Principles for Responsible Investment

HUMAN RIGHTS IN PRIVATE MARKETS:

IDENTIFYING AND ASSESSING NEGATIVE HUMAN RIGHTS OUTCOMES

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

This article summarises the key points from a workshop held on 30 June 2022 where private markets industry participants discussed how to identify and assess negative human rights outcomes associated with their business operations and investment activities.

Organisations attending the workshop

- Nick Panes – Charles River Associates (facilitator)
- Blue Wolf Capital Partners
- Helios Investment Partners
- InfraRed Capital Partners
- Partners Group
- SouthBridge
- StepStone Group
- Institute for Human Rights and Business (IHRB)
- Investor Alliance for Human Rights

KEY THEMES

1. Drivers of human rights due diligence

Participants discussed how legal and reputational risks are often the main drivers for private markets investors incorporating human rights due diligence processes into their investment activities.

2. Varying approaches to human rights due diligence

Private markets investors have typically interpreted human rights risks in a rather narrow way, mainly driven by their jurisdictions, investment strategies and the macro-environment.

3. Adapting existing ESG practices to include human rights

Private markets investors can leverage existing ESG due diligence processes and tools to conduct human rights due diligence.

4. Focusing on the practicalities of due diligence

Participants focused on two key elements of detailed human rights due diligence – on-the-ground research and face-to-face meetings – to better understand the local context. They said it was also very important to properly assess the quality and depth of any third-party due diligence.

5. How assessing human rights risks influences investment decisions

After identifying potential or actual human rights risks associated with portfolio companies, participants noted that a key step is to then assess their ability to prevent, mitigate or remediate the situation, and assess how it will impact the risk-return profile of the transaction.

This workshop is the first of a four-part series bringing together private markets investors to discuss implementing different elements of the UN Guiding Principles on Business and Human Rights (UNGPs). The workshop participants are members of the PRI private markets human rights working group.

These workshops and the working group will also support the development of guidance for private market investors on implementing the UNGPs, to be released in 2023.

The workshop was held under the Chatham House Rule. The subsequent three workshops will focus on additional components of the UNGPs:

- Workshop 2: Preventing and mitigating negative human rights outcomes
- Workshop 3: Tracking and communicating management of negative human rights outcomes
- Workshop 4: Providing or enabling access to remedy

NOTES FROM THE WORKSHOP

1. DRIVERS OF HUMAN RIGHTS DUE DILIGENCE

Participants noted that increased legal and reputational risks are in many cases driving greater focus on their human rights due diligence processes.

A. LEGAL RISK

With legislation relating to human rights proliferating across many jurisdictions – for example, the Modern Slavery Acts in the UK and Australia, the US Uyghur Forced Labor Prevention Act, the Norwegian Transparency Act and proposed mandatory corporate due diligence in the European Union – legal compliance is a clear driver for investor action.

However, participants highlighted that it is important not to view human rights in purely legal or compliance terms. They noted that enforcement of legislation, for example the UK Modern Slavery Act, has been inconsistent and has not driven significant improvements in practice. Furthermore, participants commented that it is likely that legislation and regulations pertaining to human rights, particularly in the US, will face challenges in the courts, and there will be uncertainty as to how to interpret legislation until there is a definitive resolution.

Participants suggested that investors should take a lead in changing industry behaviour, rather than waiting for enforcement of current and future legislation.

B. REPUTATIONAL RISK

Workshop participants shared that some limited partners (LPs) have become more sophisticated in their questioning regarding general partners' (GPs) human rights policies and processes. One participant noted, for example, how questions have gone from simply focusing on whether the GP had a human rights policy in place, to much more detailed questions on specific human rights issues. This LP questioning has been particularly evident in relation to high-profile issues, such as the increased attention on the living and labour conditions of the Uyghur population in China's Xinjiang region and employee health and safety considerations at the outset of the COVID-19 pandemic.

However, participants also noted that LPs' focus on human rights is not yet consistent, which in turn can still influence how private markets investors perceive the need to address human rights risks. This inconsistency can be due to human rights issues gaining and losing public attention, or market conditions or perceptions, such as the politicisation of human rights-related topics in the US, or a perception that human rights can be more prevalent in emerging markets than developed markets.

"There are demands from a number of LPs around reputational risk [related to human rights risks], but for some GPs, those represent a minority of their client base."

2. VARYING APPROACHES TO HUMAN RIGHTS DUE DILIGENCE

Workshop participants noted that a lack of a consistent and standard definition of human rights has often led investors to consider human rights in a narrow way, mainly driven by factors such as the investor's home jurisdiction, their investment strategy or focus, and the broader macro environment around human rights.

Participants suggested that country or region-specific legislation and regulations, such as the Modern Slavery Acts in the UK and Australia, have incentivised private markets investors based in those jurisdictions to develop policies and processes that respond directly to those acts, rather than look at human rights more broadly.

Additionally, the cultural and historical context of a jurisdiction can affect investors' focus. For example, the importance of racial and income inequality for stakeholders in the US was mentioned as a key reason why many US investors focus on issues such as diversity, equity and inclusion.

Participants noted that their investment strategies, or areas of focus, along with their sector and geographical exposure, have also influenced their specific areas of interest or expertise on human rights. For example, investors in the solar industry have focused specifically on understanding the risks associated with that industry's supply chain. It was also suggested that private markets investors in emerging markets often face greater demands from their LPs in relation to human rights compared to their counterparts in developed markets.

Finally, the overarching macro environment influences how investors and their clients perceive the importance of certain issues.

> "When the COVID-19 pandemic started, there was an increasing focus by all stakeholders on 'S' issues, but it was, arguably appropriately, very focused, specific and narrow – looking at operational health and safety, and employee working conditions and care."

Workshop participants agreed that this disparate and narrow focus on specific themes has often prevented private markets investors from addressing human rights in a more systematic way. One suggestion was that sustainability teams should provide clear language around human rights for others in the organisation, including investment teams. Without a clear definition, it was noted that it can be hard to know what comprehensive human rights due diligence can and should cover.

3. ADAPTING EXISTING ESG PRACTICES TO INCLUDE HUMAN RIGHTS

The consensus was that as ESG due diligence evolves and becomes well-established, it is easier to adapt those structures to look at specific human rights issues, rather than build dedicated processes for human rights.

Many of the good practices identified by participants for their human rights due diligence are equally applicable to good ESG practice more generally. These practices include:

- identifying high-level, high-risk assets or issues within the portfolio, which helps to identify where more focused and detailed due diligence (including on-the-ground work) is needed;
- incorporating human rights factors into investment decisions;
- creating and maintaining human rights risk registers;
- sending annual surveys to portfolio companies to assess and monitor changes in policies and practices on human rights over time; and
- monitoring news and incident reporting systems.

"We have a news monitoring system which captures all of our portfolio companies. The system monitors many human rights-related keywords, and if anything is flagged up, we will investigate further even if said issue did not escalate internally within the portfolio company."

4. FOCUSING ON THE PRACTICALITIES OF THE DUE DILIGENCE PROCESS

Workshop participants discussed certain practical considerations of conducting human rights due diligence, including:

A. in-person versus virtual due diligence; and
B. due diligence conducted by external parties.

A. IN-PERSON VERSUS VIRTUAL DUE DILIGENCE

The COVID-19 pandemic and resulting travel restrictions forced many investors to consider alternative ways of conducting due diligence. Participants said they have seen improvements in how technology is used during transactions, and higher efficiency in terms of travel and time. Nonetheless, several participants stressed the continued importance, particularly in the case of majority or control investors, of on-the-ground work and face-to-face stakeholder engagement, such as with labour unions or indigenous groups.

This was seen as important for both developed and emerging markets, although participants noted that emerging markets are still generally considered higher risk from a human rights perspective. Here, understanding the local context was seen as a vital step to ensure that international human rights standards are applied effectively in markets where local legislation or enforcement may be significantly lacking.

“The challenge in certain emerging markets is more of a social challenge of providing power and essential services, which lead to positive social outcomes such as increased levels of education. Therefore, GPs need to marry local conditions with international aspirations [on human rights] from LPs.”

B. DUE DILIGENCE CONDUCTED BY EXTERNAL PARTIES

A substantial part of investors’ due diligence may be based on work conducted by consultants, or other parties, such as the portfolio companies and assets, or engineering, procurement, and construction (EPC) contractors (particularly in the case of infrastructure).

Participants suggested that, whereas previously it may have been sufficient to ask third parties about their policies and practices, now the emphasis was on requesting proof of action, such as traceability audits. However, the discussion also highlighted some elements where there is still a broad range of practice within the industry – for example, when working with third parties to understand human rights risks, what would warrant the deployment of an investor’s own teams to the ground? Factors such as the level of control the investor has / would have through the transaction, the size of the deal, and the level of human rights risk were discussed. It was noted that portfolio companies and assets deemed to be lower risk were still often assessed in a relatively shallow way, and a detailed follow-up was less likely.

“When relying on external parties conducting their own due diligence, such as portfolio companies or EPC contractors, we ask them to show us what they are doing in practice, how they pass their expectations down through their supply chains, and how they are monitoring progress.”

5. HOW ASSESSING HUMAN RIGHTS RISKS INFLUENCES INVESTMENT DECISIONS

After identifying potential or actual human rights risks associated with portfolio companies, participants noted that a key step is to then assess their ability to prevent, mitigate or remediate the situation, and assess how it will impact the risk-return profile of the transaction.

This work can be critical in terms of the overall investment decision. One workshop participant explained how the potential for a long and protracted labour dispute post-transaction was a key factor in deciding to pull out of a deal. In this case, the resources and time required to prevent, mitigate and / or remediate the risks identified may have "destroyed" the investment opportunity.

"If there is a compelling reason to think about continuing a particular transaction, one has to assess whether there is a remedy for the situation, what that remedy would be, what it would cost, how it would change one's thinking about the projected risk and return and make a tough judgement call."

However, participants also noted that walking away from human rights risks can create problems. It opens the question as to who will take on the responsibility to remediate such risks, particularly given that there are no common set of standards or minimum benchmarks for human rights performance across the investment industry. One participant made a parallel with the coal divestment movement, whereby an investor may decide to divest from a business due to its exposure to thermal coal activities and the risk of stranded assets, while others will continue to invest because they have different standards around climate change and / or risk assessment.

In this regard, participants suggested two solutions:

1. limit access to capital for companies that do not adhere to a certain level of human rights standards, to help build a level playing field for investors more committed to addressing human rights risks; and
2. encourage more disclosure of human rights risks identified by investors during the pre-investment human rights due diligence process to build greater awareness of the issues and potential means of mitigation and remediation.