelines, the due diligence provision uses the concept of "adverse impacts" to mean adverse human rights impacts to rights-holders, as well as all other types of adverse impacts on matters covered by the Guidelines, unless explicitly excluded.[10] This means that impacts not addressed by traditional human rights, such as those related to the environment, corruption and industrial relations for example, should also be subject to risk-based due diligence.

An enterprise '*causes*' an adverse impact if there is causality between the operations, products or services of the enterprise and the adverse impact. Causation can occur through action as well as omissions, in other words, a failure to act. '*Contributing to*' an adverse impact should be interpreted as a substantial contribution, meaning an activity that causes, facilitates or incentivises another entity to cause an adverse

7 The Guidelines are hence applicable by MNEs in any sector and to larger as well as small- and medium-sized enterprises. Governments adhering to the Guidelines wish to encourage the widest possible observance of the Guidelines (The Guidelines Preface, paragraph 6). This Note serves to confirm this. It is not intended to define more precisely any key terms of the Guidelines than what has been the result of the 2011 negotiations.

8 Sustainable Finance Advisory, Environmental and Social Risk Due Diligence in the Financial Sector (May, 2013) p.52

9 These are (a) the meaning of "business relationships" in the financial sector (terms found in chapter II, paragraphs A.12 and chapter IV, paragraph 3 of the Guidelines) ; (b) the application of the Guidelines to sovereign wealth funds and central banks; (c) the meaning of "impacts directly linked to their business operations, products or services by a business relationship" (terms also used in chapter II, paragraph 12 A.12 and chapter IV, paragraph 3 of the Guidelines); and (d) coordination between NCPs with respect to complex and multi-layered specific instances.

10 OECD Guidelines for Multinational Enterprises, Chapter II, paragraph A10; "The recommendation in paragraph A.10 applies to those matters covered by the *Guidelines* that are related to adverse impacts. It does not apply to the chapters on Science and Technology, Competition and Taxation." OECD Guidelines for Multinational Enterprises, Chapter II, Commentary on General Policies, paragraph 14.

impact.[11] An enterprise can also "contribute" to an adverse impact if the combination of its activities and that of another entity result in an adverse impact. An enterprise's operations, products or services can also be 'directly linked' to an adverse impact through a business relationship. This concept is broad and covers adverse impacts associated with business relationships, for example in the enterprise's supply chain.

To illustrate the different categories, an example of each is given from the textile sector.[12] One could imagine a t-shirt brand with its headquarters in Europe, but sourcing its t-shirts from an Asian enterprise. This Asian supplier also produces handbags for another business enterprise in one of its other factories.

- *Causing the adverse impact:* the t-shirt brand does not allow the employees in its headquarters office to form a trade union; the t-shirt brand maintains its offices in a building known to contain an unsafe amount of asbestos.

- *Contributing to the adverse impact:* the t-shirt brand suddenly changes the delivery date of t-shirts from 1 month to 1 week, resulting in factory workers in its Asian supplier being forced into working overtime.

- *Operations, products or services 'directly linked' to the adverse impact through a business relationship*: The t-shirt brand's Asian supplier does not uphold basic health and safety standards in the factory where the t-shirts are produced. The adverse impacts are directly linked to the products of the t-shirt brand, even though the brand has in place an agreement with the supplier for it to uphold health and safety standards. The t-shirt brand is not responsible for causing or contributing to these impacts itself, but upon becoming aware of the adverse impacts (or the risks of such impacts) it has a responsibility to seek to prevent or mitigate the impacts, because there is a direct link between the impact and the t-shirt brand's products through its business relationship with the supplier. Likewise in the case that the t-shirt brand's supplier subcontracts to an enterprises that has bad labour conditions, even though the t-shirt brand does not cause or contribute to those adverse impacts, its products are directly linked to them because its products are manufactured there.

- *No direct linkage through its operations, products or services*: Adverse impacts arising at the Asian supplier's separate factory that produces handbags for another brand are *not* directly linked to the operations, products, or services of the t-shirt brand. Since due diligence is relevant for actual *and* potential adverse impacts, risk arising in different production lines should lead the t-shirt brand to consider the likelihood that such matters will spill over into their production line, and thereby later becoming 'directly linked'. If the t-shirt brand became aware of the poor labour conditions in connection with the manufacture of handbags by the same supplier, that information should prompt the t-shirt brand to apply heightened on-going due diligence to operations with that supplier. This could be done by more carefully investigating the conditions in the production line of its products or requiring additional monitoring and transparent reporting with regard to its operations with that supplier. In such circumstances, there may also be a heightened expectation of transparency and reporting, so companies "know and show" that the adverse impacts in the separate production line are not directly linked to its own products by its business relationship with the Asian supplier.

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11 OECD Guidelines for Multinational Enterprises, Chapter II, Commentary on General Policies, paragraph 14.

12 The examples are hypothetical, intended to be purely illustrative and without prejudice to the facts or responsibilities of enterprises in any real-life cases.

As noted, the Guidelines envisage a responsibility to prevent or mitigate adverse impacts directly linked to operations products or services by a business relationship, even beyond their supply chain. It is in this sense where the nature of business relationships associated with operations, products and services of FIs and becomes most relevant. To illustrate, an analogous situation in the financial sector is presented.

For this illustration, imagine a bank with its headquarters in the US, but with operations, clients and investments around the world:[13]

- *Causing the adverse impact*: the bank does not allow the employees in its headquarters office to have trade unions; or discriminates among its clients on the basis of race and gender.

- *Contributing to the adverse impact*: the bank sets an unrealistic timetable for a construction firm to build offices for the bank, resulting in labour abuses; or the bank lends money to a company to construct a large processing plant to be built on a community land that results in the displacement of affected populations without meaningful stakeholder engagement (e.g. interactive consultation, two-way communication).

- *Products, services or operations 'directly linked' to the adverse impact through a business relationship*: the bank discovers through its due diligence that the enterprise in which it holds minority shares is mining or trading in minerals from conflict areas without appropriate due diligence systems in place (e.g. *OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas*)*;* or the bank is part of a syndicated finance project for an infrastructure project that displaces local communities without meaningful stakeholder engagement, despite advance agreements made with the infrastructure enterprise to do so.

- *No direct linkage through its operations, products or services*: the bank is part of a syndicated finance project for the development of a highway. The primary developer of that infrastructure project is also managing a separate infrastructure project in the same country, the building of a dam. The developer does not have an environmental management system in place in the building of the dam, and is using environmentally harmful substances that are polluting local water supplies. The bank would not be linked to the adverse environmental and health impacts of caused by the developer, through financing a separate infrastructure project that is being managed by the same developer. However, again, due diligence is relevant for actual *and* potential adverse impacts, thus risk arising in a project should lead the bank to consider the likelihood that such matters will spill over into their investment, thereby becoming 'directly linked.' If the bank became aware of the lack of respect for environmental standards in the dam project by the developer this should prompt the bank to apply heightened due diligence to operations with that developer, which may also include heightened expectation of transparency (as described above).

Future work on the financial sector under the proactive agenda could also seek to enable a better understanding of broader due diligence concepts, including the ways in which financial institutions can cause or contribute to adverse impacts, and how those situations differ from adverse impacts that are directly linked to operations, products and services through a business relationship. The focus of this Note

13 For the sake of clarity, many of these examples are drawn from the written submissions to the OECD Working Party by the Chair of the Working Party, the OHCHR, the Former UN Secretary-General's Special Representative for Business and Human Rights and the UN Working Group on Business and Human Rights. Again, these examples are illustrative and non-exhaustive. They are hypothetical and without prejudice to the facts or responsibilities of enterprises in any real-life cases.

however remains the meaning of the concept of 'adverse impacts directly linked to operations, products or services by a business relationship' as used in the Guidelines in the context of the financial sector.

Terminology on 'directly linked'

The Guidelines as well as the UNGPs contain an expansive definition of business relationships:[14] 'The term 'business relationship' includes relationships with business partners, entities in the supply chain and any other non-State or State entities directly linked to its business operations, products or services.'[15] This expansive reading is likewise applicable in terms of business relationships in the financial sector. [16]

However, an enterprise is not always directly linked to every impact associated with a given business relationship. For this reason, a 'direct link' between the operations, products and services of the enterprise and the adverse impact should exist through the entity with which it has a business relationship. Coming back to the example given above concerning the bank, adverse impacts arising from the actions of a developer with regard to a dam infrastructure project are *not* directly linked to the operations products, or services of the bank via a business relationship the bank has with the developer through a separate project.

A first important note regarding the concept of directly linked is that causality is not a factor for determining the linkage. Company A does not need to cause the harm stemming from the conduct of Company B when "directly linked" to it. Rather, the concept of "directly linked" specifically refers to situations where Company A has *not* caused or contributed to the adverse impact caused by Company B.

Secondly, under the Guidelines an enterprise's operations, products or services are either 'directly linked' to an adverse impact through a business relationship or not linked at all. The term 'directly' was included in the text of the Guidelines in order to ensure that extremely loosely connected associations would not be covered by the due diligence provisions. It was never intended to suggest the existence of an 'indirect linkage'.[17]

In the context of the financial sector this terminology has in the past been misinterpreted. Representatives of financial institutions interviewed for a study by the Sustainable Finance Advisory reported understanding impacts caused by their clients to be "indirect impacts'' and thus potentially inapplicable in the context of the Guidelines.[18] This interpretation is not reflected in the Guidelines, and has been clarified as such by the Chair of the OECD Working Party on Responsible Business Conduct,[19] as

14 The Guidelines and UNGPs are aligned; The OECD Guidelines for Multinational Enterprises Chapter IV, Commentary on Human Rights, paragraph 37

15 The OECD Guidelines for Multinational Enterprises, Chapter II, Commentary on General Policies, paragraph 14.

16 For an extensive assessment of business relationships in general and for the financial sector specifically, reference can be made to the note by the OECD on Scope and Application of "Business Relationships" in the Financial Sector and the OECD Guidelines (June, 2014).

17 For further explanation see Note of the Chair of negotiations on the revision of the Guidelines in 2011, regarding the terminology on 'directly linked.'

18 See Sustainable Finance Advisory, "Environmental and Social Risk Due Diligence in the Financial Sector" (2013), 53.

19 See Note by the chair of the negotiations on the revision of the Guidelines (Prof Roel Nieuwenkamp) regarding the terminology on "directly linked, p. 7

well as the Office of the High Commissioner for Human Rights[20] in relation to the UN Guiding Principles on Business and Human Rights.

Thirdly, although the due diligences provisions of the Guidelines do not extend to extremely loosely connected associations, direct linkages are not limited to first-tier or immediate business relationships. It may be the case that Company B with which Company A has a business relationship is not causing or contributing to the adverse impact itself. However let's imagine that Company B's operations, products and services are directly linked to Company C, an entity that *is* causing or contributing to an adverse impact within the scope of Company A's supply chain. In that case Company A is still considered to be directly linked to the adverse impact. Hence, even if the adverse impact is caused or contributed to by an entity deeper in the supply chain (Company C), Company A is still expected to seek to prevent or mitigate the adverse impacts arising in its entire supply chain.

The *OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas* underscores this approach. Despite multiple tiers of business relationships between Company A's end product (e.g. a computer) and the mine of origin where the adverse impact arises (e.g. financing armed groups through mineral production and trade), there is nonetheless a direct link between Company A's product (computer) and the adverse impact through the business relationship with its suppliers of products containing those metals. This direct linkage gives rise to the expectation of responsible mineral supply chain management in accordance with the *OECD Due Diligence Guidance*.

Due diligence: risk assessment

Due diligence is an ongoing, both proactive and reactive, and process-oriented activity; it is to be carried out throughout the entire life-cycle of operations, products and service because circumstances change and so will adverse impacts. This means that due diligence should not be limited to an initial investigation of a potential business relationship or transaction, but should also be applied proactively through establishment of systematic measures to identify risk and prevent or mitigate potential adverse impacts, as well as through on-going monitoring of business relationships and related operations. Risks should be identified and acted upon prior to as well as during the course of a business relationship. Failure to detect risk in one instance does not mean that the due diligence systems of an enterprise are not generally effective, but due diligence systems should include a process of lesson learning when risks or other issues are brought to their attention (e.g. by external stakeholders, through a grievance mechanisms, through outside reports, etc.) and adjust the system accordingly to make it more likely to identify similar risks in the future.

The nature and extent of due diligence expected from an enterprise depends on factors such as the size of the enterprise and its clients, the context of its operations and the severity of the adverse impacts.[21] Enterprises with large numbers of business relationships should therefore identify particular relationships or types of relationships, locations, products or services where the risk of adverse impacts is most significant. Based on this risk assessment, they should prioritise for due diligence the most severe impacts and the business relationships that have the highest potential for creating such impacts.[22]

[20] See Letter from the United Nations Office of the High Commissioner for Human Rights (OHCHR), dated 27 November 201 and letter from Former UN Secretary-General's Special Representative for Business and Human Rights, Professor Ruggie, dated 22 October 2013.

[21] The OECD Guidelines for Multinational Enterprises, Chapter II, Commentary on General Policies, paragraph 15

[22] The OECD Guidelines for Multinational Enterprises, Chapter II, Commentary on General Policies, paragraph 16

The responsibility to conduct due diligence to seek to prevent or mitigate an adverse impact is applicable by the financial sector in a similar way as it is to companies in other sectors. However, it is recognised that financial institutions, as many large multinationals, may have hundreds to thousands of clients, and that it may not always be practical to conduct extensive due diligence on each of them. The Guidelines instead expect enterprises, including financial institutions, to identify general areas where the risk of adverse impacts is most significant and to prioritise due diligence on their clients accordingly, through screening and monitoring clients when the risk is high, and/or when a risk is brought to the attention of the enterprise (e.g. by an external stakeholder). In other words, the OECD Guidelines expect financial institutions to put in place due diligence *systems*, in addition to carrying out due diligence in response to particular incidents. That systemic approach to due diligence should be adaptive, building on lessons learned from across the financial institution, so that where the due diligence system failed to pick up potential or actual significant impacts initially, there is a process in place to respond and to be ready to identify and address similar risks in the future. It should inform choices about whether to invest in or finance a particular client and also about whether to call a loan or disinvest as a last resort when it may not be possible to prompt change in a client involved in a particularly serious adverse impact.

It should be noted that risk-based due diligence is not a new concept for the financial sector. Financial institutions already carry out anti-money laundering and counter-terrorist financing (AML/CTF) due diligence in order to prevent/mitigate the adverse impacts of criminal economic activity and the financing of terrorism. The risk-based due diligence approach described in the Guidelines is connected to this, but aimed at a wider range of topics included in the Guidelines.

The Guidelines are relevant for enterprises operating or based in any of the 46 countries that have adhered to the Declaration on International Investment and Multinational Enterprises. Hence, enterprises entering into business relationships with other entities that operate or are based in an Adherent country have the added advantage of aligned government expectations on due diligence. Enterprises can use this alignment of government expectations to streamline due diligence processes within the company and with other entities with which they have a business relationship.

Due diligence: responses and risk management

If an enterprise identifies a risk that it will *cause* an adverse impact, it has it within its powers to cease or prevent that impact and should make sure to do so.[23] If an enterprise identifies a risk of *contributing* to an adverse impact, it has control over its contribution and should therefore cease or prevent its contribution and use its leverage with other entities also contributing to the adverse impact to persuade them to cease or prevent any further impacts and to mitigate any remaining impacts to the greatest extent possible.[24] In both cases, the enterprise should provide or contribute to a remedy.

If an enterprise identifies a risk or is made aware of adverse impacts being *directly linked* to its operations, products, and services through its business relationships, it should seek to use its leverage to influence the entity causing the adverse impact to prevent or mitigate that impact and future impacts. This can be done by the enterprise itself or in co-operation with other entities, as appropriate.[25]

23 The OECD Guidelines for Multinational Enterprises, Chapter II, Commentary on General Policies, paragraph 18

24 The OECD Guidelines for Multinational Enterprises, Chapter II, Commentary on General Policies, paragraph 19

25 The OECD Guidelines for Multinational Enterprises, Chapter II, Commentary on General Policies, paragraph 20

However, a lack of leverage does not imply that an enterprise should not apply the recommendations of Guidelines.[26] The degree of leverage it has over its business relationship the entity causing the adverse impact is useful in considering what it can do to persuade that entity to take action, but is not relevant to considering whether it should carry out due diligence and exercise any leverage it may have. It should.

That being said, this terminology on 'directly linked' is not intended to shift responsibility from the entity causing an adverse impact to the enterprise with which it has a business relationship. The Guidelines envisage differentiated and mutually-reinforcing responses from enterprises that cause or contribute to adverse impacts, and those enterprises whose operations, products or services are directly linked to adverse impacts through a business relationship. Each enterprise is responsible for undertaking due diligence, which will vary in complexity with the size of the enterprise, the risk of severe human rights impacts, and the nature and context of its operations. Likewise the nature of risk responses will vary according to the relationship to an adverse impact. If a financial institution is made aware of its products or services being directly linked to an adverse impact through a business relationship, it has a responsibility to use its leverage to seek to prevent or mitigate that impact, however, the responsibility for addressing and remedying the impact rests with the entity causing the harm.

Finally in the case that Company A's operations, products and services are *not* directly linked to an adverse impact caused by Company B, with which the enterprise has a business relationship, paragraph A13 of Chapter II of the Guidelines still applies. Company A is expected to encourage, where practicable, business partners, including suppliers and sub-contractors, to apply principles of responsible business conduct compatible with the Guidelines.[27] So, in the example provided in paragraph 9, the bank should still encourage its developer to apply the Guidelines and avoid environmental impacts context of the dam project. However, the bank is not expected to use or increase its leverage over the developer to seek to prevent or mitigate the adverse impacts associated with the dam project (although nothing in the Guidelines would prevent it from doing so). In addition, as noted, information regarding adverse impacts at different project sites of the same developer should be taken into account by the bank in considering its own due diligence strategy. Evidence of causing adverse impacts should prompt the bank to apply heightened due diligence to operations with that developer. This could be done by more carefully investigating and monitoring the developer's actions with regard to the highway operation or requiring additional monitoring and transparent reporting with regard to its operations with that developer.

Other issues for consideration

Nature of financial institutions operations, products or services on scope of due diligence

The Secretariat imagines that it will be relevant to consider the nature of a financial institution's operations, products and services in determining the appropriate scope of its due diligence responsibilities. For example, whether the financial service or operation is primarily used to establish ownership over, finance or support the *general performance* of the client (e.g. in the case of general corporate loans or

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26 The Guidelines recognise that there can be practical limitations on the ability of enterprises to effect change in the behaviour of their suppliers, related to, amongst others, product characteristics, the number of suppliers and the structure and complexity of the supply chain. Nonetheless, enterprises are expected to influence their suppliers in any way they can, such as through contractual arrangement, voting trusts, and participation in industry-wide collaborative efforts with other enterprises with which they share common suppliers (The OECD Guidelines for Multinational Enterprises, Chapter II, Commentary on General Policies, paragraph 21 and 23). The UNGPs (Guiding Principles on Business and Human rights: Implementing the United Nations "Protect, Respect and Remedy" Framework, p. 22) refer to this as increasing leverage.

27 The OECD Guidelines for Multinational Enterprises, Chapter II, paragraph A13

financing), or only the *specific performance* of the client (e.g. in the case of project financing) may have bearing over the scope of activities it is expected to respond to under the due diligence process recommended by the Guidelines.[28]

In the case that the financial operation, product or service is primarily concerned with the general performance of the client, then the financial institution is likely expected to respond to all adverse impacts associated with any of the activities of the client [29] In the case that the financial operation, product or service is primarily associated with a specific activity of the client, then the financial institution may only be expected to respond to the impacts of those activities financed or supported by the financial institution.[30] However other factors, such as practical limitations (e.g. number of clients), the size of the financial institution, its exposure to risk of adverse impacts, the severity of those impacts and leverage should also help to tailor due diligence processes of the financial institution, allowing for prioritisation and complementarity with due diligence of other clients and entities with which the financial institution has a business relationship.

Contributing vs. Directly Linked in the context of the Financial Sector

Another area of complexity with regard to application of the Guidelines in the context of the financial sector is the distinction between contributing to an adverse impact (entailing a substantial contribution, as noted above) and adverse impacts being directly linked to financial sector operations, products and services through a business relationship. This distinction may be less clear, for example in the case of project finance, or majority or controlling holdings in an entity causing an adverse impact.

For instance, in the context of the financial sector an argument could be made that a financial institution may be contributing to an adverse impact caused by its investee company in which it has a majority or controlling holding because its majority shareholding directly supports and maintains the activities of the investee company. This argument is strengthened if that shareholding gives the financial institution a strong managerial or decision making role in the investee company, for example, in appointing individuals to the company's board, thereby further increasing its accountability for the investee company's actions.

As discussed, the relationship to an adverse impact will have implications for how it should be addressed, therefore this distinction is important. These concepts lie along a spectrum and it is likely that in some circumstances there will not always be clear answer as to whether an action or omission by a financial institution is closer to a situation of contribution or directly linked. In both cases, the emphasis should be on prevention and mitigation of adverse impacts. However if the financial institution is found to be contributing to such adverse impacts, then it should also be accountable and help to remedy the impacts in concert with the other entities causing or contributing to the harm. These issues will be explored further in the proactive agenda project on the financial sector.

28 Appropriate due diligence responses are discussed in paragraphs 23-27.

29 The issue of distinguishing whether the financial institution is contributing to adverse impacts, or if adverse impacts are directly linked to its operations, products or services by a business relationship, is a separate but related question. See paragraph 30-32 for additional discussion of 'contributing' compared to 'directly linked' in this context.

30 These initial ideas are the considerations of the Secretariat, and should be taken up and explored in more detail in the proactive agenda project on the financial sector.

Minority shareholdings and complementary due diligence processes

An important question raised in the WPRBC is to what extent and in what way are minority shareholders covered by the terminology ‘directly linked’. As explained in paragraph 10 of this Note and in an OECD Note on the application of business relationships in the financial sector,[31] the Guidelines contain an expansive description of business relationships. For the financial sector these would include suppliers, clients, customers and investee companies, including minority shareholders. This is supported by the letter from the Former UN Secretary-General's Special Representative for Business and Human Rights (Professor Ruggie), the letter from United Nations Office of the High Commissioner for Human Rights (OHCHR), and the letter from the UN Working Group on Business and Human Rights.[32] These letters contain the responses from the respective bodies to the request of the WPRBC to provide clarity on the issue of being ‘directly linked’ and the matter of minority shareholdings for the purposes of the UNGPs, which are aligned with the Guidelines. The Note of the Chair of the negotiations on the 2011 revision of the Guidelines[33] underlines these statements.

The Guidelines recognise that there might be practical limitations on the ability of enterprises to effect change in the behaviour of the individuals or entities in their business relationships. As described above, prioritization of business relationships for due diligence may be warranted based on severity of impacts. Minority shareholding relationships are no different in this regard. A multi-stakeholder project is foreseen as part of the proactive agenda on the financial sector, and will include a case study on minority shareholdings aiming to provide more practical tools for the implementation of the Guidelines in this context, considering leverage, position in the supply/value chain, etc.

Passive investment Strategies

The issue of passive investment strategies and investments in index funds has also been raised multiple times at the meetings of the WPRBC. The Secretariat recognises the complexities around this topic (and similarly complex financial strategies and products) and realises that practical guidance needs to be developed for questions such as how carrying out due diligence fits into the general principles of a passive investment strategy; and what an enterprise should do if it is made aware of an adverse impact caused or contributed by an entity in which it invests through an index fund. It is recognised that the investor has a business relationship with the fund manager (in the case of passive investments) or in some cases with the entity offering the index product (in the case of index investments); who in turn may have business relationships with the companies in which they invest in on behalf of the investor (in the case of passive investments) or with the companies they select to be part of the financial product (i.e. index) they are offering. Despite the multiple tiers of business relationships, the investor’s operations are directly linked to the adverse impacts caused or contributed to by an enterprise it is investing in, albeit passively or through an index fund.[34]

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31 OECD, Scope and Application of “Business Relationships” in the Financial Sector and the OECD Guidelines (June, 2014).

32 See and Letter from the United Nations Office of the High Commissioner for Human Rights (OHCHR), dated 27 November 2013 and letter from Former UN Secretary-General's Special Representative for Business and Human Rights, Professor Ruggie, dated 22 October 2013

33 See Note by the chair of the negotiations on the revision of the Guidelines (Prof Roel Nieuwenkamp) regarding the terminology on "directly linked.’’

34 The investor’s operation is also concerned with the general performance of the entity in which it invests in – either actively or passively. See paragraph 28 and 29.

It is also acknowledged that the services (e.g. investing on behalf of the investor), products (e.g. the index fund) or operations of the intermediaries with which the investor has a business relationship, such as a fund manager or the entity offering the index product, are themselves also directly linked to the adverse impact. Therefore, these fund managers and entities who assemble the index fund should have their own due diligence process in place on the service or product they are offering. Therefore consideration is needed on how to arrange the investor's due diligence in such a way that it is complementary to the practices of the fund manager or of the entity offering the index product. This may for instance (but subject to the findings of the proactive agenda project) imply that the investor initially focuses their due diligence on the fund manager or entity offering the index product and the policies and systems it has in place to identify and manage risk, instead of directly on the companies it invests in; while the fund manager/entity offering the index product should carry out due diligence on the companies it includes in the index funds or in the investments undertaken on behalf of the investor.[35] Of course, if risks of impacts linked to those investee companies are brought to the attention of the investor, fund manager, or index manager, all parties would be responsible for managing the risk to prevent or mitigate the adverse impact by using or increasing their leverage and taking into consideration the complementary roles of other entities with whom they have business relationships. The proactive agenda project on the financial sector will work on the implications of the Guidelines for these and other types of investments with a view to providing practical guidance.

Conclusion

Like other industries, the operations products, and services of a financial institution can be directly linked to adverse impacts caused by or contributed to by the entity with which it has a business relationship, for instance through investments.

In determining whether there is a direct linkage, causality is not a factor. Under the Guidelines an enterprise's operations, products or services are either 'directly linked' to an adverse impact through a business relationship or not linked at all- there is no such thing as an indirect linkage. Furthermore, an enterprise is not always directly linked to every impact associated with a given business relationship. Although the due diligences provisions of the Guidelines do not extend to extremely loosely connected associations, direct linkages are not limited to first-tier or immediate business relationships.

Although direct linkages through business relationships can descend through multiple tiers of a supply chain or investment structure the terminology on 'directly linked' is not intended to shift responsibility from the entity causing an adverse impact to the enterprise with which it has a business relationship. The nature of an enterprise's business relationship will determine the level and rigor of due diligence the entity is expected to exercise. The Guidelines expect enterprises to identify general areas where the risk of adverse impacts is most significant and to prioritise due diligence on their clients accordingly, screening and monitoring clients when the risk is high, and/or when a risk is brought to the attention of the enterprise.

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35 This is analogous to due diligence in the context of (conflict) minerals. The products (e.g. mobile phones) of the enterprise are directly linked to the adverse impacts caused or contributed to by upstream suppliers, despite multiple tiers of business relationships. While it may not feasible for a downstream manufacturing enterprise to know the precise mine of origin or qualitative circumstances of mining and trade for all the metals in its products, they are expected to carry out complementary due diligence appropriate to their size, overall risk context, and the nature of its activities and business relationships, In this context, downstream companies carry out due diligence on the smelters in their supply chain to ensure that the smelters are sourcing minerals responsibly, with traceability systems and on-the-ground risk assessments in place. Hence, while all parties in the supply chain of a product are responsible for carrying out due diligence (because of their business relationship with their suppliers), the way they meet this responsibility often entails tailoring due diligence to the position of the party in the supply chain, resulting in complementary and mutually-reinforcing due diligence procedures.

The proactive agenda project on the financial sector aims to find practical guidance on how to integrate these provisions of the Guidelines in the work of financial institutions. The discussions at the WPRBC meetings of 14 October 2013, 5 December 2013 and 20 March 2014 confirmed that this is a complex task that should be approached from a broad perspective. Therefore, this project is envisaged to focus on the role, scope and function of the financial sector, and the expectations to/of them. Specifically, this will include amongst others the examination of types of leverage and the role of minority shareholders in due diligence; investigation of the impact of investment strategies (i.e. passive or active) on leverage and nature of due diligence; and how to deal with investments in sovereign bonds.